2.2.2 New Engagements and Risk Classification

Introduction

This section provides policies and guidance on:

- accepting proposed entities as auditees of the Audit Office (the Office)
- assessing the potential risk associated with types of engagements
- classifying the risk within the Office's risk framework
- responding to the risk classification.

With the exception of certain request audits, the Auditor-General (A-G) cannot refuse a lawfully mandated engagement and may only undertake engagements within the statutory mandate. For further details refer to Policy 2.1.1 'Engagement Approach'.

Certain types of engagements carry higher inherent risks for the Office. The Office must identify those engagements with higher risk profiles and formulate appropriate responses.

Policies and guidance for financial audit

Accepting proposed entities as auditees of the Office

1. **Prior to accepting an entity as an auditee of the Office, the Engagement Controller (EC) must forward their recommendation to accept the entity as a new auditee to the Executive Director, Professional Services (EDPS) and the Head of Financial Audit (HoFA) for endorsement. This memorandum must include:**
   - **relevant background of the proposed entity**
   - **details of any relevant consultation that has occurred with external parties related to the proposed entity**
   - **how the proposed entity is captured by the Office mandate**
   - **a preliminary risk assessment of the proposed entity**
   - **details of the reporting framework of the proposed entity**
   - **analysis of how the proposed entity affects the Office.**

The memorandum must be completed for all proposed new GSF agencies including those that are expected to meet the exemption criteria in section 7.3 of the *Government Sector Finance Act 2018* (GSF Act) for their first year of operations and therefore not be required to prepare annual GSF financial statements under section 7.6 of the GSF Act. GSF agencies that are exempt from preparing financial statements are still auditable entities under the *Government Sector Audit Act 1983*.

2. **The EDPS and HoFA will review the EC's recommendation to accept the proposed entity as an auditee of the Office, and:**
   - **where the EDPS and HoFA endorses the recommendation, a recommendation will be made to the Deputy Auditor-General (DA-G) to approve the proposed entity as an auditee of the Office**
   - **where the EDPS and/or HoFA does not endorse the recommendation, the HoFA will discuss the outcome with the A-G and DA-G.**

3. Audit teams must complete the 'New Client Set Up Form' on Alfie to support the creation of a new auditee in Elite.

Assessing engagement risk

4. The HoFA, after consultation with the ECs, must, at least annually, recommend to the DA-G, the risk classification for all engagements. Once confirmed by the DA-G, the assessment must be made available on Alfie.

5. To determine the engagement classification as either normal or greater than normal risk, the EC should consider:

- **ethical requirements, including independence, and professional, legal, regulatory, and business conflicts (see Conflicts of Interest and Professional Independence Policy)**
- **whether the auditee is a Public Interest Entities (PIE) or PIE-like in accordance with the Public Interest Entities and Materiality Settings Guidance Note**
- **engagement risk factors.**

6. The HoFA must provide the DA-G with the information necessary to allow the DA-G to advise the A-G that engagement risk is being appropriately assessed and addressed.

7. The DA-G, on recommendation from the HoFA, must confirm the engagement risk when:

- **the A-G is required to undertake an engagement for a new auditee**
- **the A-G is required to undertake a new engagement for an existing auditee**
- **the auditee has been assessed as a PIE or PIE-like**
- **an EC changes the engagement risk assessment.**

To assess whether an entity is to be treated in a manner consistent with a PIE (that is, PIE-like), refer to the Public Interest Entities and Materiality Settings Guidance Note. By their nature, NSW public sector entities have a higher level of public interest than other entities because they are taxpayer funded, subject to parliamentary oversight and often engage with the general public. This does not of itself mean that all public sectors entities will be assessed as PIE-like.

Responding to risk and PIE assessments

8. For engagements assessed as greater than normal risk and/or a PIE/PIE-like, the EC must:

- **refer to the Public Interest Entities and Materiality Settings Guidance Note when determining materiality for PIE-like auditees**
- **ensure the methodology requirements for responding to increased engagement risk are applied, and appropriate responses to address the risk are planned**
- **determine, in consultation with the Financial Audit Executive, whether an Engagement Quality Reviewer (EQR) is required. Responsibility for appointing the EQR is outlined in Policy 2.2.3 'Engagement Quality Review'.**

9. The EC must consider the significance of new information obtained throughout the engagement that may impact the existing assessment. If new information indicates changes in the engagement risk profile, or its PIE status, the assessment must be re-evaluated and planning decisions reconsidered.

10. ECs can address the threat posed by increased engagement risk by including any number of the below:
    - increasing involvement of senior engagement team members throughout planning and executing the engagement
    - consulting with experts on key issues and judgements
    - increasing focus on identified risk factors, procedures applied, consultations undertaken on key issues and judgements and documentation of conclusions reached
    - applying additional review procedures to monitor and manage both specific and pervasive risk
    - lowering materiality or applying a larger haircut
    - emphasising an increased need for maintaining professional scepticism
    - incorporating additional elements of unpredictability.

Policies and guidance for performance audit

Assessing engagement risk

11. The AA-G Performance Audit, after consultation with the ECs, must, during the scoping phase of an audit, recommend to the DA-G, the risk classification for each engagement.

12. To determine the engagement classification of a performance audit as either normal or greater than normal risk, the EC should consider:
    - **ethical requirements, including independence, and professional, legal, regulatory, and business conflicts (see Conflicts of Interest and Professional Independence Policy)**
    - **engagement risk factors outlined below.**

Responding to risk

13. Performance audit engagements assessed as greater than normal risk must have an EQR appointed by the AA-G Performance Audit, in accordance with Policy 2.2.3 'Engagement Quality Review'.

14. The EC must consider the significance of new information obtained throughout the engagement that may impact the existing assessment where an engagement was initially approved as a normal risk engagement. If new information indicates changes in the engagement risk profile, the EC must:
    - **reassess the appropriateness of the risk classification**
    - **advise the AA-G Performance Audit, DA-G and A-G.**

15. If an engagement has been elevated to greater than normal risk as a result of new information, an EQR must be appointed to the engagement in accordance with Policy 2.2.3 'Engagement Quality Review'.

Effective date

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Guidance on engagement risk factors

Certain types of engagements present higher risk profiles to the Office. Risks to the Office include, but are not limited to, regulatory / litigation risks and reputational risks. Auditors should use their professional judgement in determining the overall engagement risk based on the balance of factors that may be presented. The identification of one of the below factors on its own, does not automatically give rise to a greater than normal risk.

Financial audit

The level of engagement risk is likely to increase for the following engagement types:

- general purpose financial audit engagements where the auditee has been assessed as a PIE or 'PIE-like'
- non general purpose financial audit engagements within the AUASB Framework described at 2.1.1 Engagement Approach and Summary of Engagement Types: Assurance Levels and Subject Matter, which require specialist skills or competencies
- engagements which are subject to or will be filed within a local or foreign regulatory authority
- engagements subject to APES 215 'Forensic Accounting Services' such as Public Interest Disclosures or work completed for Parliamentary Committees, refer to policy 2.2.8 Forensic Accounting Services.

In addition to the above, the risk is likely to increase where the auditee presents (but not limited to) the following indications:

- the entity governance structure is weak and/or those charged with governance / management take inappropriate actions regarding deficiencies in the internal control environment and/or previous audit recommendations
- management do not communicate values or ethics to staff, management is dominated by an individual or small group and/or management take unusually high levels of risk
- management imposed restrictions that limit access to people or information, management failure to volunteer information or place unreasonable demands or time restraints on the audit team, a history of disputes with management or general lack of co-operation with auditors
- frequent changes in key personnel or management, inexperience or low staff morale
- management is excessively concerned about the selection of certain accounting policies or estimates
- the organisational structure is unduly complex, perhaps with multiple programs or functions and/or rapidly expanding and/or changing
- the impact of amalgamations, dissolutions or transfers arising from Machinery of Government
- systems or programs that are not well managed or poorly controlled, or constantly changing. This could also include migration to new systems or utilising legacy systems that have not been appropriately maintained or supported by the software vendor
- the design, maintenance and controls over accounting and information systems, including if applicable those systems that manage performance information, are poor including inadequate questioning on financial results, performance results, actual results against budget, and lack of management involvement in the computer processing environment
- there are higher risks due to the nature of the business and the business environment such as volatility of the industry, high dependency on debt and/or greater than normal pressure from regulatory authorities and other social and political impacts
- there is a lack of, or poorly managed, internal audit function
- management do not show a commitment to reliable financial or performance related reporting, such as aggressive interpretation of standards or manipulation of financial or performance related data to achieve certain desired results
- higher than normal going concern issues exist such as predicted cash flow difficulties and low or negative equity balances

- there are significant or complex accounting issues including significant related party transactions outside the normal course of business, unusually significant level and/or nature of accounting estimates, changes in accounting policies or a history of prior period errors
- incidences of cyber attacks resulting in data loss
- significant changes to legislation/Treasurer's Directors etc that will have an impact on the auditee, an example being the introduction of sustainability reporting
- level and nature of complaints received by either the Office or the entity (particularly for serious and substantial waste).

In determining the level of engagement risk, the financial audit team may consider the engagement risk assessment performed by the performance audit team for their audit.

Performance audit

The level of engagement risk is likely to increase because of (but not limited to) the following:

- the audit topic is broad in coverage in that it:
  - spans multiple areas and/or responsibilities within an entity
  - spans multiple entities with responsibilities to deliver a policy objective.
- the policy objectives subject to audit appear inconsistent, vague, lack clarity or are otherwise loosely described
- the subject matter is complex and/or technical and likely to require the work of experts
- significant business risks which impact on the economy, efficiency or effectiveness of a program or the entity as a whole. Examples of relevant risks may include economic risk, political risk, legal risk, program risk and so on, the subject matter[1] receives a sustained level of critical interest by external stakeholders (such as parliament, the judiciary, or the media)
- level and nature of complaints received by either the Office or the entity, particularly for serious and substantial waste (as it applies to the audit objective)
- previous performance engagements related to the subject matter or entity have reported significant adverse findings.

In determining the level of engagement risk, the performance audit team should consider the engagement risk assessment performed by the financial audit team for their audit of the relevant agency(ies) financial statements.

[1] This factor is likely to arise if the audit has been requested under section 27B(3) of the *Government Sector Audit Act 1983* or section 421E of the *Local Government Act 1993.*