



**TERMS OF REFERENCE FOR AUDITS
OF NGO AND NIM PROJECTS**

TABLE OF CONTENTS

Introduction	3
A. Background	5
B. Project Management.....	7
C. Consultations with concerned parties	9
D. Description of Financial Reports (UNDP CDR) to be audited	9
E. Audit Services Required - Updated	10
F. The Audit Report and Management Letter	11
Annex 1: Audit Services Required.....	16
Annex 2: Qualifications of an Auditor.....	18
Annex 3: Sample Audit Report - revised.....	19
Annex 4: Definition of Audit Opinions	24
Annex 6: Categorization of Audit Findings by Risk Severity.....	26
Annex 7: Classification of possible causes of Audit Findings	27
Annex 8: Template for NGO/NIM Auditors to Review and Sign the Updated Action Plans for Prior Year Audit Observations and Recommendations	28
Annex 9: Template for audit data and observations.....	29
Annex 10: Guidance on Formulating Audit Observations -REVISED.....	33
Annex 11: SAS 220 - GUIDANCE ON AUDITMATERIALITY	36

INTRODUCTION

Throughout this document the term "implementing partner" is used to refer to the institution designated to manage the project. Where the project is nationally implemented (NIM), this will refer to a government institution. Where the project is NGO executed, this will refer to an NGO. The term "government coordinating authority" refers to the government institution, which is the official UNDP counterpart.

This Terms of Reference (TOR) is intended to provide guidance to UNDP country offices and to the government implementing partner (IP) (or NGO) in agreeing to the terms of reference for the projects managed by governments (or NGOs). These audits are under the responsibility of the UNDP country office.

The TOR has been revised to highlight requirements in the audit services required (Part E and Annex 1) as well as areas to be covered in the audit report and management letter (Part F and Annex 3), as follows:

- Auditors must certify, express an opinion, and quantify the net financial impact on each of the following:
 - (i) UNDP Statement of Expenditure - **the CDR** - for the period 1 January to 31 December 2011
 - (ii) Statement of Cash position reported by the project as at 31 December 2011
 - (iii) Statement of assets and equipment as at 31 December 2011
- Auditors must indicate the risks associated with their findings and provide a categorization by risk: High, Medium, or Low.
- Auditors must provide a classification of possible causes of the audit findings.
- Auditors must provide the monetary value of the Net Financial Impact of the qualification if the audit opinion on the CDR is Qualified, Adverse or Disclaimer.

Follow-up to resolve Audit Observations - New

1. The United Nations Board of Audit (UN BoA) have commented on the NGO/NIM audit results and the cases where they noted a lack of conclusive actions to properly address an audit qualification in the previous year audit and the related Net Financial Impact (NFI). They also commented on the recurrence of the same significant audit issues in the same projects without being duly resolved. This is unacceptable and country offices must ensure adequate and direct action is taken to prevent the same deficiencies from recurring in the future. If further guidance is needed, country offices should contact OAI, NGO/NIM unit or the respective OAI Regional Audit Centre.

A Critical New Audit Requirement - new

2. Following the International Audit Standard (ISA) 450 and ISA 710 that came into effect on December 2010 there is a new requirement regarding a previous year modified audit opinion¹ This audit standard requires that auditors, when expressing an opinion on this year's statements, to take into account the possible effect of a prior year modified opinion that has not been properly corrected or resolved.

3. Consequently, a previous year modified opinion that has not been properly resolved may cause the auditors to issue a modified opinion in their current year audit report. If proper attention is not paid to this aspect, the risk could be a significant accumulation of unresolved modified opinions from previous

¹ A "modified" audit opinion means either a qualified opinion, a disclaimer opinion or an adverse opinion.

years that would lead the UN BoA to issue a modified audit opinion on UNDP financial statements. (Refer to Annex 5)

Country offices must ensure the audit services are adequately covered as specified in the present TOR and Combined Delivery Reports (CDRs) are duly certified by the Implementing Partners and Auditors and signed by UNDP CO Management and attached to the audit reports; the same applies for the Statement of Cash (cash and bank balances of the project) and Statement of Assets and Equipment. If the project does not hold any assets of equipment or there is no cash at hand or bank account, the auditors must clearly indicate this in the opinion page and certify it.

- Annex 1** provides the audit services required or standard scope of audit.
- Annex 2** describes the qualifications of an auditor and may help in the process of selecting auditors. Where the TOR is being supplied to a short list of firms as part of a request for proposals (RFP) and the firms short listed have been pre-qualified, then the list of qualifications would not be needed.
- Annex 3** is a sample of audit report that needs to be submitted by the auditor. A management letter needs to be attached to the audit report. (ISA 705, 710) - **REVISED**
- Annex 4** provides a definition of audit opinions
- Annex 5** provides guidance on Reporting Prior Year Modified opinion not corrected (ISA 450 and 710) – **NEW**
- Annex 6** defines the three risk categories of audit findings
- Annex 7** provides the classification of possible causes of audit findings
- Annex 8** provides a template sample of certified prior year updated action plan (Y2010) that needs to be uploaded in CARDS – **REVISED**
- Annex 9** provides a Template for audit data and observations for Y2010 audits that auditors need to submit and the CO copy paste in CARDS the information – **NEW**
- Annex 10** provides guidance on formulating audit observations and recommendations– new annex
- Annex 11** provides guidance on Audit Materiality (SAS 220)

What follows is the proposed structure with guidance on the contents of the TOR that need to be communicated to the NGO/NIM auditors by the UNDP country office.

A. Background

There are five projects to be audited and their brief description is given in the following paragraphs:

Consolidation of Democracy and Good Governance (CDGG)

Consolidation of Democracy and Good Governance in Lesotho (CDGG) is a five-year programme jointly funded by the government of Ireland and the United Nations Development Programme (UNDP) designed to build on the existing multi-donor support whose main purpose is to institutionalise and deepen democracy and good governance through improved electoral processes, effective functioning of parliament and enhanced promotion of human rights.

Specifically, the CDGG will provide support to: (1) harmonization and streamlining of the electoral legislation to ensure that elections add value to democratic governance and political stability; (2) parliamentary reforms to improve the effectiveness of the legislature in its three-pronged mandate of law-making, representation and oversight; and (3) the promotion and protection of human rights in accordance with the principles of the Universal Declaration of Human Rights. To achieve its primary goals and objectives, the CDGG has identified, albeit not limited to, the following key institutions as enabling partners: The Independent Electoral Commission (IEC), Parliament, Ministry of Justice, Human Rights and Correctional Services and the Office of Ombudsman.

Lesotho Local Government Development Programme

The United Nations Development Programme (UNDP) in Lesotho, in collaboration with the United Nations Capital Development Fund (UNCDF) and the Government of Lesotho, is in the process of operationalising the Lesotho Local Development Programme (LLDP). The LLDP focuses on institutional development and capacity building aspects of decentralisation and local development including the development of systems and elaboration of procedures for community infrastructure and service delivery.

Institution of a system at both the central and local level enabling decentralized, inclusive, pro-poor effective planning and budgeting of local development, including the institution of financing mechanisms for local public infrastructure, social service provision, and local economic development of rural communities.

Engaging Political Parties, Youth and Media in MDGs

With five years remaining until the Millennium Development Goals target date of 2015, and Lesotho's latest MDG status report of 2008 suggesting that only three of the eight goals enjoy a strong supportive environment for their achievement, it has become increasingly obvious that the country needs to employ innovative new ways towards improving its prospects at achieving the MDGs.

For Lesotho, the Millennium Development Goals, adopted by the United Nations General Assembly at its 56th session in 2001, define the country's priority development targets which, if attained, would ensure vastly improved livelihoods for all her people. The Goals' distinct quality is their universal appeal and relevance which transcend any parochial considerations and ought to be a rallying point for entire institutions, communities and individuals throughout the land. In this regard, it is noteworthy that while the government has come out openly to formulate policies and set up institutions that support

attainment of some of the goals, and while certain sections of the private sector including business, NGOs, faith –based organizations and civil society entities have, likewise, added their discrete contribution to the national effort, there is scope for more innovative involvement of additional sections of the population. Attainment of the Goals would touch and positively affect the lives of virtually all of the people of Lesotho. It is in this context that all sections of the Basotho nation must join in to pull their weight towards achievement of the Millennium Development Goals by the globally designated target date of 2015.

Lesotho Renewable Energy Based Rural Electrification

The project aims at reducing Lesotho’s energy-related CO2 emissions by introducing renewable energy technologies as a substitute for fossil fuel (paraffin and diesel) in rural areas remote from the national electricity grid and improving people’s livelihoods by improving their access to and affordability of modern energy services.

To achieve the above objective, the project will aim for the following:

To remove barriers to the wide-scale utilization of renewable energy technologies (PV, wind and mini hydro) and to meet the basic electricity needs of households, small businesses and of community users like health clinics and schools, initially in the three pilot districts, but eventually in the whole country.

Africa Adaptation Programme for Climate Change

Lesotho as a nation is prone to a number of key environmental stresses mainly drought, land degradation, desertification and loss of biodiversity. Under predicted climate change conditions these afore-mentioned stresses will get more pronounced and hence undermine sustainable development efforts.

The climate of Lesotho is characterized by summer rainfall and cold, dry winters. Predictions from several global circulation models (GCM) for the years, 2030, 2050 and 2075 derived from climate change (CC) scenarios suggest that there will be warmer future climatic conditions with lower precipitation in the spring and summer seasons, higher precipitation in winter and gradually increasing precipitation in autumn. This will result in a shift in precipitation patterns such that seasonal rains that currently occur in summer could set in later in autumn. The effect of this could be serious on the agro-ecological conditions as the growing season will be pushed forward or shortened. Notwithstanding, the increase of precipitation in winter suggests increased frontal systems activity which is characterized by heavy snowfall occurrences and ravaging winds associated with destruction of property, livestock and loss of human lives. In general it is predicted that there will be an increase of extreme events of floods, droughts and snowfall.

Poverty Reduction Monitoring Project

UNDP through the Joint UNCT and Development Partners Support Towards the Establishment of A national Monitoring and Evaluation System and Strengthening of the Statistical System to Monitor Development Progress in Lesotho has provided strategic support and facilitation towards the establishment of an effective monitoring mechanism for national level Plans and programmes.

This is being achieved through the following areas of support:

Through this project, UNDP supported the establishment of viable mechanisms for a National Monitoring and Evaluation System (NMES) and a comprehensive process in developing an efficient system of integrated surveys with techniques of data collection, processing, dissemination and data exchange

Under the NMES, with the leadership of the Government an exit strategy to ensure sustainable and seamless transition of the project activities has been designed and is geared for implementation in 2011. In 2010 this component of the project conducted a Statistical and Monitoring & evaluation capacity assessment survey, the report highlights

Estimated Project Expenditure - FY 2011 (Amounts in USD)

Consolidation of Democracy	618,718
Local Development	32,772
Political Parties	171,546
Rural Electrification	376,472
Africa Adaptation	694,428
Poverty Reduction	194,105
Total	2,088,041

NB: GDGG comprise of six sub projects

The TOR is directed to the audit of special purpose financial statements, which are referred to as Combined Delivery Reports (CDR).

B. Project Management

Management arrangements and oversight of UNDP programming activities need to be established appropriately both at programme and project levels to ensure UNDP’s accountability for programming activities, results and the use of resources, while at the same time fostering national ownership and alignment to national processes. Minimum requirements for such management and oversight arrangements include the elements or functions describe below. To the extent possible, existing national, UN Country Team (UNCT) and other structures should be used to fulfil these functions.

Programme Management Arrangements:

Government Coordinating Agency: This Agency is responsible for defining, assessing, and monitoring programme outputs towards country-level outcomes. This Agency will work closely with UNDP to ensure that the plan of the programme includes necessary aspects, including identification of projects required to achieve the expected outcomes. The Government Coordinating Agency is often the government planning/finance/foreign affairs ministry.

UNDP Country Office: The UNDP Country Office is responsible for developing and managing the UNDP Country Programme to ensure that the programme outputs are delivered as planned, contributing to the achievement of programme outcomes as per UNDAF and CPD (as agreed with national counterparts).

Country Programme Board: At the overall programme management level, a Country Programme Board shall be set up as a mechanism for consultation and on the consensus basis making management decisions on programme issues. The Country Programme Board is responsible for oversight of the UNDP Country Programme implementation, as well as its contribution to the overall UN Country Team efforts (within UNDAF). The Country Programme Board is as a minimum composed of the Heads (or their designated representatives) of the Government Coordinating Agency and UNDP Office respectively.

UNDP Programme Manager: The UNDP Programme Manager is responsible for the successful programme management and contribution to the achievement of programme outcomes. The Programme Manager is also responsible for developing an evaluation plan and commissioning and using evaluations in accordance with the UNDP evaluation policy.

Programme Assurance: Programme Assurance is the responsibility of the each Programme Board member. The Programme Assurance role supports respective Programme Board member in carrying out programme oversight and monitoring functions. This role ensures appropriate programme management milestones are managed and completed. Programme Assurance should be independent of the Programme Manager. A Monitoring and Evaluation Specialist (or a Focal Point as some UNDP Country Offices have appointed) typically holds the Programme Assurance role.

Project Management Arrangements

Establishing an effective project management structure is crucial for its success. Every project has a need for direction, management, control and communication, using a structure that differs from line management. As a project is normally cross functional and involves partnership, its structure needs to be more flexible, and is likely to require a broad base of skills for a specific period of time. The UNDP Project Management structure consists of roles and responsibilities that bring together the various interests and skills involved in, and required by, the project.

Government Cooperating Agency: The Government Cooperating Agency is the governmental unit directly responsible for the government's participation in each UNDP-assisted project. In consultation with the Implementing Partner, the Government Cooperating Agency will designate its representative for each project, who would typically perform the role and functions of either the Executive or Senior Beneficiary in the Project Board as appropriate for each particular project.

Implementing Partner: The Implementing Partner is the entity responsible and accountable for managing a project, including the monitoring and evaluation of project interventions, achieving project outputs, and for the effective use of UNDP resources.

A Responsible Party is defined as an entity that has been selected to act on behalf of the Implementing Partner on the basis of a written agreement or contract to purchase goods or provide services using the project budget. In addition, the Responsible Party may manage the use of these goods and services to carry out project activities and produce outputs. All Responsible Parties are directly accountable to the Implementing Partner in accordance with the terms of their agreement or contract with the Implementing Partner.

Project Board (also called Project Steering Committee): The Project Board is the group responsible for making by consensus, management decisions for a project when guidance is required by the Project Manager, including recommendation for UNDP/Implementing Partner approval of project plans and revisions.

Project Director (also called Executive): individual representing the project ownership to chair the group. There should be only one project executive, who should normally be a national counterpart. Typically held by Government Cooperating Agency or UNDP

Development Partners (also called Supplier): individuals or groups representing the interests of the parties concerned which provide funding and/or technical expertise to the project. Typically includes Implementing Partners, UNDP, and donors.

Beneficiary Representative: individuals or groups of individuals representing the interests of those who will ultimately benefit from the project. The primary function within the Board is to ensure the realization of project results from the perspective of project beneficiaries. Often CSO representative(s) can fulfil this role.

Project Assurance: Project Assurance is the responsibility of each Project Board member; however the role can be delegated. The project assurance role supports the Project Board by carrying out objective and independent project oversight and monitoring functions.

Project Manager: The Project Manager has the authority to run the project on a day-to-day basis on behalf of the Implementing Partner within the constraints laid down by the Board. The Project Manager is responsible for day-to-day management and decision-making for the project.

Project Support: The Project Support role provides project administration, management and technical support to the Project Manager as required by the needs of the individual project or Project Manager. It is necessary to keep Project Support and Project Assurance roles separate in order to maintain the independence of Project Assurance.

C. Consultations with concerned parties

Prior to the start of audit work the auditor will be required to consult with the UNDP country office, the government counterpart, and the implementing partner for each project. Further, upon completion of the draft audit report and management letter, the auditor will be required to meet with the UNDP country office and the government entity co-ordinating authority to debrief them on its major findings from the audit and its recommendations for future improvements as well as to seek their feedback thereon.

D. Description of Financial Reports (UNDP CDR) to be audited

Description of the Combined Delivery Report and Supporting Schedules

The report to be audited is referred to as the Combined Delivery Report (CDR). This report is prepared by UNDP, using an in-house accounting software package called ATLAS. The CDR serves as the official financial statement that **must** be certified by the auditors. Project financial statements, if certified, **must** reconcile to the expenditure appearing in the CDR and must be attached to the audit report. As described in more detail below, the CDR combines expenditures from three disbursement sources for a calendar year. The three disbursement sources include:

1. Implementing partner (either Government or NGO)

UNDP procedures require that where funds are advanced to the executing agency, the agency must submit to the UNDP country office, on a quarterly basis, a financial report including: (1) the status of the advance; (2) a list of the disbursements made since the previous financial report; and (3) a request for a new advance. The UNDP country office enters the disbursements in ATLAS through the year as the financial reports are received. These implementing partner disbursements are recorded in the *Government* expenditure column in the CDR.

2. UNDP (country office, headquarters and other country offices)

Disbursements made by UNDP from its own bank accounts are entered in ATLAS by the UNDP country office. These UNDP disbursements are recorded in the *UNDP* expenditure columns in the CDR. These disbursements may be classified as either *direct payments* or *UNDP support services*. This distinction, while very important for audit purposes, is not apparent from the CDR and can only be provided by the UNDP country office as a supporting schedule. A brief description of each category is provided below.

- a) **Direct Payments** - This is where the implementing partner is responsible for the expenditure but requested UNDP to effect payment to the vendor/consultant on its behalf. The implementing partner is accountable for the disbursement and maintains all supporting documentation. UNDP simply effects payments on the basis of properly authorised requests

and gives the implementing partner a copy of the related disbursement voucher as evidence that payment was made.

- b) UNDP Support Services - This is where the government and UNDP have agreed that UNDP will provide support services to the project and signed a Letter of Agreement. These support services must be described in the Letter of Agreement. UNDP is fully responsible and accountable for these expenditures and, accordingly, maintains all supporting documentation for the disbursement. This expenditure is outside the scope of audit and, therefore, will not be reviewed by the auditors. This scope limitation should not be used as a reason for issuing a qualified audit opinion on the CDR. Where there is no signed Letter of Agreement for UNDP Support Services or a CPAP with the respective clauses of the LOA for UNDP Support Services, the audit should also cover the UNDP expenditures under CO support. The CO must include this information in the TOR/contract for the auditors.

3. *UN agencies*

The UN agency reports its expenditures to UNDP and to the government. The UNDP country office enters the expenditures in ATLAS. These UN agency expenditures are recorded in the *UN Agencies* expenditure column in the CDR.

At the end of the year, after receiving the fourth quarter financial report from the implementing partner and the year-end expenditure report from the UN agency, UNDP prepares the CDR and submits it to the implementing partner for signature. UNDP will provide the auditor with the signed CDR together with the following supporting documentation.

1. The quarterly financial reports submitted by the implementing partner.
2. A list of the direct payments processed by UNDP at the request of the implementing partner.
3. A list of the disbursement made by UNDP as part of support services provided to the implementing partner.
4. The UN agency expenditure statement for the year.
5. Relevant financial reports that show expenditure of GFATM sub-recipients for the year which need to be reconciled to the CDR expenditure
6. Letter of Agreement for UNDP support services signed between UNDP and the Government (or CPAP with relevant clauses regarding UNDP support services)
7. Relevant financial reports that show expenditures of UNDP CO support, if there is no Letter of Agreement.

E. Audit Services Required - Updated

The scope of the audit services required should be sufficiently clear to properly define what is expected of the auditor but not in any way that restricts the audit procedures or techniques the auditor may wish to use to form an opinion. It should specify at least the following:

- A definition of the entity or the portion of an entity that is subject to audit. This will normally be the project office whether located within a government department or in a separate location.
- The audit will be carried out in accordance with either ISA² or INTOSAI³ auditing standards.
- The audit period is 1 January to 31 December of the year 2011.

²International Standards of Auditing (ISA) published by the International Auditing Practices Committee of the International Federation of Accountants

³International Organization of Supreme Audit Institutions

- The scope of the audit is limited to the implementing partner expenditures, which are defined as including: (1) all disbursements listed in the quarterly financial reports submitted by the implementing partner; and (2) the direct payments processed by UNDP at the request of the implementing partner.
- The auditor is required to verify the mathematical accuracy of the CDR by ensuring that the expenditures described in the supporting documentation (the quarterly financial reports, the list of direct payments processed by UNDP at the request of the government) are reconciled to the expenditures, by disbursing source, in the CDR.
- The auditor is required to state in the audit report the amount of expenditures excluded from the scope of the audit because they were made by UNDP as part of direct support services and the amount of total expenditures excluded because they were made by a UN agency. (Please refer to Section D-2(b) above. This scope limitation is not a valid reason for the auditors to issue a qualified audit opinion on the CDR.)
- The auditor is required to state in the audit report if the audit was not in conformity with any of the above and indicate the alternative standards or procedures followed.
- That the auditor is required to express an opinion as to the overall financial situation of the project for the period 1 January to 31 December 2011 and will certify:
 1. The statement of expenditure (**the CDR**) for the period from 1 January to 31 December 2011;
 2. The statement of cash position (cash and bank balances of the project) reported by the projects as at 31 December 2011; and
 3. The statement of assets and equipment held by the project as at 31 December 2011.
- That the auditor is required to, as applicable, report in monetary value, the net financial impact of any modified audit opinion (modified opinions can be qualified, adverse, or disclaimer) on the statement of expenditure (Combined Delivery Report (CDR)) where applicable.
- That the auditor/audit firm is required to submit a draft audit report by 10 April 2012 and a final signed audit report with signed UNDP statements by 14 May 2012.

Note: Audit opinions must be one of the following: (a) qualified (negative), (b), unqualified (favourable), (c) adverse (negative), or (d) disclaimer (negative). If the audit opinion is other than “unqualified” (favourable) the audit report **must** describe both the nature and amount of the possible effects on the financial statements. The report should also make a reference to the section of the management letter with regard to the related audit observation number and the action taken or planned to be taken to address and conclusively correct the issues underlying the qualification. A definition of audit opinions is provided in Annex 4.

F. The Audit Report and Management Letter

The TOR should clearly indicate the expected contents of the audit report and management letter and the topics/areas to be covered by the auditors.

Audit Report – **VERY IMPORTANT**

The audit report should clearly indicate the auditor's opinion (Refer to Annex 3 for a sample Audit Report). This would include at least the following:

- That it is a special purpose and confidential report.
- The audit standards that were applied (ISAs, or national standards that comply with one of the ISA in all material respects).
- The period covered by the audit opinion
- The amount of expenditure audited
- The amount of the net financial impact of the modified audit opinion on the CDR, if modified.
- The reason(s) resulting in the issuance of a modified audit opinion, qualified, adverse or disclaimer opinion (the reason(s) must be also included in the management letter as an audit observation(s)
- The scope limitation (description and value) for those transactions that are the responsibility of UNDP (as part of direct CO support services to NIM) or a UN agency. Important to note: Such scope limitation should not be reason for a qualified audit opinion as such transactions would be, in general, excluded from the audit scope.
- Whether the UNDP Combined Delivery Report (CDR) - for the period from 1 January to 31 December 2011 is adequately and fairly presented and whether the disbursements are made in accordance with the purpose for which funds have been allocated to the project;

(a) A Financial Audit to express an opinion on the project's financial statements that includes

- Expression of an opinion on whether the statement of expenditure presents fairly the expenditure incurred by the project over a specified period in accordance with UNDP accounting policies and that the expenditures incurred were: (i) in conformity with the approved project budgets; (ii) for the approved purposes of the project; (iii) in compliance with the relevant regulations and rules, policies and procedures of the Government or UNDP; and (iv) supported by properly approved vouchers and other supporting documents. The Combined Delivery Report (CDR) is the mandatory and official statement of expenditure to be certified. Other forms of statement of expenditure that may be prepared by a project office are not accepted.).
- Whether the result of the prior year's audits resulting in modified audit opinions on the UNDP CDR had conclusive actions to properly address an audit qualification in the previous year audit and the related Net Financial Impact (NFI). If there is a lack of conclusive actions, the auditors must take into account the possible effect of a prior year modified opinion that has not been properly corrected or resolved.

<p>Note: Consequently, a previous year modified opinion that has not been properly resolved may cause the auditors to issue a modified opinion in their current year audit report. If proper attention is not paid to this aspect, the risk could be a significant accumulation of unresolved modified opinions from previous years</p>
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- Expression of an opinion on the value and existence of the project's statement of assets and equipment as at a given date. This statement must include all assets and equipment available as at 31 December 2011 and not only those purchased in a given period. Where a NGO/NIM project does not have any assets or equipment, it will not be necessary to express such an opinion, however, this should be disclosed in the audit report.

- Express an opinion on the value and existence of the cash held by the project as at a given date, i.e. 31 December 2011. Where a dedicated project bank account is opened and used solely for the cash transactions of a NGO/NIM project, e.g. if the project is in a remote location. The Audit Firm is required to express an opinion on the Statement of Cash Position where a dedicated bank account for the NGO/NIM project has been established and/or the project holds petty cash. Where the project does not hold any cash, this should be disclosed in the audit report.

The Financial Audit will be conducted in accordance with International Standards of Auditing (ISA).

- (b) An audit to assess and express an opinion on the project's internal controls and systems.

The deliverable will be an audit report similar to a long form management letter that covers the internal control weaknesses identified and the audit recommendations to address them.

The management letter should be attached to the audit report and cover the following topics/issues:

- A general review of a project's progress and timeliness in relation to progress milestones and the planned completion date, both of which should be stated in the project document or Annual Work Plan (AWP). This is not intended to address whether there has been compliance with specific covenants relating to specific performance criteria or outputs. However, general compliance with broad covenants such as implementing the project with economy and efficiency might be commented upon but not with the legal force of an audit opinion.
- An assessment of a project's internal control system with equal emphasis on: (i) the effectiveness of the system in providing the project management with useful and timely information for the proper management of the project; and (ii) the general effectiveness of the internal control system in protecting the assets and resources of the project.
- A description of any specific internal control weaknesses noted in the financial management of the project and the audit procedures followed to address or compensate for the weaknesses. Recommendations to resolve/eliminate the internal control weaknesses noted should be included.

The audit of internal controls and systems will be conducted in accordance with the International Standards for Audit (ISA).

The management letter should also include the following:

- Effective audit observations/recommendations (guidelines in Annex 10)
- The categorization of audit observations by risk severity: High, Medium, or Low. Definitions of these categories are given in Annex 6.
- The classification of possible causes of the audit observations. Definitions of these causes are given in Annex 7.
- Management comments/response to audit observations and recommendations (project management and/or UNDP, as applicable).
- Indication of observations that affect the audit opinion (when qualified, adverse or disclaimer opinion is given)

More detailed guidance for the above general categories is provided below.

Review of project progress

As part of the general review of project progress, specific steps could include the following:

- Review annual and quarterly work plans, quarterly and annual financial reports, and requests for direct payments and assess in terms of their timeliness and their compliance with the project document or the AWP, and the UNDP Programme Operations Policies and Procedures (POPP) on Results Management.
- Review the annual project report prepared by the implementing partner and assess in terms of compliance with UNDP guidelines and whether the implementing partner met its responsibilities for monitoring described in the project document or AWP.
- Review whether the decisions and/or recommendations of the above activities have been followed through by the implementing partner.
- Review the pace of project progress and comment on the causes for delays.
- Comment on whether implementation services of the UN Agency(s) were provided in line with the project document or AWP.

Assessment of internal control

The auditor is required to conduct a general assessment of internal controls according to established internal control standards. An example of established internal control standards is available from the Organization of Supreme Audit Institutions (INTOSAI). The INTOSAI standards are intended for use by government managers to use as a framework to establish effective internal control structures. For further information, the INTOSAI *Guidelines for Internal Control Standards* can be found on the INTOSAI Web site www.intosai.org. An overview of the standards can be found in the UNDP Contact tool (Chapter 6).

In addition to the above general assessment, additional specific steps could include the following:

- Review expenditures made by the implementing partner and assess whether they are in accordance with the project document, AWP and budgets; and are in compliance with the UNDP POPP on Results Management.
- Review the process for procurement/contracting activities and assess whether it was transparent and competitive.
- Review the use, control and disposal of non-expendable equipment and assess whether it is in compliance with UNDP POPP on Results Management; and also whether the equipment procured met the identified needs and whether its use was in line with intended purposes.
- Review the process for recruiting project personnel and consultants and assess whether it was transparent and competitive.
- Review the implementing partner accounting records and assess their adequacy for maintaining accurate and complete records of receipts and disbursements of cash; and for supporting the preparation of the quarterly financial report.
- Review the records of requests for direct payments and ensure that they were signed by authorised government officials.

Recommendations for improvement

Recommendations should be directed to a specific entity so there is no confusion regarding who is responsible for implementation. The response of the entity should be included in the management letter, immediately following the recommendation.

Also, the auditor may wish to comment on "good practices" (if any) that were developed by the implementing partner that should be shared with other project personnel.

Available Facilities and Right of Access

There should be a description of the nature and the location of all records belonging to the project. This list should specify those records kept at the implementing partner's headquarters and those that are located at other offices.

The TOR should state that the auditor would have full and complete access at any time to all records and documents (including books of account, legal agreements, minutes of committee meetings, bank records, invoices and contracts etc.) and all employees of the entity. The auditor should be advised that he/she has a right of access to banks, consultants, contractors and other persons or firms engaged by the project management. If an auditor may not have unrestricted access to any records, person or location during the course of the audit, this restriction should be clearly defined, with reasons, in the TOR.

ANNEX 1: AUDIT SERVICES REQUIRED

The scope of audit services shall be in accordance with International Standards for Audit (ISA) and cover the overall management of the project's implementation, monitoring and supervision. The audit work should include the review of work plans, progress reports, project resources, project budgets, project expenditure, project delivery, recruitment, operational and financial closing of projects (if applicable) and disposal or transfer of assets. To this effect, the scope of the audit shall cover the following areas as they are performed at the level of the project:

Human resources

The audit work shall cover the competitiveness, transparency and effectiveness of the recruitment and hiring of personnel and include performance appraisal, attendance control, calculation of salaries and entitlements, payroll preparation and payment, and management of personnel records.

Finance

The audit work shall cover the adequacy of the accounting and financial operations and reporting systems. These include budget control, cash management, certification and approving authority, receipt of funds, and disbursement of funds, recording of all financial transactions in expenditure reports, records maintenance and control.

Procurement

The audit work shall cover the competitiveness, transparency and effectiveness of the procurement activities of the project in order to ensure that the equipment and services purchased meet the requirement of either the government (or NGO) or UNDP and include the following:

- As applicable, delegations of authorities, procurement thresholds, call for bids and proposals, evaluation of bids and proposals and approval/signature of contracts and purchase orders
- Receiving and inspection procedures to determine the conformity of equipment with the agreed specifications and, when applicable, the use of independent experts to inspect the delivery of highly technical and expensive equipment
- Evaluation of the procedures established to mitigate the risk of purchasing equipment that do not meet specifications or is later proven to be defective
- Management and control over the variation orders.

The audit work in the area of procurement shall also cover the use of consulting firms and the adequacy of procedures to obtain fully qualified and experienced personnel and assessment of their work before final payment is made.

Asset Management

The audit work shall cover equipment (typically vehicles and office equipment) purchased for use of the project. The procedures for receipt, storage, and disposal shall also be reviewed.

Cash Management

The audit work shall cover all cash funds held by the project and review procedures for safeguarding of cash.

General Administration

The audit work shall cover travel activities, vehicle management, shipping services, office premises and lease management, office communications and IT systems, and records maintenance.

Note: The above scope shall cover those transactions performed at the level of the project to include direct payments made by the UNDP country office at the request of the project.

Scope Limitation

Transactions/actions that are performed by the UNDP office at the request and on behalf of the project (i.e. UNDP direct support services to NIM) where there is a signed Letter of Agreement (LOA) are **not** to be included in the audit scope. **Important note:** Such scope limitation should not be a reason for issuing a modified audit opinion by the auditors. Please refer to Section D., 2(b) for additional information.

ANNEX 2: QUALIFICATIONS OF AN AUDITOR

If included as part of a Request for Proposal, this section will need to be modified to take into consideration whether the firms invited to propose have already been pre-qualified.

The TOR should state that the auditor must be completely impartial and independent from all aspects of management or financial interests in the entity being audited. The auditor should not, during the period covered by the audit nor during the undertaking of the audit, be employed by, serve as director for, or have any financial or close business relationships with any senior participant in the management of the entity. It may be appropriate to remind an auditor of any existing statutory requirements relating to independence and to require an auditor to disclose any relationship that might possibly compromise his/her independence.

The auditor should be experienced in applying either ISA or INTOSAI audit standards, whichever is applicable for the audit. The auditor must employ adequate staff with appropriate professional qualifications and suitable experience with ISA or INTOSAI standards, including experience in auditing the accounts of entities comparable in size and complexity to the entity being audited.

Curriculum vitae (CVs) should be provided to the client by the principal of the firm of auditors who would be responsible for signing the opinion, together with the CVs of managers, supervisors and key personnel proposed as part of the audit team. It would be appropriate to indicate required/minimum professional qualifications necessary for the senior auditors/principals responsible for the audit. CVs should include details on audits carried out by the applicable staff, including on-going assignments indicating capability and capacity to undertake the audit.

ANNEX 3: SAMPLE AUDIT REPORT - REVISED

Auditor's report to:

The National Project Director and The Resident Representative

Format for Financial Certifications

I. Sample Certification for Statement of Expenditure

REPORT OF THE INDEPENDENT AUDITORS TO UNDP [insert project name] (Refer to ISA 700)

We have audited the accompanying Statement of expenditure ("the statement") of the project [insert award and project number(s)], [insert official title of project] for the period [insert period covered].

Management is responsible for the preparation of the statement for <name/title> project and for such internal control as management determines is necessary to enable the preparation of a statement that is free from material misstatement, whether due to fraud or error.

Our responsibility is to express an opinion on the statement based on our audit. We conducted our audit in accordance with International Standards on Auditing (ISA). Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the statement. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the project's preparation of the statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the project's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the presentation of the statement

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion

Clean Opinion: Option 1: (Unmodified)

In our opinion, the attached statement of expenditure presents fairly, in all material respects, the expenditure of [insert amount in US\$] incurred by the project [insert official title of project] for the period [insert period covered] in accordance with agreed upon accounting policies [if needed add - and the note to the statement] and were: (i) in conformity with the approved project budgets; (ii) for the approved purposes of the project; (iii) in compliance with the relevant UNDP regulations and rules, policies and procedures; and (iv) supported by properly approved vouchers and other supporting documents.

Modified Opinions (Refer to ISA 705)

Option 2: (Qualified opinion)

In our opinion, the attached statement of expenditure, except for the reasons indicated above in paragraphs (1), (2), (3), etc., [there should be a separate Basis for Qualified Opinion Paragraph where the

basis for Qualified opinion is clearly explained] presents fairly in all material respects the expenditure of [insert amount in US\$] incurred by the project [insert official title of project] for the period [insert period covered] in accordance with UNDP accounting policies [if needed add: and the note to the statement].

Option 3: (Adverse opinion)

In our opinion, based on the significance of the matter discussed in paragraph (1), (2), (3) etc. [there should be a separate Basis for Adverse Opinion Paragraph where the basis for adverse opinion is clearly explained] the statement of expenditure does not give a true and fair view of the expenditure of [insert amount in US\$] incurred by the project [insert official title of project] for the period from [insert period covered]

Option 4: (Disclaimer of opinion)

Because of the significance of the matter described in paragraph (1),(2), (3), etc [there should be a separate Basis for Disclaimer of Opinion Paragraph where the basis for disclaimer of opinion is clearly explained] we were unable to obtain sufficient appropriate evidence to provide a basis for an audit opinion. Accordingly we are unable to express an opinion on the statement of expenditure of [insert amount in US\$] incurred by the project [insert official title of project] and audited by us for the period from [insert period covered].

Emphasis of Matter [if applicable] (Refer to ISA 706)

We draw attention to Note [insert number] to the statement of expenditure which describes the uncertainty related to the [insert the issue]. Our opinion is not qualified in respect of this matter.

Auditor's Signature

Date of the auditor's report

Auditor's address

II. Sample Certification for Statement of Assets (Refer to ISA 700)

We have audited the accompanying statement of assets ("the statement") of the project number [insert award and project number(s)], [insert official title of project] as at [insert date].

Management is responsible for the preparation of the statement for <name/title> project and for such internal control as management determines is necessary to enable the preparation of the statement that is free from material misstatement, whether due to fraud or error.

Our responsibility is to express an opinion on the statement based on our audit. We conducted our audit in accordance with International Standards on Auditing (ISA). Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the statement. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the project's preparation of the statement in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the project's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the presentation of the statement .

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion

Option 1: (Unmodified)

In our opinion, the attached statement of assets presents fairly, in all material respects, the balance of inventory of the project [insert official title of project] amounting to [insert amount in \$US] as at [insert date].in accordance with UNDP accounting policies [if needed add: set out in the note to the schedule].

Modified Opinions (Refer to ISA 705)

Option 2: (Qualified opinion)

In our opinion, the attached statement of assets, except for the reasons indicated above in paragraphs (1), (2), (3), etc., [there should be a separate Basis for Qualified Opinion Paragraph where the basis for Qualified opinion is clearly explained] presents fairly in all material respects the balance of inventory of [insert amount in US\$] incurred by the project [insert official title of project] as at [insert date]. in accordance with agreed upon accounting policies [if needed add: set out in the note to the schedule].

Option 3: (Adverse opinion)

In our opinion, based on the significance of the matter discussed in paragraph (1), (2), (3) etc [there should be a separate Basis for Adverse Opinion Paragraph where the basis for adverse opinion is clearly explained] the statement of assets does not give a true and fair view of the expenditure of [insert amount in US\$] incurred by the project [insert official title of project] and audited by us as at [insert date].

Option 4: (Disclaimer of opinion)

Because of the significance of the matter described in paragraph (1),(2), (3), etc. [there should be a separate Basis for Disclaimer of Opinion Paragraph where the basis for disclaimer of opinion is clearly explained] we were unable to obtain sufficient appropriate evidence to provide a basis for an audit opinion. Accordingly we are unable to express an opinion on the statement of assets of [insert amount in US\$] incurred by the project [insert official title of project] and audited by us as at [insert date].

Emphasis of Matter [if applicable] (Refer to ISA 706)

We draw attention to Note [insert number] to the statement of assets which describes the uncertainty related to the [insert the issue]. Our opinion is not qualified in respect of this matter.

Auditor's Signature

Date of the auditor's report

Auditor's address

III. Sample Certification of Statement of Cash Position (Statement of Cash Position is required only if there is separate bank account for each of the projects and/or petty cash) (Refer to ISA 700)

We have audited the accompanying statement of cash ("the statement") of the project number [insert award and project number(s)], [insert official title of project] as at XXX.

Management of <project name/title> project is responsible for the preparation of the statement for project and for such internal control as management determines is necessary to enable the preparation of a schedule that is free from material misstatement, whether due to fraud or error.

Our responsibility is to express an opinion on the statement based on our audit. We conducted our audit in accordance with International Standards on Auditing (ISA). Those standards require that we

comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the statement. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the project's preparation of the statement in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the project's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the presentation of the statement.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion

Option 1: (Unmodified)

In our opinion, the attached Statement of cash position presents fairly, in all material respects, the cash and bank balance of the UNDP project [insert official title of project] amounting to [insert amount in \$US] as at [insert date] in accordance with the UNDP accounting policies [if needed add: set out in the note to the statement].

Modified Opinions (Refer to ISA 705)

Option 2: (Qualified opinion)

In our opinion, the attached statement of cash, except for the reasons indicated above in paragraphs (1), (2), (3), etc., [there should be a separate Basis for Qualified Opinion Paragraph where the basis for Qualified opinion is clearly explained] presents fairly in all material respects the cash and bank balance amounting to [insert amount in US\$] as at [insert date] in accordance with the UNDP accounting policies [if needed add: set out in the note to the statement].

Option 3: (Adverse opinion)

In our opinion, based on the significance of the matter discussed in paragraph (1), (2), (3) etc [there should be a separate Basis for Adverse Opinion Paragraph where the basis for adverse opinion is clearly explained] the statement of cash does not give a true and fair view of the cash and bank balance of [insert amount in US\$] audited by us as at [insert date].

Option 4: (Disclaimer of opinion)

Because of the significance of the matter described in paragraph (1),(2), (3), etc [there should be a separate Basis for Disclaimer of Opinion Paragraph where the basis for disclaimer of opinion is clearly explained] we were unable to obtain sufficient appropriate evidence to provide a basis for an audit opinion. Accordingly we are unable to express an opinion on the statement of cash in the amount of [insert amount in US\$] audited by us as at [insert date].

Emphasis of Matter [if applicable] (Refer to ISA 706)

We draw attention to Note X to the statement of cash which describe the uncertainty related to [give explanation of the uncertainty]. Our opinion is not qualified in respect of this matter.

Auditor's Signature

Date of the auditor's report

Auditor's address

This report is intended solely for the information and use of UNDP and the Government of XYZ Country (or NGO).

Date of issuance: _____

AUDITOR'S NAME (Please print): _____

AUDITOR'S SIGNATURE: _____

STAMP AND SEAL OF AUDIT FIRM: _____

AUDIT FIRM ADDRESS: _____

AUDIT FIRM TEL. NO. _____

Note: Audit opinions must be one of the following: (a) qualified, (b), unqualified, (c) adverse, or (d) disclaimer. If the audit opinion is other than "unqualified" the audit report must describe both the nature and amount of the possible effects on the UNDP financial statement (CDR) (Amount of qualification/**Net Financial Impact**). A definition of audit opinions is provided in Annex 4.

ANNEX 4: DEFINITION OF AUDIT OPINIONS

Unqualified (Clean or positive) Opinion

An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

Qualified Opinion – a modified (negative) audit opinion

A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being 'except for' the effects of the matter to which the qualification relates.

Disclaimer of opinion – a modified (negative) audit opinion

A *disclaimer of opinion* should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

Adverse – a modified (negative) audit opinion

An *adverse opinion* is expressed by an auditor when the financial statements are significantly misrepresented, misstated, and do not accurately reflect the expenditure incurred and reported in the financial statements (**UNDP CDR**, statement of cash, statement of assets and equipment).

An *adverse opinion* is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Annex 5: International Standard for Audit (ISA) 450 and 710

Guidance on Reporting Prior Year Modified opinion not corrected

Following the International Audit Standard (ISA) 450 and ISA 710 that came into effect on December 2010 there is a new requirement regarding a previous year modified audit opinion⁴ This audit standard requires that auditors, when expressing an opinion on this year's statements, to take into account the possible effect of a prior year modified opinion that has not been properly corrected or resolved.

Consequently, a previous year modified opinion that has not been properly resolved may cause the auditors to issue a modified opinion in their current year audit report. If proper attention is not paid to this aspect, the risk could be a significant accumulation of unresolved modified opinions from previous years that would lead the UN BoA to issue a modified audit opinion on UNDP financial statements.

⁴ A "modified" audit opinion means either a qualified opinion, a disclaimer opinion or an adverse opinion.

ANNEX 6: CATEGORIZATION OF AUDIT FINDINGS BY RISK SEVERITY

High	Action that is considered imperative to ensure that UNDP is not exposed to high risks (i.e. failure to take action could result in major consequences and issues).
Medium	Action that is considered necessary to avoid exposure to significant risks (i.e. failure to take action could result in significant consequences).
Low	Action that is considered desirable and should result in enhanced control or better value for money.

ANNEX 7: CLASSIFICATION OF POSSIBLE CAUSES OF AUDIT FINDINGS

1. Lack of/or inadequate policies/procedures/guidelines
2. Lack of/or inadequate guidance/supervision at the project level
3. Inadequate guidance/monitoring at UNDP country office level
4. Lack of/or insufficient resources (specify: financial, human or, technical resources)
5. Inadequate planning
6. Inadequate training
7. Human error
8. Intentional overriding of internal controls
9. Inadequate management structure

ANNEX 8: TEMPLATE FOR NGO/NIM AUDITORS TO REVIEW AND SIGN THE UPDATED ACTION PLANS FOR PRIOR YEAR AUDIT OBSERVATIONS AND RECOMMENDATIONS

Award No.:		Project No.:		Opinion Type:									
Obs No	Observation	Recommendation	Audit Area	Audit Cause	Risk Severity	Proj/CO Mngt Comments	Action(s) Planned	Target Impl. Date	Action Unit	Person Responsible for Action	Updated Status	Actual Impl. Date	Description of Status Update
Award No.:		Project No.:		Opinion Type:									
Obs No	Observation	Recommendation	Audit Area	Audit Cause	Risk Severity	Proj/CO Mngt Comments	Action(s) Planned	Target Impl. Date	Action Unit	Person Respsble. for Action	Updated Status	Actual Impl. Date	Description of Status Update
Award No.:		Project No.:		Opinion Type:									
Obs No	Observation	Recommendation	Audit Area	Audit Cause	Risk Severity	Proj/CO Mngt Comments	Action(s) Planned	Target Impl. Date	Action Unit	Person Respsble. for Action	Updated Status	Actual Impl. Date	Description of Status Update

Implementing Partner (IP)	UNDP Country Office	Government Auditors/Audit Firm
Signature of IP Official: _____	Signature of UNDP Official: _____	Signature of Audit firm Official: _____
Name and title (print): _____	Name and title (print): _____	Name and title (print): _____
Date: _____	Date: _____	Date: _____
		Stamp and Seal of audit firm: _____

Note: The values for the “Updated Status” could be: Implemented, In Progress, Not Implemented, N/A or Withdrawn. “N/A” means not applicable and would be used if there is an overall change in a project’s working environment that makes last year’s audit observation no longer applicable. For example, the project has been closed. Another example for using “N/A” is a project that had its own bank account and last year’ audit recommendation called for

the need to perform monthly bank reconciliation. However the following year, the auditor notes that the bank account has been closed. "Withdrawn" would be used if there is an overall change in a project's working environment that makes last year's audit observation and recommendation no longer valid. "Withdrawn" is very rarely used.

ANNEX 9: TEMPLATE FOR AUDIT DATA AND OBSERVATIONS

The information in the four tables below should be completed by the NGO/NIM auditors and signed. The CO can obtain the electronic version of the word document and copy and paste the information in CARDS for each award/project audit report.

Table 1 - Template for NGO/NIM auditors to report on the audit of the UNDP CDR

UNDP Combined Delivery Report (CDR) as at 31 December 2010							
1	Award No.	Project No.	Amount audited and certified (US\$)	Audit opinion (unqualified, qualified, adverse, disclaimer)	Total amount of qualification of audit opinion (if qualified, adverse or disclaimer opinion)	Reason(s) for qualification of audit opinion and breakdown of NFI amount (US)	Observation(s) that had impact on qualification of audit opinion (list observation number(s) and page of audit report/management letter)

Table 2 - Template for NGO/NIM auditors to report on the audit of the statement of cash position

Statement of Cash Position				
Award No.	Project No.	Value of Cash Position	Audit Opinion - Statement of Cash Position	Total amount of qualification - Statement of Cash

		Statement as at 31 December 2010 (US\$)		Position (US\$)

Table 3 – Template for NGO/NIM auditors to report on the audit of the statement of assets and equipment

Statement of assets and equipment				
Award No.	Project No.	Value of Assets and equipment as at 31 December 2010 (cumulative from project start date) (US\$)	Audit Opinion - Statement of Assets and Equipment	Total amount of qualification on the Statement of assets and equipment (US\$)

Table 4 - Template for NGO/NIM auditors to report on audit observations and recommendations

Award No.	Project No.	Observ. No	Audit Observation	Recommendation	Audit Area	Audit Cause	Risk Severity	Project/CO Mngmt. Comments

Name and position of Auditor: _____

Signature of Auditor: _____ Date: _____

Name and stamp of Audit Firm: _____

ANNEX 10: GUIDANCE ON FORMULATING AUDIT OBSERVATIONS -REVISED

Parts of the note that follows are from an article in the Internal Auditor, April, 1999 by Brian M. Schwartz. The purpose of this note is to provide guidance on formulating audit observations and recommendations that are effective.

Effective audit observations should consist of 5 common elements:

- 1) Condition;
- 2) Criteria;
- 3) Cause;
- 4) Effect, potential impact or Risk; and
- 5) Recommendation.

Items 1 to 4 must be part of what constitutes an audit observation. Below are helpful tips on each of these areas.

CONDITION

The "Condition" refers to a conclusion, problem, or opportunity noted during the audit review. It directly addresses a control objective or some other standard of performance. Sample condition statements include:

- "The appropriate individual did not authorize this document."
- "The account has not been reconciled for three months."
- "The process can be streamlined to save six hours per day."

When documenting the condition, it is important to include the necessary level of detail in the description of the problem. Someone who has not participated in the audit, but has some basic understanding of the subject matter or function, should be able to comprehend any condition statement.

CRITERIA

This element describes the standard being used as the benchmark for evaluation. In other words, it depicts the ideal condition. The criteria may reference a specific policy, procedure, or government regulation. At other times, the criteria may simply be a matter of common sense or prudent business practice. For example, a criteria statement might state that "Per policy #1234, all loans greater than \$100,000 must be approved by the board of directors;" or "Payroll processing responsibilities should be segregated to control the authorization of master file changes."

CAUSE

As the name suggests, the cause statement explains why the identified problem occurred in the first place. The cause is probably the most critical attribute of the finding form. Without determining why the condition occurred, the situation cannot be properly remedied.

In documenting the cause, the auditor should identify the underlying reason behind the problem. A surface explanation that fails to uncover the root cause will not lead to an effective recommendation.

In addition, a quote from an appropriate individual could serve as the cause statement, i.e. why the condition has occurred. Some audit managers consider only a cause statement from management as appropriate, while others prefer a statement from the individual who actually performs the respective task. It is usually preferred to obtain both points of view, since such an approach is more likely to identify the root cause of the problem.

Possible Causes

In addition to explaining the and giving details about the "Cause" in the text of an audit observation, UNDP requires that the auditor also summarizes the cause statement in the audit report by using one of the following 9 pre-established cause statements:

1. Lack of/or inadequate policies/procedures/guidelines
2. Lack of/or inadequate guidance/supervision at the project level
3. Inadequate guidance/monitoring at UNDP country office level
4. Lack of/or insufficient resources (specify: financial, human or, technical resources)
5. Inadequate planning
6. Inadequate training
7. Human error
8. Intentional overriding of internal controls
9. Inadequate management structure

EFFECT, POTENTIAL IMPACT OR RISK

The effect statement describes the particular risk that could exist (the potential impact or risk) or that has already existed (the effect) as a result of the condition or problem. Basically, it answers the question, "so what?" Effect statements often discuss the potential for loss, noncompliance, or customer dissatisfaction created by the problem.

Management is likely to zero in on the information provided in this aspect of the audit observation, as it allows them to see how the condition will negatively impact their activities. As a result, the effect statement often serves as the catalyst for a positive change.

One note of caution is in order - the risk suggested by the effect statement should not be overblown or exaggerated. While auditors are responsible for pointing out risks associated with control breakdowns, the effect statement should remain reasonable, plausible and should not be worded as if the world were coming to an end. If auditees are to take the audit observation seriously and respect what an auditor has to say, an auditor talks about risk in realistic, not exaggerated, terms.

Risk Levels

In addition to explaining the and giving details about the "Effect, potential impact or risk" in the text of an audit observation, UNDP requires that the auditor also identifies the risk level in the audit report by using one of the following 3 pre-established risk levels:

High Action that is considered imperative to ensure that UNDP is not exposed to high risks

(i.e. failure to take action could result in major consequences and issues).

Medium Action that is considered necessary to avoid exposure to significant risks (i.e. failure to take action could result in significant consequences).

Low Action that is considered desirable and should result in enhanced control or better value for money.

RECOMMENDATION

This aspect suggests how the situation might be remedied. An effective recommendation directly relates to and targets the cause. It isn't enough to state in general terms that management should fix the problem; the recommendation statement should also explain how remediation is to be achieved.

A good recommendation maintains the proper balance between the risk presented and the cost to control it. Before making a recommendation, the auditor should consider the following questions:

Does the recommendation solve the problem and eliminate or reduce the risk?

- Can the recommendation be implemented within the current environment?
- Is the recommendation cost-effective?
- Will the recommendation act as a temporary bandage or a permanent solution?

Examples of effective recommendations include monthly or quarterly physical inventories of all assets and equipment with reconciliation to appropriate records.

ADDITIONAL TIPS

Whenever possible, similar findings should be combined into one form so that the case for implementing the recommendation is strengthened.

Playing devil's advocate can be an extremely helpful exercise. After completing the audit observation and recommendation, auditors should place themselves in the auditee's shoes and challenge/question the validity of the issue. If the issue cannot stand up to this exercise, it probably should not be included in the audit report.

ANNEX 11: SAS 220 - GUIDANCE ON AUDIT MATERIALITY

Below are some highlights from the Statement of Auditing Standards (SAS) 220 – Audit Materiality. These are meant to provide guidance to the auditors in determining the materiality of observations for reporting purposes and as they might affect the audit opinion. The auditors should refer to SAS 220 for more details.

The purpose of the SAS is to establish standards and provide guidance on the concept of materiality and its relationship with audit risk.

Auditors should consider materiality and its relationship with audit risk when conducting an audit (SAS 220.1)

A matter is material if knowledge of the matter would reasonably influence the economic decisions of users taken on the basis of the financial statements. Materiality may be considered in the context of the financial statements as a whole, any individual statements within the financial statements or individual items included within the financial statements.

Materiality depends on the nature and size of the item or error judged in the particular circumstances. Since materiality has both qualitative and quantitative aspects, it is not capable of any general mathematical definition.

Auditors should plan and perform the audit so as to provide them with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement and give a true and fair view. (SAS 220.2)

The assessment of what is material is a matter of professional judgement.

Auditors would consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, an error in a month end procedure could be an indication of a potential material misstatement if that error is repeated each month.

In evaluating the fair presentation of the financial statements, auditors should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material (SAS 220.4).