Session 5.0 Developing Researchable Question and Audit Criteria

Overview

After defining audit topic and audit objective, participants will develop the researchable question and/or its sub researchable question(s), and then defining audit criteria for each specific researchable/sub researchable question.

The purpose of this session is to discuss the concept of audit criteria in Performance Auditing and relationship between the audit objective, audit criteria, and researchable question.

Learning Objective

By the end of the session, the participants should be able to:

- Understand the concept of defining performance audit criteria;
- Develop audit criteria through the use of researchable question(s).

Basic Concept

The word '*criteria*' is the plural form of '*criterion*' which means a rule, a standard or a test by which something can be judged. Audit criteria, therefore, are a set of reasonable and attainable standards that serve as yardsticks to assess performance of the subject matter under review. The appropriate audit criteria are, therefore, essential for auditing.

Auditors need a means of measuring or judging the performance of the matters subject to audit. The standards used for this purpose are referred to as audit criteria.

In financial audits, transactions that are examined tend to be judged by the auditor as being 'correct' or 'incorrect,' 'legal' or 'illegal,' etc. Such criteria tend to be relatively closed and are usually prefixed by, for example, the legislation establishing the audited entity. For performance audits, however, the choice of audit criteria is normally relatively open and formulated by the auditor, and as mentioned earlier, criteria are often less important in the problem-oriented approach. In the problem-oriented approach it is more important to formulate testable (verifiable) hypotheses on possible causes to the audit problem.

Thus, in performance auditing, the general concepts of economy, efficiency, and effectiveness need to be interpreted in relation to the subject matter, and the resulting criteria will vary from one audit to another. In defining audit criteria, auditors must ensure that they are relevant, reasonable, and attainable. Finally, every criterion is elaborated in the form of questions. These questions are factual in character and intended to describe or measure the practical situation to be audited.

Defining Audit Criteria

In the process of performance auditing, the second most crucial step after setting up the audit objectives is defining audit criteria.

The audit criteria represent the normative standards against which the audit evidence is judged. The criteria will vary according to the specific audit subject and objectives, the legislation governing the undertaking or the audited entity, the stated objectives, and the specific conditions that the SAI deems relevant and important for the case.

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Audit criteria can also be defined as reasonable and attainable standards of performance against which the economy, efficiency, and effectiveness of activities that can be assessed. In performance audit, those general concepts need to be interpreted in relation to the subject matter and the resulting criteria will vary from one audit to another.

Since there are no generally accepted criteria, the auditors have to develop tailor-made criteria for each audit assignment. This can often give rise to disagreement with the audited entity. Therefore, the auditors should discuss their criteria with the audited entity's management. An audit assignment with unaccepted audit criteria on the behalf of the audited entity could lead to highly controversial and even unreliable audit reports.

The Importance of Audit Criteria

Audit conclusions should be convincing and acceptable to the entity in particular, and to any other users or readers in general. It would be required for performance auditors in minimizing the subjective elements in drawing conclusions. Therefore, setting audit criteria is an important step in performance auditing. If audit criteria are not set, there will be no basis for comparison and, consequently, no basis for developing audit findings, conclusions or recommendations.

Audit criteria represent best or good practices, a reasonable and informed person's expectation of "what should be." When criteria are compared to what actually exists, audit findings are generated. Meeting or exceeding the criteria might indicate "best practice," but failing to meet criteria would indicate that improvements could be made.

One of the benefits in setting criteria in advance is that we have a clear idea from the beginning of what to look for during the audit assignment, instead of hoping to find interesting points by mere chance.

Criteria can perform a series of important roles to assist the performance audit assignment, for example:

1. To form a basis communication within the audit team and SAI management concerning the nature of the audit;
2. To form the basis communication with the audited entity's management, which the audit team will often ask in understanding the management, the agreement of the audit criteria and finally the acceptance of the audit results;
3. To link the objectives to the audit programs carried out during implementation phase;
4. To form the basis for data collection phase of the audit, providing a basis to build procedures in collecting audit evidence; and
5. To provide the basis for audit findings, to help in give a structure to audit observations.

The level of details of the criteria and forms taken will determine the success rate of the user. However, it is important to appreciate that satisfactory performance does not mean perfect performance, but more about what a reasonable person would expect while taking into account the circumstances.

Characteristics of Good Audit Criteria

Suitable criteria are those that are relevant to the matters being audited and appropriate to the circumstances. They focused, wherever possible, on the results expected to be achieved

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by the operation, system, control, etc. The assessment of whether or not criteria are met can be proven through audit observations. If auditors used improper criteria, inappropriate conclusions may be drawn about the audited entity's operations. In audit planning, suitable criteria should be identified to enable the auditor assessing the matters subject to audit.

The suitability of criteria depends on factors such as:

1. the audit objective, i.e. criteria suitable for matters related to economy are different from those related to efficiency; and
2. the portion of the entity, management control system or organizational unit to be examined, e.g. criteria suitable for human resources management are different from those related to capital asset management.

Some characteristics of suitable criteria include (ASOSAI, 2000):

1. Reliability: can be proven reliable if the drawn conclusions are consistent when the criteria are used by different auditors in similar circumstances.
2. Objectivity: free from any bias coming from the auditor's or management's judgments.
3. Usefulness: the criteria can help produce findings and conclusions that meet users' information needs.
4. Understandability: clearly stated and are not subject to significantly different interpretations.
5. Comparability: consistent with those used in previous performance audits of the audited entity.
6. Completeness: refers to the development of all significant criteria appropriate to particular matters.
7. Acceptability: agreeable to independent experts in the field, audited entities, legislature, media, and general public.

In defining audit criteria, auditors must ensure that these characteristics are met. Finally, every criterion is elaborated in the form of questions. These questions are factual in character and intended to describe or measure the practical situation to be audited.

Sources of Audit Criteria

Performance information of the audited entity, either quantitative measures or qualitative assessments, is fundamental to evaluate economy, efficiency and effectiveness. Criteria related to satisfactory performance can be derived from the agency's own objectives or from accepted standards of performance in the industry and/or government, or other relevant sources. The judgment of the auditor plays an important role in identifying relevant and reliable sources.

To avoid the necessity to create criteria from the very first principle for each audit, the audit team should investigate the following sources of existing criteria:

1. Laws, rules, and regulations governing the operation of the audited entity;
2. Decisions made by the legislature or the executive;
3. Central agency policies, standards, directives and guidelines;
4. Criteria used previously in similar audits or by other SAIs;
5. Agencies (inside or outside the government or even the country) carrying out similar activities;

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6. Professional standards, experiences and values;
7. General management and subject matter literature;
8. Standards set by International bodies;
9. Interviews with professionals, independent expert advice and know-how; and
10. New or established scientific knowledge and other reliable information.

While those sources provide the basis for developing suitable criteria for the audit, some of them may require interpretation and modification to ensure their relevance to the audited entity. Criteria must be realistic and take into account the context of the audited agency and the local conditions. For example, perhaps it is unfair to apply the SFM from the ITTO standards on countries that do not have tropical forests. When adopting forest management practices that are generally accepted in tropical countries, suitable adjustments must be made according to the conditions of forests owned by respective countries. Auditors should seek guidance from all over sources and then formulate realistic audit criteria.

The basis of the audit criteria may be considered from different angles:

1. depending on the case in point, the most authoritative sources will either be official standards (such as goals laid down in laws and regulation, decisions and policies taken by the legislature or the executive branch), or
2. on the basis of scientific grounds of the standards, greater emphasis will be placed on specialists' scientific literature and other sources such as professional standards and best practices.

Some key criteria that relate directly to the audited entity itself are as follows:

1. Enabling and related legislation;
2. Agency's operating and procedures manuals;
3. Central agency's policies, standards, directives and guidelines;
4. Performance standards set by management or previous inquiries by the legislature, or past performances;
5. Basic planning documents such as feasibility study and approved plan;
6. Financial reports of the entity;
7. Expenditure statements;
8. Budget documents; and
9. Project reports.

It should also be noted that in examining performance information obtained from the audited entity, the audit team should:

1. consider whether audited entity had adequate procedures in place and can be relied upon to measure and report performance;
2. ascertain whether the performance is measured comprehensively, relevantly and justice on a cost-benefit basis;
3. examine procedures to determine if they relate to the agency's corporate goals; and
4. consider whether the performance measures are incorporated into decision-making process of the management, that is, whether they are reported and used within the audited entity.

Those considerations should be taken into account by the auditors when they examine quantitative and qualitative performance

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information because those considerations are essential elements in all performance audits.

SAIs may influence the audited entity through performance audit conclusions and recommendations to develop explicit criteria as part of their program planning, implementation and monitoring system.

SAIs should note the implications of the emerging shift in the role of many governments from a 'provider of services' to a 'facilitator and regulator' and the increasing use of private operators in public sector. Performance audit focus on the economy, efficiency and effectiveness of public sector activities may have to be modified, taking into account the increasing privatization and liberalization of public sector operations in many countries. SAIs will be called upon new approaches, techniques and criteria for performance audit of programs that may not be directly funded by the governments, but may affect general public by way of quality of service, cost and equity of access. In this environment, performance auditing needs to take into account the shift from a 'government-centered' to a more 'people-oriented' approach.

Constrains in Defining Audit Criteria

Sometimes it is easy to determine the audit criteria, such as when the goals set by the legislature or the executive branches are clear, precise, and relevant. However, this is often not the case. The purpose may be vague, conflicting or non-existent. In such circumstances, the auditors might have to reconstruct the criteria. One possibility is to apply a 'theoretical' approach, by allowing experts in the field to answer questions such as: 'what ought to be the ideal results under perfect conditions according to rational thinking or best-known comparable practice?' Alternatively, to define and obtain support for well-founded and realistic criteria, it may prove helpful to apply an 'empirical' approach, involving discussions with stakeholders and decision makers.

Objectives set by the legislature or the executive branches are also sometimes vague or conflicting. Under such conditions, the auditors might have to interpret the objectives to make them more operational or measurable. One possibility is to get experts and stakeholders in the field to answer questions such as: How should the goals/objectives and objectives be interpreted and measured best? What should be the expected results under the given conditions? What is the best-known comparable practice? If the objectives are conflicting, one option –if other alternatives seem inappropriate –is to divide the audit project into several sequential studies, covering one goal at a time. In cases of vague or long-term goals/objectives it might sometimes be possible to narrow the scope somewhat and look for short-term perspectives and direct criteria. (There are of course other options available).

Develop Audit Criteria from Researchable Questions

The audit team can generally develop criteria based on laws and/or regulations. In these circumstances, the auditors need only to ensure that the criteria are related to the audit objective. To ensure the completeness of criteria being used in the audit, the auditor can use researchable questions on each of their audit objectives. If the criteria can be used as the basis to answer the researchable questions, it means the criteria have already been complete.

The importance of good questions for good research question includes defining the

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investigation, setting the boundaries, and providing direction. Questions should be clear and specific, also include terms that can be defined and measured, and together they should fully address the audit objectives.

Developing research questions can be done by looking at the 3Es concept (economy, effectiveness and efficiency)

1. The principle of ECONOMY requires that the resources used by the audited entity for pursuing its activities shall be made available in due time, inappropriate quantity and quality and at the best price;

   Are resources used in forest rehabilitation obtained by minimizing the cost of inputs, while maintaining the quality in line with the principles and practices of healthy administration and policy management?

2. The principle of EFFICIENCY concerns about the best relationship between resources employed and results achieved;

   Are forest rehabilitation activities capable of producing maximum output (reducing the extent of critical region) with the number of inputs (resources) given?

   Or

   Are forest rehabilitation activities capable of producing output (reducing the extent of critical region) with the use of minimal inputs (resources)?

3. The principle of EFFECTIVENESS concerns about attaining specific objectives set and achieving the intended results.

   Has the rehabilitation of forest been implemented effectively to restore, maintain, and improve the functions of forests and lands so that the carrying capacity, productivity, and its role in supporting life system are maintained?

There are 3 types of researchable questions:

1. **Descriptive questions** usually ask ***what is*** (or was) the current situation or condition? This type of question is often appropriate to studies, or to the survey phase of an audit. But descriptive issues are sometimes addressed in the annual reports as well, for example:

   - *How does the audited entity manage the dispute resolution process?*
   - *How does the audited entity relate to the communities it serves?*
   - *Were alternative program options considered?*

   Those questions often lay the groundwork for normative audit projects because one needs to know something about how particular activity is performed before passing judgment on it. They can also set the stage for cause and effect analysis, or they can stand on their own. For example, many government programs like Employment Insurance have a multitude of direct and indirect effects that are not well known or understood. Perhaps the most useful thing we can do is just describing what some of those effects are, without attempting to quantify or pass judgment on them.

2. **Normative questions** deal with the difference between an observed condition and a criterion. While a descriptive question asks "what is?" and stops there, a normative question also asks "***what should be*?"** and then compares the two conditions. This is

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the type of questions we have to answer in all our criteria-based audits. Ideally, a normative question would include the criterion that has to be met. For example, if the audit objective is to determine "due" regard for economy or efficiency, at this point the auditor would try to define what that means: 100 percent accuracy or compliance, or something less?

If variance exists, a normative enquiry does not establish whether the target or the performance is at fault, nor does it determine the cause of the variance and how to remedy it. This would require a cause and effect enquiry.

3. **Cause-and-effect** questions go beyond descriptive and normative questions to examine the impact, extent, or magnitude of changes or variances. Examples might be: Why does the department not follow all the rules in assessing applications for contributions? To what extent does its failure to do so affect program success? Cause-and-effect analysis is the normal approach used in evaluations, and the research design for this sort of work often presents difficult methodological problems, for example, to deal with questions of attribution.

   Time spent on the first two steps in examination planning will pay off in helping to develop a practical, manageable approach to data collection, and credible conclusions. If the audit objectives are too broad, there may not be cost-effective or, indeed, any way to collect the necessary data, and the objectives of the project would have to be renegotiated or scaled down.

Research questions can also be obtained from the insight that comes from personal experience, theory, observations, contemporary issues, or engagement with the literature. It's a good idea to evaluate your research question before completing the researchable question:

- ✓ Is the question right for auditors?
  - Will the question hold auditors interest?
  - Can auditors manage any potential biases/subjectivities the auditors may have?
- ✓ Is the question right to be used in the field?
  - Will the findings be considered significant?
  - Will it make a contribution?
- ✓ Is the question well articulated?
  - Are the terms well-defined?
  - Are there any unchecked assumptions?
- ✓ Is the question doable?
  - Can information be collected in an attempt to answer the question?
  - Do auditors have the skills and expertise necessary to access this information? If not, can the skills be developed?
  - Will auditors be able to get it all done within audit time constraints?
  - Are costs likely to exceed audit budget?
  - Are there any potential ethics problems?
- ✓ Does the question get the tick of approval from those in the know?
  - Does the supervisor think that auditors on the right track?
  - Do 'experts' in the field think the question is relevant/ important/ doable?

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If the researchable question is too broad and difficult to formulate specific criteria, the auditor can split the main researchable question into more than one sub researchable questions. Each sub researchable question will have its specific criteria. In this case, the auditor has to ensure that all sub researchable questions have already answered the researchable question.

Summary

In performance audit, auditors assess the performance of an organization against pre-determined expectations of performance or criteria. The audit criteria represent the normative standards against which audit evidence is judged. The criteria will vary according to the specific audit subject and objectives, the legislation governing the undertaking or the audited entity, the stated objectives, and the specific conditions that the SAI deems relevant and important for the case.

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