



EUROPEAN  
COURT  
OF AUDITORS

# Financial and Compliance audit Manual

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**Directorate of Audit Quality Control**  
**September 2017**

# OVERVIEW

## PARTS OF THE FINANCIAL AND COMPLIANCE AUDIT MANUAL

**INTRODUCTION**

**PART 1 - GENERAL**

**PART 2 - RELIABILITY OF THE ACCOUNTS (FINANCIAL AUDIT)**

**PART 3 - COMPLIANCE WITH APPLICABLE LAWS AND REGULATIONS  
(COMPLIANCE AUDIT)**

**GLOSSARY AND ACRONYMS**

**DETAILED TABLE OF CONTENTS**

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**Introduction**

1 - General

2 - Reliability of Accounts

3 - Compliance with Applicable  
Laws and Regulations

Glossary and Acronyms

# INTRODUCTION

## TABLE OF CONTENTS

**Purpose and focus of the manual**

**Structure of ECA's audit methodology**

**Structure of the Financial and Compliance Audit Manual**

## PURPOSE AND FOCUS OF THE MANUAL

**Purpose** The manual has been written to help the European Court of auditors (hereafter ECA) to produce high-quality financial and compliance audits. It sets out the principles underlying ECA's approach to such audits and the procedures to be employed.

The aim is to help auditors conduct financial and compliance audits in an economic, efficient and effective manner. To help achieve this purpose, the focus of the manual is on:

- a *risk-based approach*, which focuses the audit effort on areas of exposure to the auditor, the aim being to reach an appropriate conclusion. Risk is revised as further information is obtained in the course of the audit;
- the exercise of *sound judgment*, based on professional standards.

## STRUCTURE OF THE ECA'S AUDIT METHODOLOGY

**ISAs**  
**ISSAIs** The financial and compliance audit manual (FCAM) sets out principles contained in the International Standards on Auditing (ISAs<sup>1</sup>) produced by the International Federation of Accountants (IFAC), and in the standards of the International Organisation of Supreme Audit Institutions (INTOSAI), especially the Financial and Compliance Audit Guidelines (ISSAIs<sup>2</sup>) which are relevant to the ECA's audit, together with guidance on how they are to be applied in the ECA's DAS and other financial and compliance (F/C) audits. The manual is in turn supported by practical guidance, such as checklists, instructions, detailed methods.

**The FCAM does not provide verbatim the full text of the standards, but indicates the most important elements of the standards, to which the auditor/reader should refer in full, where necessary.**

“In carrying out its duties and responsibilities within its mandate as laid down in the Treaty and the Financial Regulation, the ECA conducts its audits in accordance with the IFAC and INTOSAI International Auditing Standards<sup>3</sup>, guidelines and Codes of Ethics, in so far as these are applicable in the European Union context.

Auditors are required to respect the ECA Financial and Compliance Audit

<sup>1</sup> Extracts from Handbook of International Quality Control Auditing, Review, Other Assurance, and Related Services Pronouncements of the International Auditing and Assurance Standards Board, published by the International Federation of Accountants (IFAC) in April 2010 are used with permission of IFAC.

<sup>2</sup> ISSAIs: International Standards of Supreme Audit Institutions

<sup>3</sup> For financial audit, the INTOSAI International Auditing Standards consist of the entire set of IFAC Standards complemented by practice notes adopted by INTOSAI to adapt the former to the public sector context.

Manual as well as all the audit procedures adopted by the ECA.”

The term auditor refers to different competences in the audit process.

## STRUCTURE OF THE FINANCIAL AND COMPLIANCE AUDIT MANUAL

### Three parts

The manual is divided into three separate parts devoted to the following areas:

- principles and procedures applicable to all of the ECA's *financial* and *compliance* audits;
- principles and procedures for audits of the *reliability of the consolidated annual accounts*;
- principles and procedures for audits of *compliance with applicable laws and regulations*.

### comprising four sections

Each part comprises four sections, broken down into a number of chapters.

**Section 1** sets out the **framework** for financial and compliance audits in the European Union context.

**Section 2** describes audit **planning**, including setting materiality, identifying key risk areas through understanding the entity, and designing appropriate audit testing, as the basis for an efficient and effective audit.

**Section 3** identifies the methodologies to be used during the **examination** phase so as to acquire sufficient, relevant and reliable audit evidence, the aim being to reach a conclusion about the audit objective(s).

**Section 4** describes the reports to be produced and the types of opinions that may be provided when **reporting** on the ECA's financial and compliance audits.

Mandatory elements are termed as '**should**' statements throughout the manual.

Users are invited to look first at the chapters in the general part concerning any aspect of audit work on which they seek guidance. For further information about either reliability or compliance audits, users are invited to read the corresponding chapters in the reliability or compliance parts of the manual.

Introduction

**1 - General**

2 – Reliability of Accounts

3 - Compliance with Applicable  
Laws and Regulations

Glossary and Acronyms

# **PART 1. GENERAL**

## **TABLE OF CONTENTS**

**Section 1 - Framework**

**Section 2 - Planning**

**Section 3 - Examination**

**Section 4 - Reporting**

**Appendix I - Inherent risk factors**

**Appendix II - Details relating to internal control components**

**Appendix III - ECA's Statement of Assurance 2015**

**1. GENERAL**

**Section 1 - Framework**  
Section 2 - Planning  
Section 3 - Examination  
Section 4 - Reporting  
Appendices

**PART 1. GENERAL**

**SECTION 1 - FRAMEWORK**

**TABLE OF CONTENTS**

- 1.1 Definition of an assurance engagement**
- 1.2 Applicability of the manual**
- 1.3 What is ECA required to audit?**
- 1.4 What audit reports and opinions must be produced?**
- 1.5 ECA's legal right of access**
- 1.6 ECA's professional obligations regarding financial and compliance audits**
- 1.7 Types and objectives of financial and compliance audits carried out by ECA**
- 1.8 Audit assertions**
- 1.9 Overview of the financial and compliance audit process**
- 1.10 Documentation of audit work**
- 1.11 Quality control**

## 1.1 DEFINITION OF AN ASSURANCE ENGAGEMENT

The ECA conducts its engagements so as to express a conclusion(s) and, where required, an opinion on a given subject, whether it be the reliability of the consolidated annual accounts or compliance with applicable laws and regulations. The ECA's engagements are called assurance engagements, as they are designed to enhance the degree of confidence, or assurance, of the intended users in the subject concerned, by applying objective criteria thereto. An assurance engagement may be:

### Reasonable assurance

*a reasonable assurance engagement* (an audit): this requires the auditor to reduce risk to an acceptably low level so as to obtain reasonable assurance as the basis for a positive form of expression of the conclusion(s) and, where required, an opinion reached on the basis of audit procedures performed (e.g. "the accounts present/do not present fairly...");

### Limited assurance

*a limited assurance engagement* (a review): the auditor performs more limited procedures than those required of an audit, thus enabling him/her to obtain limited or moderate assurance as the basis for a negative form of expression of his/her conclusion ("nothing has come to our attention to indicate that...").

This manual addresses reasonable assurance engagements, which constitute the ECA's current work. Limited assurance engagements that might be undertaken would be subject to the less onerous procedures described in IFAC's International Standards on Review Engagements and in the relevant ISSAI guidelines.

## 1.2 APPLICABILITY OF THE MANUAL

### All annual audits and selected audits

The text of the manual mostly refers to the general budget of the European Union and to the European Commission as the main auditee, as these constitute the ECA's principal audit area. However, this framework applies to all annual financial and compliance audits carried out by the ECA, including those of the European Development Funds (EDFs), agencies, offices and other bodies, as well as other financial or compliance audits selected for implementation.

## 1.3 WHAT IS THE ECA REQUIRED TO AUDIT?

The Treaty on the Functioning of the European Union (TFEU), Article 287, as well as the Regulations for the EDFs and agencies, set out ECA's legal

obligations for financial and compliance audits, and define the terms of ECA's engagements in this regard. For example, the TFEU specifies that ECA:

**(i) Financial audits of the reliability of accounts (Financial audits)**

Examine accounts

*"shall examine the accounts of all revenue and expenditure of the Union ... and of all bodies, offices and agencies set up by the Union in so far as the relevant constituent instrument (i.e. the legislation establishing the body concerned) does not preclude such examination".*

**(ii) Audits of legality and regularity (Compliance audits)**

Examine legality and regularity

*"shall examine whether all revenue has been received and all expenditure incurred in a lawful and regular manner...In doing so, it shall report in particular on any cases of irregularity. The audit of revenue shall be carried out on the basis both of the amounts established as due and the amounts actually paid to the Union. The audit of expenditure shall be carried out on the basis both of commitments undertaken and payments made".*

**(iii) Other audits**

Observations on specific questions

*"may also, at any time, submit observations, particularly in the form of special reports, on specific questions..."* The latter statement allows ECA to carry out selected financial and compliance audits, in addition to those specifically required under (i) and (ii) above.

## 1.4 WHAT AUDIT REPORTS AND OPINIONS MUST BE PRODUCED?

Statement of assurance

Article 287 of the TFEU states that: *"The Court of Auditors shall provide the European Parliament and the Council with a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions.... This statement may be supplemented by specific assessments for each major area of Union activity".*

Annual report

The same Article also states: *"The Court of Auditors shall draw up an annual report after the close of each financial year."* Current practice is that this Statement of Assurance<sup>4</sup> is included in the European Court of Auditors' Annual Report on the implementation of the general budget, which also contains specific assessments of the main Multiannual Financial Framework (MFF) headings.

EDFs, agencies, offices and similar bodies

As required by the applicable Regulations, a similar Statement of Assurance-type opinion and Annual Report is produced for the EDFs. Audit reports are also produced for ECA's audits of the accounts of agencies, offices and similar

<sup>4</sup> Commonly referred to as the DAS (an abbreviation of the French term "déclaration d'assurance").

bodies. In order to provide the respective discharge authority with reports that are comparable on a year-by-year basis and to allow for greater harmonisation in its audit approach, these reports contain DAS-type opinions.

For types of audit reports published please refer to [Chapter 4.1.2, table 14 of the general part](#) of this manual.

## 1.5 ECA'S LEGAL RIGHT OF ACCESS

### Audit to final beneficiary level

The TFEU (Article 287) gives ECA the right to audit *"on the spot in the other institutions of the Union, on the premises of any body, office or agency which manages revenue or expenditure on behalf of the Union and in the Member States, including on the premises of any natural or legal person in receipt of payments from the budget."* This allows ECA to audit down to final beneficiary/recipient- level.

### Duty of discretion

Staff of the European Union is required to exercise the greatest discretion with regard to facts and information coming into their knowledge in the course of or in connection with the performance of their duties<sup>5</sup>. The extensive rights of access to information that are accorded to ECA mean that this duty of discretion is particularly important, especially as the information handled by staff is frequently of a sensitive nature.

## 1.6 ECA'S PROFESSIONAL OBLIGATIONS REGARDING FINANCIAL AND COMPLIANCE AUDITS

### ISAs and ISSAIs

The ECA Audit Policy is to conduct its audits in accordance with the IFAC (ISA) and INTOSAI (ISSAI) standards and Codes of Ethics, insofar as they are applicable in the EU context. The ISAs and ISSAIs are relevant to audits of the reliability of the accounts and, by analogy, to audits of compliance with applicable laws and regulations.

## 1.7 TYPES AND OBJECTIVES OF FINANCIAL AND COMPLIANCE AUDITS CARRIED OUT BY ECA

The purpose of financial and compliance audits is to enable ECA to form a conclusion on the particular audit objectives and, where required, to issue an audit opinion. Based on the legal requirements identified above, ECA's financial and compliance audits typically encompass audits of:

### (i) Reliability of the accounts

the *reliability of the accounts*, which comprise the financial statements and the report(s) on implementation of the budget. The overall audit objective

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<sup>5</sup> Staff Regulations of Officials of the EC, Articles 17-19; Conditions of Employment of Other Servants of the EC, Article 11.

for reliability is to establish whether the consolidated annual accounts present fairly, in all material respects, the financial position and the results of operations and cash flows in accordance with the applicable financial reporting framework.

**(ii) Legality and regularity of underlying transactions**

the *legality and regularity of transactions underlying the accounts*. The overall audit objective for compliance is to establish whether the transactions comply, in all material respects, with the applicable laws and regulations (i.e. the TFEU, the Financial Regulation, Implementing Rules, specific regulations, financing decisions and contractual provisions).

**(iii) Selected compliance audits**

*selected topics*, chosen on the basis of their priority at a given time. The objectives of such audits depend on the nature of the particular audit task, e.g. investigation of the causes of a high incidence of illegal or irregular transactions identified in previous audits, or the functioning of a particular control system at Commission and Member State level.

*Financial and compliance audits entail testing the effectiveness of internal control systems*. This may pertain to those systems concerned with (i) the reliability of the consolidated annual accounts or (ii) preventing or detecting and correcting illegal and irregular revenue and expenditure.

## 1.8 AUDIT ASSERTIONS

**Definition of assertions**

The above audit objectives are supported by specific audit objectives. The latter can also be thought of as assertions or representations made by auditee management. Such assertions may be explicit (e.g. where auditee management states that the accounts are prepared based on IPSASs) or implicit (e.g. where auditee management implies that transactions for which payments have been made are eligible according to the relevant rules). The auditor uses assertions to consider the different types of potential misstatement or non-compliance that may occur. The specific assertions for reliability, legality and regularity, and internal control systems are as follows:

**Reliability:**  
**for the period**

**Reliability**

**(a) Assertions about classes of transactions and events for the period under audit**

*Occurrence*—transactions and events that have been recorded have occurred and pertain to the entity.

*Completeness*—all transactions and events that should have been recorded have been recorded.

*Accuracy*—amounts and other data relating to recorded transactions and events have been recorded appropriately.

*Cut-off*—transactions and events have been recorded in the correct accounting period.

*Classification*—transactions and events have been recorded in the proper accounts.

at period end

*Legality and regularity*—budgetary appropriations are available<sup>6</sup>.

**(b) Assertions about account balances at period end**

*Existence*—assets, liabilities, and equity interests exist.

*Rights and obligations*—the entity holds or controls the rights to assets, and liabilities constitute obligations for the entity.

*Completeness*—all assets, liabilities and equity interests that should have been recorded have been recorded.

presentation

*Valuation and allocation*—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

**(c) Assertions about presentation and disclosure**

*Occurrence and rights and obligations*—disclosed events, transactions, and other matters have occurred and pertain to the entity.

*Completeness*—all disclosures that should have been included in the financial statements have been included.

*Classification and understandability*—financial information is appropriately presented and described, and disclosures are clearly expressed.

Legality and regularity

*Accuracy and valuation*—financial and other information is disclosed fairly and at appropriate amounts.

Legality and regularity

*Reality and measurement*—underlying operations exist and are accurately determined

*Eligibility of underlying transactions*—eligibility criteria are met for the various transactions

*Compliance with other regulatory requirements*—other (non-eligibility) criteria are met

*Correctness of calculations*—all calculations are correctly undertaken

*Completeness and accuracy of accounting*—all transactions are accounted for, are not included more than once, and are recorded in the correct accounting period and at correct value

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<sup>6</sup> An illegal and irregular transaction is not declared as affecting the reliability of the accounts if it has been correctly entered in the accounts. However, the financial impact or risks of irregularities must be disclosed adequately.

**Table 1: Types and objectives of financial and compliance audits**

	Financial Audits	Compliance Audits	
<b>Subject</b>	Reliability of the annual annual accounts	Legality and regularity of underlying transactions	Compliance with applicable laws and regulations for selected topic
	Effectiveness of internal control systems <sup>7</sup>		
	Recurrent tasks: audit programme for these audits remains generally unchanged from year to year		Selected task: audit programme depends on the specific objective of the audit
	Recurrent or selected task		
<b>Task substance</b>	Examine accounts, determine if they give a true and fair view	Review procedures and financial records to determine whether laws, regulations, rules and procedures set out by legislation are being followed; test the reality and legality of underlying transactions.	
	Test systems to determine if they are effective for purpose (reliability or compliance)		
<b>Assertions</b>	Occurrence; completeness; accuracy; cut-off; classification; legality and regularity; existence; rights and obligations; valuation and allocation. Distinguish between events for the period, those at period end, and presentation	Occurrence; completeness; accuracy; cut-off; existence; rights and obligations; valuation; and eligibility.	Depends on the audit objective(s)
	Proper design, maintenance and continuous effective operation of systems		

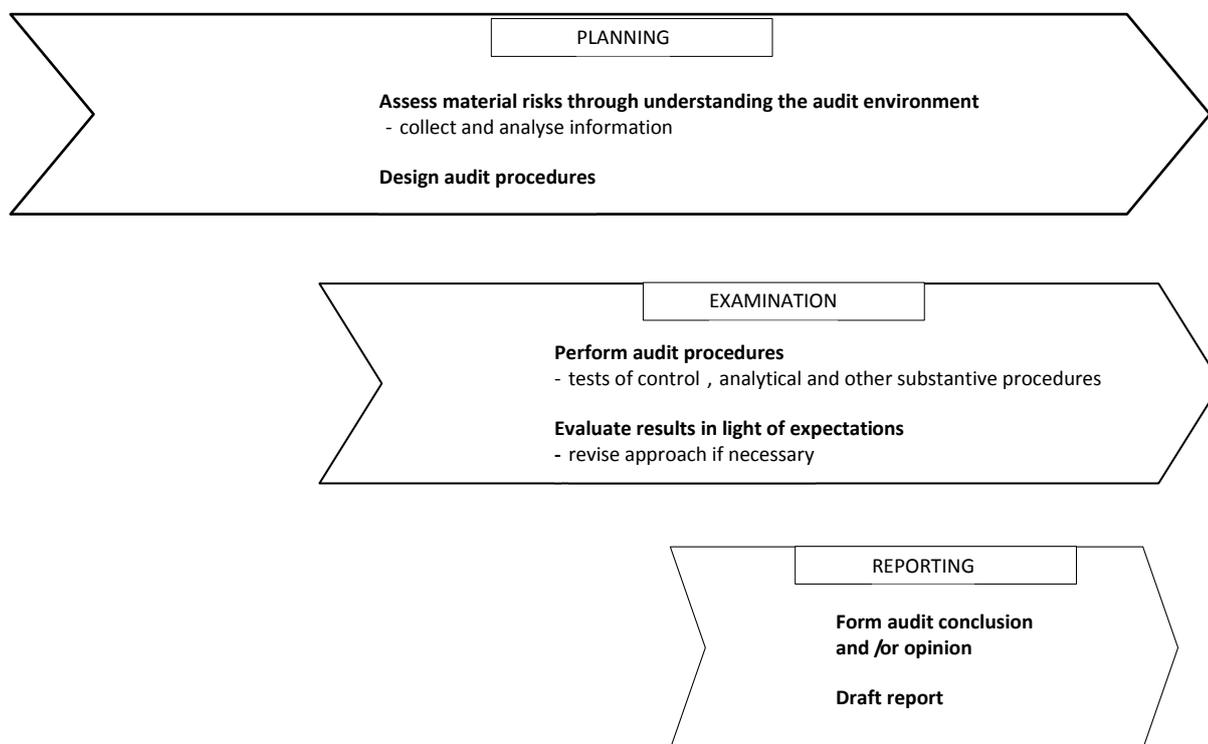
## 1.9 OVERVIEW OF THE FINANCIAL AND COMPLIANCE AUDIT PROCESS

### Decision-making process based on judgment

ECA's financial and compliance audits consist of a process of gathering, updating and analysing information from different sources, in order ultimately to make decisions, draw conclusions and, where required, issue an audit opinion, based on sound professional judgment. Although the planning, examination and reporting phases are presented sequentially in this manual, the whole process is iterative, as illustrated below. Accordingly, the auditor may perform some of the procedures concurrently or may, at any point in the process, return to and reconsider a previous step based on new information.

<sup>7</sup> Effectiveness of internal control systems - the system has been properly designed and maintained, and was in continuous effective operation throughout the period

**Figure 1: Timing of the audit process**



## 1.10 DOCUMENTATION OF AUDIT WORK

ISSAI 1230  
[ISA 230]

*The objective of the auditor is to have a sufficient and appropriate record of the basis for the auditor's report, and evidence that the audit was planned and performed in accordance with ISSAIs and applicable legal and regulatory requirements.*

ISSAI 4000<sup>8</sup>

*The auditor shall prepare audit documentation that is sufficiently detailed to provide a clear understanding of the work performed, evidence obtained and conclusions reached. The auditor shall prepare the audit documentation in a timely manner, keep it up to date throughout the audit, and complete the documentation of the evidence supporting the audit findings before the audit report is issued.*

- 1.10.1 Timely Preparation of Audit Documentation
- 1.10.2 Documentation of the Audit Procedures Performed and Audit Evidence Obtained
- 1.10.3 Assembly of the Audit Files
- 1.10.4 Changes to Audit Documentation

### 1.10.1 Timely Preparation of Audit Documentation

The auditor **should** prepare audit documentation on a timely basis.

### 1.10.2 Documentation of the Audit Procedures Performed and Audit Evidence Obtained

The auditor **should** prepare the audit documentation so as to enable an experienced auditor not having participated in the audit to understand: the nature, timing and extent of audit procedures performed; the results of the audit procedures and the audit evidence obtained; and significant matters arising during the audit, the conclusions reached, and significant professional judgements made in reaching those conclusions.

The auditor **should** have (i) a sufficient and appropriate record of the basis for the audit conclusions and, where appropriate, the audit opinion, and (ii) evidence that the audit was performed in accordance with international auditing standards and applicable legal and regulatory requirements. The planning, examination and reporting of the audit **should** be documented on a timely basis in ECA's electronic audit support system, which contains standard audit programmes, workpapers and, where appropriate, in hard

Evidence that is  
timely, in electronic or other format

<sup>8</sup> Paragraph 89.

copy files.

### 1.10.3 Assembly of the Audit Files

The auditor **should** complete assembly of the final (current) audit file on a timely basis after the date of the auditor's report.

in permanent or current files

Information of a long-term nature which is useful for future audits **should** be kept in a permanent file which is updated regularly, while information on the audit in progress **should** be included in a current file.

### 1.10.4 Changes to Audit Documentation

If, in exceptional circumstances, after the date of the auditor's report the auditor has to perform new or additional audit procedures or draw new conclusions, the auditor **should** document: the circumstances encountered; the new additional audit procedures performed, audit evidence obtained, and conclusions reached; and when and by whom the resulting changes to audit documentation were made and, reviewed.

## 1.11 QUALITY CONTROL

### 1.11.1 Definition of quality control

### 1.11.2 Elements of a system of quality control

***The objective of ECA is to establish and maintain a system of quality control to provide it with reasonable assurance that:***

**ISQC1  
ISSAI 40**

***(a) ECA and its personnel comply with professional standards and applicable legal and regulatory requirements; and***

**[ISA 220]**

***(b) Reports issued by ECA are appropriate in the circumstances.***

**ISSAI 4000<sup>9</sup>**

***The ECA shall take responsibility for the overall quality of the audit to ensure that the audits are carried out in accordance with relevant professional standards, laws and regulations, and that the reports are appropriate in the circumstances.***

***The ECA shall ensure that the audit team collectively has the necessary professional competence to perform the audit.***

### 1.11.1 Definition of quality control

<sup>9</sup> Paragraphs 80 & 85

Quality control consists of all measures taken and procedures carried out within the audit process that seek to guarantee the quality of audit work and of the resulting report.

### 1.11.2 Elements of a system of quality control

The ECA has established and maintains a system of quality control that includes policies and procedures that address each of the following elements:

- (a) Leadership responsibilities for quality within ECA.
- (b) Relevant ethical requirements.
- (c) Acceptance and continuance.
- (d) Human resources.
- (e) Engagement performance (quality control).
- (f) Monitoring (quality assurance).

The ECA documents its policies and procedures and communicates them to its personnel.

Maintaining a system of quality control requires ongoing monitoring and a commitment to continuous improvement.

1. GENERAL

Section 1 - Framework  
**Section 2 - Planning**  
Section 3 - Examination  
Section 4 - Reporting  
Appendices

PART 1. GENERAL

**SECTION 2 - PLANNING**

TABLE OF CONTENTS

**2.1 Planning overview**

**2.2 Determining materiality**

2.3 Identifying and assessing the risk of material misstatement ~~risks~~ through understanding the auditee and its environment

**2.4 Considering the sufficiency, relevance and reliability of audit evidence**

**2.5 Designing audit procedures**

**2.6 Drawing up the Audit Planning Memorandum and Audit Programme**

## 2.1 PLANNING OVERVIEW

ISSAI 1300  
[ISA 300]

*The objective of the auditor is to plan the audit so that it will be performed in an effective manner.*

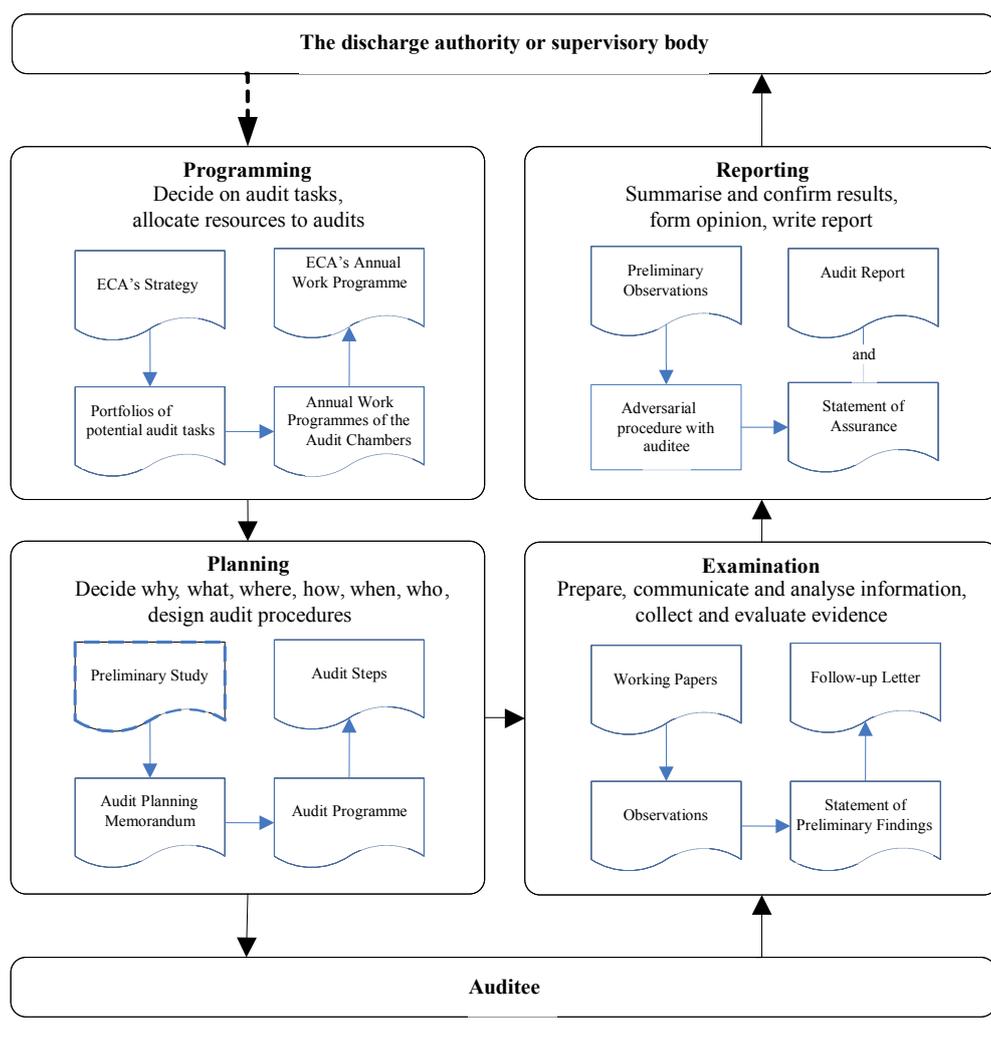
- 2.1.1 Programming as the starting point of the audit task
- 2.1.2 What is meant by planning an audit
- 2.1.3 Importance and nature of planning
- 2.1.4 Steps in the planning phase

### 2.1.1 Programming as the starting point of the audit task

#### Annual Work Programme

ECA's Annual Work Programme (AWP) identifies the audit tasks to be performed in a given year, encompassing financial, compliance and performance audits, as well as the resources allocated to such tasks and their planned completion dates. Individual audit tasks are then undertaken in line with the AWP, and begin with the planning of the task, as the basis for carrying out audit work which aims to reach a conclusion about the audit objective(s) and, where required, form an audit opinion, as shown.

**Figure 2: The audit from beginning to end**



## 2.1.2 What is meant by planning an audit

<b>Reduce risk of wrong conclusions</b>	<p>Planning an audit involves collecting and assessing information and making decisions as to the audit scope, approach, timing and resources. The aim is to perform audit work that reduces, to an acceptably low level, the risk of reaching a wrong conclusion or, where required, an opinion on the audit objective(s).</p>
<b>Outputs of planning</b>	<p>The outputs of audit planning are an Audit Planning Memorandum (APM), which commits the resources and sets out the overall strategy for the audit, and Audit Programmes, which contain the instructions for the nature, timing and extent of audit work to be performed. Audit work <b>should not</b> be started until the APM has been adopted by the chamber responsible.</p>

## 2.1.3 Importance and nature of planning

<b>Basis for quality audit</b>	<p>Good planning helps to ensure that audit effort is allocated on the basis of risk; potential problems are identified and resolved on a timely basis; and the audit is properly organised and managed in order to be performed in an economic, efficient and effective manner.</p>
<b>Iterative process</b>	<p>The nature and extent of planning activities will vary according to the size and complexity of the audited subject and the auditor's previous experience with the auditee. Although concentrated in the planning phase, audit planning does not only take place at this stage, but is rather a continual and iterative process; it is an activity that continues throughout the audit, responding to new circumstances such as unforeseen changes in the auditee's operations or systems, or unexpected results coming to light during the examination phase of the audit.</p>
<b>Requiring professional judgment and scepticism</b>	<p>It must be recognised that a financial or compliance audit is not a series of mechanical steps to be completed. Most importantly, <i>professional judgment and scepticism</i> <b>should</b> be exercised when planning, as well as performing and reporting on audits. Auditors <b>should</b> also take account of knowledge obtained from relevant performance audits in the area.</p>

## 2.1.4 Steps in the planning phase

<p>The auditor needs to plan how (s)he will:</p>	
<b>Determine materiality</b>	<p>(a) <i>determine materiality</i>, both from a quantitative and qualitative perspective;</p>

- |  |   |
|--|---|
| <i>Identify and assess material risks</i>                              | (b) <i>identify and assess material risks</i> through understanding the entity and its environment, including its internal control;               |
| <i>Design audit procedures</i>   | (c) <i>design audit procedures</i> regarding the nature, timing and extent of the audit work to be performed in response to the risks identified; |
| <i>Draw up an Audit Planning Memorandum (APM) and audit programme.</i> | (d) <i>draw up an Audit Planning Memorandum (APM) and audit programme.</i>  |

Each of these aspects is addressed in turn in the following chapters in this section.

## 2.2 DETERMINING MATERIALITY

ISSAI 1320  
[ISA 320]

*The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.*

ISSAI 1450  
[ISA 450]

- 2.2.1 Introduction and definition
- 2.2.2 A focus on the users of information
- 2.2.3 Reasons for establishing materiality
- 2.2.4 When to consider materiality
- 2.2.5 Quantitative and qualitative aspects
- 2.2.6 Documenting materiality

### 2.2.1 Introduction and definition

Materiality is a fundamental concept in financial and compliance audit. It sets the level of deviation that the auditor considers is likely to influence users of the financial information (e.g. financial statements).

An item or group of items may be material due to their amount, nature (inherent characteristics) or the context in which the deviation occurs.

### 2.2.2 A focus on the users of information

Consider what is important to users

users' expectations. In ECA's context, if users do not or cannot provide information as regards what is material to them, the auditor determines materiality at the earliest possible stage during audit planning.

Variety of users

Users of information in the EU context, who must be considered when determining materiality, are primarily the European Parliament and Council (in particular due to the discharge procedure) but also the Commission and other EU institutions, Member State authorities, media and the general public. Given the variety of users, determining materiality is a matter of professional judgment.

Professional judgment

### 2.2.3 Reasons for establishing materiality

Helps to determine the extent of audit tests and to evaluate results

Setting materiality limits helps the auditor to plan the audit so as to ensure that material deviations are detected by audit tests and ECA's resources are employed economically, efficiently and effectively. Auditing to a stricter (lower) materiality threshold requires more audit testing; however, the auditor must avoid "over-auditing" in areas that do not merit extensive work.

## 2.2.4 When to consider materiality

Materiality **should** be considered by the auditor during:

<i>Planning</i>	<i>planning</i> , to help assess material risks and determine the nature, timing and extent of audit procedures;
<i>Examination</i>	<i>examination</i> , when considering new information that may require planned procedures to be revised, and evaluating the effect of deviations;
<i>Reporting</i>	<i>reporting</i> , when reaching final conclusions and, where required, forming an audit opinion.

## 2.2.5 Quantitative and qualitative aspects

Auditors **should** consider both quantitative and qualitative materiality.

Quantitative materiality is numerical

(i) *Quantitative materiality* is determined by setting a numerical value - the *materiality threshold*. This threshold serves as a determining factor both in the calculation of sample sizes for substantive testing and in the interpretation of the results of the audit.

The numerical value is achieved by taking a *percentage* of an appropriate *base*, which both reflect, in the auditor's judgment, the measures that users of the information are most likely to consider important.

0,5 - 2%

For ECA, the threshold *percentage* is between 0,5% and 2%. While the choice is a matter of judgment, a threshold of 2% is generally used. Based on users' expectations (see 2.2.2) a different threshold may be applied. In addition to the threshold percentage, a ceiling may also be set in terms of the absolute amount.

of expenditure or revenue, or balance sheet

The *base* is usually total expenditure (i.e. utilisation of commitment appropriations for the audit of commitments and utilisation of payment appropriations for the audit of payments) or total revenue for audits of legality and regularity, or the balance sheet amount for reliability audits.

with threshold reviewed

Because ECA's recurrent (i.e. annual) financial and compliance audits are generally planned before the final accounts are available, a tentative materiality threshold is set using budget rather than actual data. As actual

data on expenditure or revenue becomes available, the auditor **should** review the materiality threshold to determine whether it remains suitable.

**Qualitative materiality**

(ii) *Qualitative materiality* **should** also always be assessed by auditors. Even though quantitatively immaterial, certain types of misstatements or irregularities could have a material impact on or warrant disclosure in financial reports. Qualitative materiality includes items that may be either:

**material by nature**

*material by nature*: this is related to *inherent characteristics* and concerns issues where there may be specific disclosure requirements or high political or public interest. It includes any suspicion of serious mismanagement, fraud, illegality or irregularity or intentional misstatement or misrepresentation of results or information;

**material by context**

*material by context*: this concerns items that are *material by their circumstance*, so that they change the impression given to users. It includes instances where a minor error may have a significant effect, e.g. misclassification of expenditure as income, so that an actual deficit is reported as a surplus in financial statements.

An example would be where, while the total value of irregularity errors is below the materiality threshold, the auditor is aware that the Budgetary Control Committee has expressed a special interest in irregularities, and thus considers that those found merit mention in ECA's report. Issues that are material by nature or context are to be disclosed; however, only in exceptional cases- to be decided by ECA - are they to be taken into consideration in the audit opinion.

## 2.2.6 Documenting materiality

The auditor **should** document the materiality levels and changes made thereto during the audit.

## 2.3 IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT RISKS THROUGH UNDERSTANDING THE AUDITEE AND ITS ENVIRONMENT

ISSAI 1315  
[ISA 315]

*The objective of the auditor is to identify and assess the risks to the audited entity not meeting its objectives<sup>10</sup>, thereby providing a basis for designing and implementing audit procedures. Such risks are identified and assessed through understanding the entity and its environment, including its internal control.*

- 2.3.1 Audit risk and risk assessment procedures
- 2.3.2 Understanding the entity and its environment
- 2.3.3 identifying and assessing inherent risk
- 2.3.4 The entity's internal control
- 2.3.5 Understanding the entity's internal control
- 2.3.6 Identifying and assessing control risk
- 2.3.7 Setting detection risk
- 2.3.8 Assurance model
- 2.3.9 Documentation

### 2.3.1 Audit risk and risk assessment procedures

**Definition of assurance and audit risk**

It is not normally practical or cost-effective for auditors to collect evidence in order to have absolute (100%) assurance or confidence of detecting all material deviations. Instead, auditors try to ensure that their conclusions and opinions are based on reasonable assurance which is obtained from the audit work.

**Audit risk generally 5% for reasonable assurance**

Audit risk is the inverse of audit assurance. It is the risk that the auditor is willing to tolerate coming to a wrong conclusion. In practice, audit risk is unavoidable. The ECA has determined as a matter of policy that audit risk is *normally* 5% for audits providing reasonable assurance. As a consequence the degree of assurance is  $DA = 100 - AR = 95\%$ .

**Components of audit risk**

The components of audit risk are:

- inherent risk, relating to the nature of the entity;
- control risk, concerning the entity's controls; and
- detection risk - the risk that the auditor does not detect deviations.

Assessment of risks is a *judgment* rather than a precise measurement. The level attributed to each component is estimated by the auditor on the basis of his/her professional judgment, informed by the procedures outlined below.

**Audit risk model**

The audit risk model, as shown below, helps auditors to determine how comprehensive the audit work must be so as to attain the desired assurance for their conclusions.

<sup>10</sup> Depending on the type of audit, the relevant objectives may concern reliability of the accounts, compliance with applicable laws and regulations, or proper functioning of systems.

$$\text{Audit risk (AR)} = \text{Inherent risk (IR)} \times \text{Control risk (CR)} \times \text{Detection risk (DR)}$$

**Equation in balance**

This equation must always be in balance. The higher the auditor assesses the level of inherent and/or control risk to be, the lower the detection risk must be. This requires more substantive audit work (larger sample sizes). Equally, the lower the combined inherent and control risk is assessed to be, the higher the detection risk will be. This in turn means less substantive work and more systems work. More systems and controls need to be tested as the planning assumption must be verified and because the systems work also contributes to the overall assurance. Fraud risk is an element of both inherent and control risk.

Audit risk **should** be considered when:

- planning the audit, including the design of audit procedures;
- carrying out audit procedures; and
- evaluating the results of the audit tests carried out.

**Procedures to identify and assess risk**

In order to identify and assess the risk of the entity not meeting its objectives in relation to reliability and compliance, and thus help design the audit procedures to be undertaken, the auditor **should** perform risk assessment procedures as early in the audit as possible, based on various sources of information, as illustrated in Table 2 below.

**include entity's risk assessment process**

The entity's own risk-assessment process can be a source of information. For example, at the European Commission, the annual Management Plan (MP) contains ~~the~~ an analysis of internal control and risk management for the Directorate-General (DG) concerned and the Annual Activity Report (AAR) provides an overview of critical risks encountered and their impact on the achievement of the DG's objectives. However, the auditor **should** exercise professional scepticism, as risks identified by the auditee may not address those that are of importance for audit purposes, and such information may be biased.

**Table 2: Risk assessment procedures**

Risk assessment procedures	Sources of information
<i>Analysis</i> of relationships in and between financial and non-financial information, through a study of plausible relationships, including trends and ratios. Examples include comparison of actual information against budget, licence income to number of licences, and import duties to physical import data.	Financial and non-financial information, in order to provide a broad initial indication of unusual or unexpected relationships.
<i>Inspection</i> consists of examining records or documents, whether internal or external, in paper form, electronic form, or other media, or tangible assets.	Visits to the entity's premises and facilities
	Internal documents - MP, records, manuals
	Other information - the auditee's budget; AAR
	External information- economic journals; regulatory and financial publications
	Findings from previous audits by ECA, Internal Audit Service (IAS), Internal Audit Capabilities (IACs), Supreme Audit Institution (SAI), or the Commission's anti-fraud office (OLAF)
<i>Observation</i> consists of looking at a process or procedure being performed by others. It provides information about the performance of the process or procedure, but is limited to the point in time at which the observation takes place.	Observation of entity activities and operations being carried out
<i>Inquiry</i> consists of seeking information of knowledgeable persons, inside or outside the audited entity.	Those charged with governance, management and others within the entity

These risk-assessment procedures are employed in order to gain an understanding of the following, each of which is discussed below:

the entity and its environment, thereby identifying the *inherent risks* in the area under consideration, including risks as regards related parties and fraud;

the internal control arrangements at each relevant level (Commission, Member State, intermediary, beneficiary), to help identify the *control risks*.<sup>11</sup>

### 2.3.2 Understanding the entity and its environment

#### Understanding the entity's business

Auditors acquire an understanding of the entity so as to have a frame of reference within which to plan and perform the audit and to exercise sound professional judgment.

<sup>11</sup> This preliminary assessment of control risk is to be distinguished from the in-depth evaluation of internal control that will be required if tests of controls are undertaken as part of the overall audit approach.

so as to help reach a conclusion about audit objectives

The auditor's understanding of the entity and its operations **should** focus on those elements necessary to help reach a conclusion about the audit objectives. Typically, (s)he needs to acquire an understanding of the following:

*Legal framework* - legal basis for the activity and relevant parts of the Financial Regulation, Implementing Rules and other rules and regulations.

*General organisation and governance* of the activity/audited entity, including operational structure, resources and management arrangements.

*Business processes* - the policy concerned, objectives and strategies, locations, and types/volume/values of programmes/projects.

*Business risks* related to the entity's objectives and strategies that may result in material deviations. This includes an understanding of the entity's related party relationships and transactions (e.g. obtain from management the names of related parties, the nature of the relationships, and any transactions entered into with such parties during the period).

*Performance measures* – an understanding of such measures (e.g. performance indicators, variance analysis) allows the auditor to consider whether pressures to achieve performance targets may result in management actions that increase the risk of material misstatement or irregularity.

Understanding the applicable management method

While the Commission is responsible for overall implementation of the budget (Article 317 of the TFEU), the Financial Regulation<sup>12</sup> provides for three different management methods for budget implementation. Each method involves a different allocation of roles and responsibilities for the implementation of the budget, which **should** be taken into account when planning, undertaking and reporting on an audit.

*Direct management* - The Commission executes the budget directly through its services, including through its staff in the EU Delegations or through the Executive Agencies.

*Shared management (with Member States)* - The Commission relies on the Member States to implement certain policies (for example, the management of the European Agricultural Guarantee Fund is entrusted to national bodies).;

*Indirect management* - Under this management mode the Commission

<sup>12</sup> Article 53 58 of the Financial Regulation applicable to the general budget of the European Union and its rules of application, Regulation (EU, Euratom) no 966/2012 of the European Parliament and of the Council of 25/10/2012 on the financial rules applicable to the general budget of the Union and repealing Council Regulation (EC, Euratom) No 1605/2002 (OJ L298 of 26/10/2012), and Commission delegated Regulation (EU) no 1268/2012 of 29/10/2012 on the rules of application of Regulation (EU, Euratom) No 966/2012 of the European Parliament and of the Council on the financial rules applicable to the general budget of the Union (OJ L362 of 31/12/2012).

delegates budget execution tasks to several types of partners: international organisations, decentralised agencies and joint undertakings, national agencies, specialised EU bodies or third countries.

**Understanding the specific regulations**

Specific regulations exist for each activity (e.g. each policy area in the Commission), setting out the specific requirements for that area of activity, including any multiannual nature of EU activities. The auditor **should** acquire a good understanding of such specific regulations during the planning phase.

### 2.3.3 Identifying and assessing inherent risk

**Definition of inherent risk**

Inherent risk is the risk, related to the *nature of the activities, operations and management structures* that deviations will occur which, if not prevented or detected and corrected by internal control, will result in the entity's objectives in terms of reliability and legality/regularity not being achieved. Inherent risk is estimated by the auditor, based on his/her understanding of the entity's activities.

**High or Not high**

The auditor **should** make a preliminary assessment of inherent risk at the overall level (e.g. as regards the policy area or agency as a whole) in order to identify risk areas specific to the audit that must be taken into account when planning and carrying out audit procedures. The auditor may assess inherent risk to be High or Not High. In areas where inherent risk is high, assurance is needed that control risk is being managed adequately.

**Significant risks**

The auditor **should** determine which of the inherent risks identified are, in his/her judgment, risks that require special audit consideration (significant risks). For such risks, the auditor **should** obtain an understanding of the relevant internal controls. If appropriate controls do not exist for significant risks, this may indicate a material weakness in the entity's internal control.

Areas of significant risk can include transactions that:

- are complex, unusual, non-routine, or outside the normal course of business (less likely to be subject to controls), or involve third parties;
- are subject to a high degree of subjectivity in their measurement (requiring estimates and assumptions, or the exercise of judgment by auditee management);
- have the potential for fraud.

A listing of inherent risk factors is included in [Appendix I](#).

## 2.3.4 The entity's internal control

### Definition of internal control<sup>13</sup>

Internal control is an integral process (i.e. a series of actions that permeate an entity's activities) that is effected by an entity's management and personnel. International standards use the terminology "Internal Control", in the European context the terminology "Supervisory and Control Systems" is used. Internal control is designed to address risks and to provide reasonable assurance that, in pursuit of the entity's mission, the following general objectives are being achieved:

- fulfilling accountability obligations;
- complying with applicable laws and regulations;
- safeguarding resources against loss, misuse and damage;
- executing orderly, ethical, economical, efficient and effective operations.

### (ii) Components of internal control

Internal control systems, including information technology (IT) systems, can be divided into five interrelated control components, as follows:

**Table 3: Internal control components**

CONTROL COMPONENT	PURPOSES
<b>Control environment</b>	To provide for the fundamental organisational structure, discipline and values of the entity. This creates an appropriate framework to ensure good governance of the resources entrusted.
<b>Risk assessment</b>	To identify and analyse internal and external risks to the achievement of the entity's objectives. In the Commission, all activities must have <i>objectives</i> that are intended to be <i>specific, measurable, achievable, relevant and timely (SMART)</i> , as well as risk analysis and risk management of the main activities.
<b>Control activities</b>	To define the policies and specific procedures implemented by the entity to ensure that the identified risks are appropriately managed. They include a range of activities as diverse as authorisations, verifications, reviews of operating performance, information processing, physical controls and segregation of duties. Control activities include controls over related party relationships and transactions.
<b>Information &amp; communication</b>	To ensure an appropriate framework for achieving the financial reporting and compliance objectives; it includes the accounting system, procedures and records to initiate, record, process and report transactions and to maintain accountability for the related assets, liabilities and equity.
<b>Monitoring</b>	To ensure ongoing assessment of performance. This includes internal audit and evaluation, as well as the annual review of internal control.

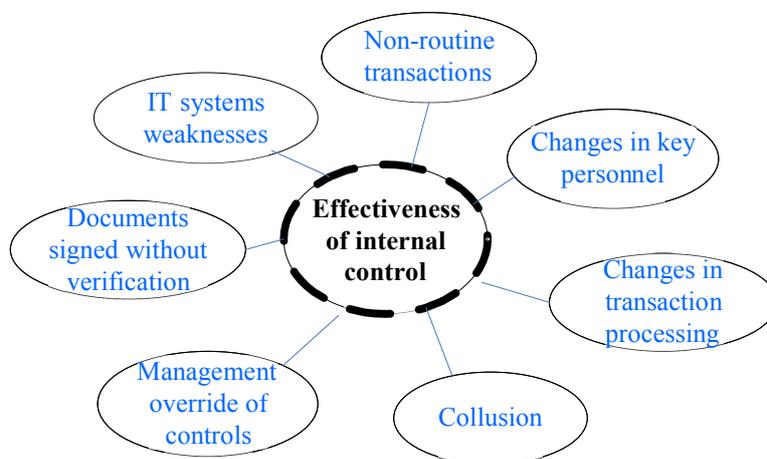
<sup>13</sup> Based on INTOSAI GOV 9100 Definition as per INTOSAI "G-guidelines for internal control standards for the public sector."

The auditor **should** obtain an understanding of these control components.

**Limitations of internal controls**

When evaluating and testing controls, the auditor **should** carefully consider the inherent limitations of internal controls, as well as the cost-effectiveness of testing controls. Internal controls can only provide *reasonable* assurance that control objectives are achieved. Furthermore, audit evidence cannot be obtained solely from internal controls as the following inherent limitations can affect their effectiveness:

**Figure 3: Examples of limitations on the effectiveness of internal control**



By carrying out tests of controls, the auditor is seeking positive proof of the existence of key controls (those controls that are designed to prevent, or detect and correct, a material deviation), and their continuous, consistent and effective operation. However, the evidence obtained is often only weakly persuasive or negative (e.g. lack of a required signature), rather than convincing and positive (i.e. that the control did in fact take place).

**2.3.5 Understanding the entity's internal control**

**Auditor's objectives in understanding internal control**

The auditor's objectives in understanding and making a preliminary evaluation of internal control **should** be defined at the outset. These objectives may include:

*to help design the nature, timing and extent of audit procedures.* The auditor may be able to limit the amount of substantive testing if key controls are found to be properly designed and operating continuously and

effectively throughout the period under review. Under this system-based approach, the auditor aims to obtain some of the required confidence from the entity's internal control and can thus reduce the degree of confidence to be obtained from substantive testing;

*to gain an understanding of the extent to which improvements in internal control systems are being made year-on-year.* In this way, feedback can be provided to auditee management and the discharge authority, e.g. conclusions on the effectiveness of internal control which helps to fulfil ECA's mission of contributing to improving the financial management of EU funds;

*to reach conclusions about the effectiveness of an internal control system,* where this is the specific objective of the audit, e.g. for certain selected audit tasks or for additional reporting on the effectiveness of internal control in the context of the DAS.

Irrespective of the auditor's objective in identifying and evaluating internal controls, during the planning phase (s)he:

**Evaluate design and determine if implemented**

(i) *Evaluates the design* of internal controls relevant to the audit, by considering whether the controls, individually or in combination with other controls, are capable of effectively preventing, or detecting and correcting, deviations.

(ii) *Determines whether they have been implemented* (i.e. they exist and the entity is using them).

**Walk-through tests**

The auditor considers the design of a control when determining whether to consider its implementation. In order to understand and confirm the operation of a control, (s)he carries out "*walk-through tests*" of a small number of transactions (no more than three). Obtaining an understanding of an entity's controls **should not** be considered to be a test of their operating effectiveness; such testing is carried out in the examination phase.

**Focus on relevant key controls**

Only those controls that are relevant to the audit objective **should** be considered. It is a matter for the auditor's professional judgment as to whether a control, individually or in combination with others, is relevant. Furthermore, the auditor **should** consider which controls are to be considered as key. The number of key controls to be selected for testing is the absolute minimum to ensure that all relevant risks are covered.

Relevant factors may include such matters as:

- Materiality.
- The significance of the related risk.

- The size of the entity.
- The nature of the entity's business, including its organisation and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

#### Top-down approach

To ensure an economic, efficient and effective audit, the audit approach **should** seek to place reliance on controls at the highest level where the control is judged to be effective for audit purposes ("top-down approach"). In the EU context, controls exist at a number of different levels:

*Commission controls:* The monitoring or supervisory controls implemented by the Commission are likely to involve a high degree of aggregation and a low level of detail, with a focus on exception reporting;

*Member State controls:* Controls here will be at a more detailed level, and may include budgetary monitoring, variance analysis, and monitoring of progress;

*Controls by paying agency, managing authority, certifying body or audit authority:* Control is based on detailed procedures relating to individual transactions or small groups of transactions, including controls over information processing.

#### Manual or automated controls

The use of manual or automated elements in internal control affects the manner in which transactions are initiated, recorded, processed, and reported. To understand internal control, the auditor **should** consider whether the entity has responded adequately to the risks arising from the use of IT (inaccurate processing, unauthorised access and changes, potential loss of data) or manual systems (controls may be bypassed or overridden, simple errors and mistakes may occur) by establishing effective controls.

## 2.3.6 Identifying and assessing control risk

#### Definition of control risk

Control risk is the risk that the internal control arrangements will fail to prevent material deviations, or to detect and correct them on a timely basis. Control risk is *assessed by the auditor*, based on his/her evaluation of the entity's internal control. Where control risk is likely to be high, the auditor

**should** mostly obtain the required assurance from substantive testing, as reliance cannot be placed on internal controls.

**Compensating controls**

The preliminary assessment of control risk requires the auditor to consider the five components of internal control (see [Appendix II](#) for further details). However, the auditor's primary consideration is whether, and how, a specific control prevents, or detects and corrects, deviations, rather than its classification as a particular component. If an expected control does not exist, auditors **should** enquire about any *compensating controls* that may be in place that would have the same effect. The auditor's assessment of control risk may be *Low, Medium or High*, as follows:

**Table 4: Assessment of internal controls and related control risk**

<i>Status of internal control</i>	<i>Control risk</i>	<i>Description</i>
Excellent	Low	In circumstances where information is available from recent audits in the same area that indicates that internal control is excellent in its design and implementation.
Good	Medium	Internal control appears to be in place and properly designed, and is likely to operate effectively and continuously throughout the period under review.
Poor	High	Internal control is non-existent, poorly designed or appears to be poorly implemented.

**IT system**

In addition to evaluating the control risk for all significant risks, the auditor **should** also evaluate the entity's controls over those risks for which, in the auditor's judgment, it is not possible or practicable to reduce risks to an acceptable level using only substantive procedures. This is the case, for instance, if an entity's information system permits highly automated processing with minimal manual intervention; only evaluation and testing of controls as to the accuracy and completeness of information will provide sufficient appropriate audit evidence.

The overall assessment of control risk **should** be no better than the assessment of the control environment, as even 'excellent' control procedures can be undermined by a poor control environment.

**Tests of controls**

Auditors **should** design and perform tests of controls where:

- (a) the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating

effectively (that is, the auditor intends to rely on the operating effectiveness of controls when determining the nature, timing and extent of substantive procedures); or

(b) substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

#### Reaching a conclusion about system design

The auditor can now, on the basis of his/her evaluation of the relevant key high-level controls, reach overall conclusions about the system design. If the auditor assesses that internal control is designed properly, expects that it has operated continuously and effectively throughout the period under review, and intends to rely on it, (s)he **should** design tests of controls ([chapter 2.5](#)) and perform these in order to confirm the operation of such controls ([see chapter 3.2](#)). The auditor does not need to test controls which are poorly designed because (s)he will not be able to rely on them.

### 2.3.7 Setting detection risk

#### Detection risk level helps determine audit procedures

Detection risk, which is under the control of the auditor, is the risk that (s)he will not detect a deviation that has not been corrected by the organisation's internal controls. Based on the level of audit risk that is acceptable, and an assessment of the entity's inherent and control risks, the auditor determines the nature, timing and extent of audit procedures necessary to achieve the resulting detection risk. For example:

if a lower audit risk is required, detection risk can be reduced by carrying out more substantive procedures, as this affords a greater probability that the auditor will detect material misstatements or irregularities.

if intending to place reliance on internal control, tests of control must be carried out. If the control does not function as intended (thus increasing control risk), detection risk must be decreased, meaning an increase in substantive procedures.

### 2.3.8 Assurance model

The ECA applies an assurance model indicating the level of confidence (to be) derived from the two principal sources of the DAS, supervisory and control systems and substantive testing<sup>14</sup>.

Furthermore, for audits of the legality and regularity of the underlying transactions, additional audit evidence may be available from two supporting sources:

<sup>14</sup> The ECA's assurance model is based on the audit risk model taking due consideration of the particular characteristics of the ECA's audit environment.

- the Annual Activity Reports (AARs) and statements by the Directors-General, which constitute written management representations. Because of the importance of compliance in the EU context, the auditor analyses representations provided annually by Directors-General on the discharge of their responsibility for the legality and regularity of transactions, particularly in areas where direct evidence is not available to the auditor.
- the work of other auditors. This refers to the external audits carried out by other auditors, such as the Supreme Audit Institution of the relevant Member State or the certifying bodies of the Member States.

#### Combined risk assessment

The starting point is the assessment of the inherent risk (high/not high) and the preliminary evaluation of the supervisory and control systems (poor, good, excellent), the aim being to estimate the degree of confidence that can be derived from the latter. Depending on the results, the level of substantive testing providing the remaining confidence level has to be determined.

Given that 95% confidence is generally required of audit testing, the nature and extent of planned audit tests will vary, depending on the auditor's assessment of both inherent and control risk (known as the combined risk assessment).

#### Values assigned to different risks

The following table shows the components of the audit risk model, and the resulting types of audit tests to be carried out. Values are assigned for the assessed inherent risk (not high = 0,6 and high = 1,0) and assessed control risk (low = 0,15; medium = 0,25 and high = 1,0. As ECA's audit risk is set at 5%, and the auditor estimates the inherent risk and control risk, detection risk is calculated using the audit risk equation  $DR = AR / (IR \times CR)$ ).

**Table 5: Assurance model**

Assessed inherent risk (IR)	Evaluation of internal control systems	Assurance obtained from combined risk assessment	Residual level of substantive testing to be carried out	Corresponding minimum degree of confidence to be derived from substantive tests (%)	Corresponding minimum sample size
Not high	Excellent	High controls assurance	Minimum	45	30
	Good	Medium controls assurance	Standard	67	55
	Poor, or where controls not tested	Low controls assurance	Focused	92	125
High	Excellent	High controls assurance	Standard	67	55
	Good	Medium controls assurance	Standard	80	80
	Poor, or where controls not tested	Low controls assurance	Focused	95	150

For example, for the best-case scenario (IR = 0,6 and CR = 0,15) with audit risk at 0,05, detection risk is 0,55 (0,05 / 0,6 x 0,15). By definition, the confidence level to be derived from substantive testing is 45% (1 - 0,55).

(1) It is for the auditor to decide whether the work and the results obtained as part of the overall evaluation of supervisory and control systems and substantive testing are sufficient to provide the required confidence level in the context of the audit in question. This table **should** be used indicatively. Where there is difficulty carrying out all the necessary audit work and reaching the confidence level of 95%, either more audit evidence must be obtained by other means (e.g. using the results of systems evaluations and substantive tests by Commission departments, Member States and/or other auditors), or the scope of the audit conclusion must be limited.

(2) The table is based on the hypothesis that the samples have been randomly selected. When a two-stage sampling method is used, the sample size **should** be increased by 20% to compensate for the increased sampling risk (i.e. the risk that all transactions at second-stage sampling do not have the same probability to be drawn).

(3) Sample sizes are rounded to the nearest multiple of 5.

**Definitions:**

*Minimum substantive testing:* Tests of controls are performed, plus a limited amount of substantive tests. Some substantive tests **should** always be carried out due to (i) the risk of collusion, management override of controls, etc., and (ii) the fact that the ISAs/ISSAIs state that *all material accounts should be tested*. It is emphasised that, if intending to derive confidence from controls, those controls **should** be tested.

*Standard substantive testing:* Tests of controls are performed, as well as a

relatively large number of substantive tests, as most of the required confidence is derived from substantive testing.

*Focused substantive testing:* The required confidence is largely derived from substantive tests. Note that some control tests may be carried out for the purpose of providing feedback to entity management about control weaknesses.

*Degree of confidence:* Probability that the error of the population lies within a certain interval (confidence interval).

*Degree of assurance:*  $DA = 100 - AR$ , where AR is the Audit Risk which for ECA is set at 5%. If assurance is only derived from substantive testing then the confidence level is to be set at 95%. In this case the degree of confidence equals the degree of assurance.

### 2.3.9 Documentation

The auditor **should** document the key elements for understanding the entity's environment and its internal controls and the assessed risks.

## 2.4 CONSIDERING THE SUFFICIENCY AND RELEVANCE OF AUDIT EVIDENCE

ISSAI 1500  
[ISA 500]

*The objective of the auditor is to design and perform audit procedures so as to be able to obtain sufficient and relevant audit evidence.*

- 2.4.1 What is audit evidence?
- 2.4.2 Sufficiency of audit evidence
- 2.4.3 Relevance of audit evidence
- 2.4.4 Corroboration or triangulation of audit evidence
- 2.4.5 Sources of audit evidence
- 2.4.6 Types of audit evidence
- 2.4.7 Audit procedures to obtain audit evidence
- 2.4.8 Access to audit evidence
- 2.4.9 Confidentiality of audit evidence
- 2.4.10 Documentation of audit evidence

### 2.4.1 What is audit evidence?

Information needed to arrive at conclusions

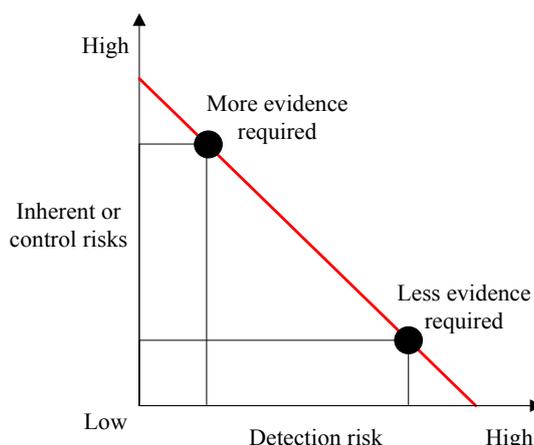
Audit evidence is all of the information used by the auditor to arrive at audit conclusions and, where required, an audit opinion. Auditors typically do not examine all the information available. This would be impractical, prohibitively costly and unnecessary, as conclusions and opinions can generally be reached by using sampling and other means of selecting items for testing. Furthermore, the audit evidence available is usually persuasive (i.e. pointing the auditor in a particular direction) rather than conclusive (i.e. giving a definitive answer).

Exercise professional judgment and scepticism

The audit **should** be planned and performed so that the audit evidence acquired is sufficient, relevant and reliable for supporting the conclusions and, where required, an audit opinion. Sufficiency, relevance and reliability are interrelated, and apply to audit evidence from tests of controls and substantive procedures. When evaluating audit evidence for these qualities, the auditor uses *professional judgment* and exercises *professional scepticism*. The higher the auditor's assessment of risk, the more sufficient, reliable and relevant is the audit evidence which the auditor **should** obtain from substantive procedures<sup>15</sup>.

<sup>15</sup> See Assurance Model, chapter [2.3.8](#).

**Figure 4: Relationship between audit risk components and audit evidence required**



There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risks need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept higher detection risk and still reduce audit risk to an acceptably low level.

### 2.4.2 Sufficiency of audit evidence

Sufficiency relates to the *quantity* of audit evidence - auditors **should** collect enough evidence to enable them to substantiate their conclusions in relation to the audit objectives.

Quantity influenced by risk and quality

There is no formula to express in absolute terms how much evidence there must be for it to be considered sufficient. However, the quantity needed is affected by the *degree of risk* and the *quality* of such audit evidence - the higher the quality, the less evidence may be required.

### 2.4.3 Relevance and reliability of audit evidence

Helps reach a conclusion about an objective

Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure. For evidence to be relevant, it **should** help to answer the individual audit objective or assertion. Relevance also requires the evidence to apply to the period under review - the total evidence must be representative of the entire period being audited.

### 2.4.4 Reliability of audit evidence

Reliability depends on source and type

Evidence is *reliable* if it fulfils the necessary requirements for credibility. The reliability of audit evidence is affected by its *source* - whether internal or external to the audited entity - and *type* - whether physical, documentary, oral or analytical - and is dependent on the circumstances

under which it is obtained. While recognising that exceptions may exist, the following useful generalisations state that audit evidence is more reliable when it is:

obtained from *independent sources* outside the entity (e.g. confirmation received from a third party), as opposed to being generated internally;

subject to *effective related controls* if internally generated;

obtained *directly by the auditor* (e.g. observation of the application of a control) rather than indirectly (e.g. enquiry about the application of a control);

#### Generalisations

in *documentary form*, whether paper, electronic, or another medium, rather than verbal statements;

provided by *original documents* rather than photocopies or faxes.

### 2.4.4 Corroboration or triangulation of audit evidence

#### Greater confidence

Audit evidence is more persuasive and provides a higher degree of confidence when items of evidence from different sources or of a different nature are consistent with one another. This is known as corroboration or triangulation. In addition, obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor **should** determine what additional audit procedures are necessary to resolve the inconsistency and thus allow the information to be used as audit evidence.

### 2.4.5 Sources of audit evidence

Audit evidence may be obtained from within or outside the entity, or be produced directly by the auditor. Different sources **should** be employed when collecting evidence so as to ensure it is corroborated.

**Table 6: Sources of audit evidence**

<i>Source</i>	<i>Examples of evidence</i>	<i>Quality as evidence</i>	<i>Audit considerations</i>
Internal	Information from databases, documents and records produced by the audited entity	Lower, due to potential bias	Accuracy and completeness of such information <b>should</b> be evaluated
External	Confirmations (from banks, etc.) Work of other auditors/experts	Higher	Independence of the third party
Auditor	Analysis, computation, enquiry, inspection and observation	Highest	Base information may have been produced internally

## 2.46. Types of audit evidence

Audit evidence may be physical, documentary, oral or analytical. The audit procedures to obtain such evidence, and issues to be considered, are:

**Table 7: Types of audit evidence**

<i>Audit procedures to obtain evidence</i>	<i>Considerations</i>
<i>PHYSICAL</i>	
Direct inspection or observation of people, property or events	While usually the most persuasive evidence, the auditor must be aware that his/her presence may distort reality.
<i>DOCUMENTARY</i>	
Review of accounting documents and records, manuals, management representations	Useful information may not always be documented, necessitating the use of other approaches.
<i>ORAL</i>	
Enquiry or interviews of auditee staff or third parties, documented or corroborated where possible.	Only on the rarest of occasions will the auditor accept information obtained in interviews to be reliable in its own right. (Reliability of audit evidence is greater if: obtained directly by the auditor rather than indirectly or by inference; received in documentary form rather than just orally,
<i>ANALYTICAL</i>	
Analysis through reasoning, reclassification, computation and comparison.	Such evidence is obtained by using professional judgment to evaluate physical, documentary and oral evidence.

## 2.4.7 Audit procedures to obtain audit evidence

### Mixture of procedures

Audit procedures, or combinations thereof, may be used as risk assessment procedures at the planning phase, or as tests of controls or substantive procedures during the examination phase, depending on the context in which they are applied by the auditor.

Evidence is obtained at the audit examination phase by carrying out a mixture of tests of controls, substantive tests of details and analytical procedures, as well as using information from other sources such as management representations and the work of others. While the auditor obtains some audit evidence by testing the records (e.g. computation or analysis), this alone is not sufficient audit evidence on which to base an audit conclusion, and other procedures are also used, e.g. inspection, observation, enquiry and confirmation.

### at planning and examination phases

The auditor **should** make a judgment as to which method of obtaining evidence will be suitably reliable, and balance the reliability of evidence against the cost of obtaining it.

## 2.4.8 Access to audit evidence

### Legal basis for access

The TFEU<sup>16</sup> states that: "*The other institutions of the Union, any bodies, offices or agencies managing revenue or expenditure on behalf of the Union, any natural or legal person in receipt of payments from the budget, and the national audit bodies or, if these do not have the necessary powers, the competent national departments, shall forward to the Court of Auditors, at its request, any document or information necessary to carry out its task*". It is a matter for ECA to determine what documents or information it deems necessary in this regard.

Given this legal requirement, it is only in very rare cases that the required documents or information may not be made accessible for audit purposes.

## 2.4.9 Confidentiality of audit evidence

Special attention **should** be paid to confidential documents. If documents produced by management are classified as confidential, the auditor or his/her superior at the appropriate level will discuss how this confidential information might best be used.

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<sup>16</sup> Article 287(3) of the Treaty on the Functioning of the European Union.

Information and documentation relating to cases of discovered or suspected frauds **should** be handled with particular care.

### 2.4.10 Documentation of audit evidence

Auditors **should** adequately document the audit evidence in working papers in ECA's electronic audit support system and in hard copy where necessary. Such evidence includes the work performed, findings and conclusions, and the rationale for major decisions. Information that is not pertinent to work done or conclusions reached **should not** be included.

## 2.5 DESIGNING AUDIT PROCEDURES

ISSAI 1330  
[ISA 330]

*The objective of the auditor is to obtain sufficient appropriate audit evidence about assessed risks through designing and implementing appropriate responses to those risks.*

2.5.1 Elements to consider when designing audit procedures

2.5.2 Contents of an audit procedure

2.5.3 How to design audit procedures

2.5.4 Designing tests of controls - nature, timing and extent

2.5.5 Designing substantive procedures - nature, timing and extent

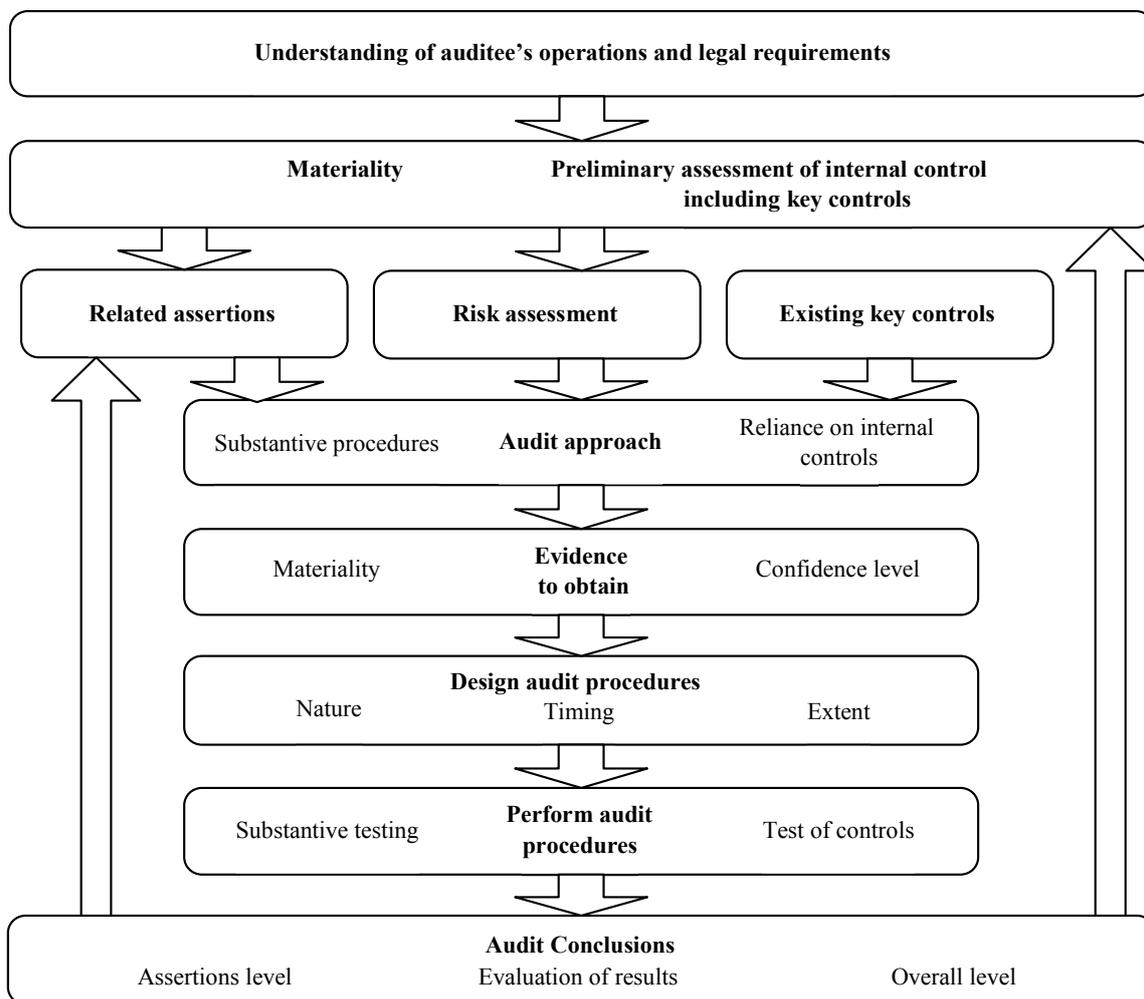
2.5.6 Audit sampling and other means of selecting items for testing

### 2.5.1 Elements to consider when designing audit procedures

#### Materiality and risk

Audit procedures, which aim to obtain the *required assurance* in the most *cost-effective way*, are designed on the basis of the knowledge acquired by the auditor and **should** take into account important aspects, such as materiality and risk, as shown in the following figure:

**Figure 5: Detailed audit process**



**Why audit procedures?**

Audit procedures are designed by the auditor, based on the assessed risk, in order to:

- (i) carry out an *appropriate audit test*, at the right time and covering the right period;
- (ii) obtain sufficient, relevant and reliable *audit evidence*; and
- (iii) reach the appropriate confidence level to support *audit conclusions*.

**2.5.2 Contents of an audit procedure**

An audit procedure **should** include the following elements:

1. the audit objective(s) of the procedure and/or audit test(s);
2. the output expected from the procedure;
3. the assertion, rule, regulation, or requirement to be addressed;

4. the assessed risk;
5. the related key control(s);
6. the audit step(s): evidence to obtain, work to perform, type of procedure to use (enquiry, re-performance, etc), documents to obtain, staff to interview, etc.;
7. the audit conclusion on the test's objective(s) or, in the event of a negative conclusion, further possible testing or impact on the audit approach and related audit procedures.

### 2.5.3 How to design audit procedures

When designing audit procedures, the auditor **should** determine:

Audit approach and assurance	(i) What evidence is needed ( <i>the audit approach</i> )
	(ii) The <i>level of assurance</i> to be derived from audit procedures
Nature, timing and extent of audit procedures	(iii) How and where to obtain the required evidence ( <i>nature of audit procedures</i> )
	(iv) When to obtain the required evidence ( <i>timing of audit procedures</i> )
Cost-effective procedures	(v) How much testing is needed to obtain evidence ( <i>extent of audit procedures</i> )
	(vi) How to design <i>economic, efficient and effective audit procedures</i>

(i) The audit approach

The audit approach may consist of:

- *a reliance or systems-based approach*: Tests of controls are undertaken in those instances where the preliminary assessment has indicated that controls are excellent or good, supported by substantive procedures; or
- *a substantive approach*. Substantive procedures are employed where the preliminary assessment shows controls to be poor, or where testing shows that the controls have not operated continuously and effectively during the period being audited, or where controls (even if deemed to be good or excellent) are not tested (whether due to lack of resources, expertise, etc.)

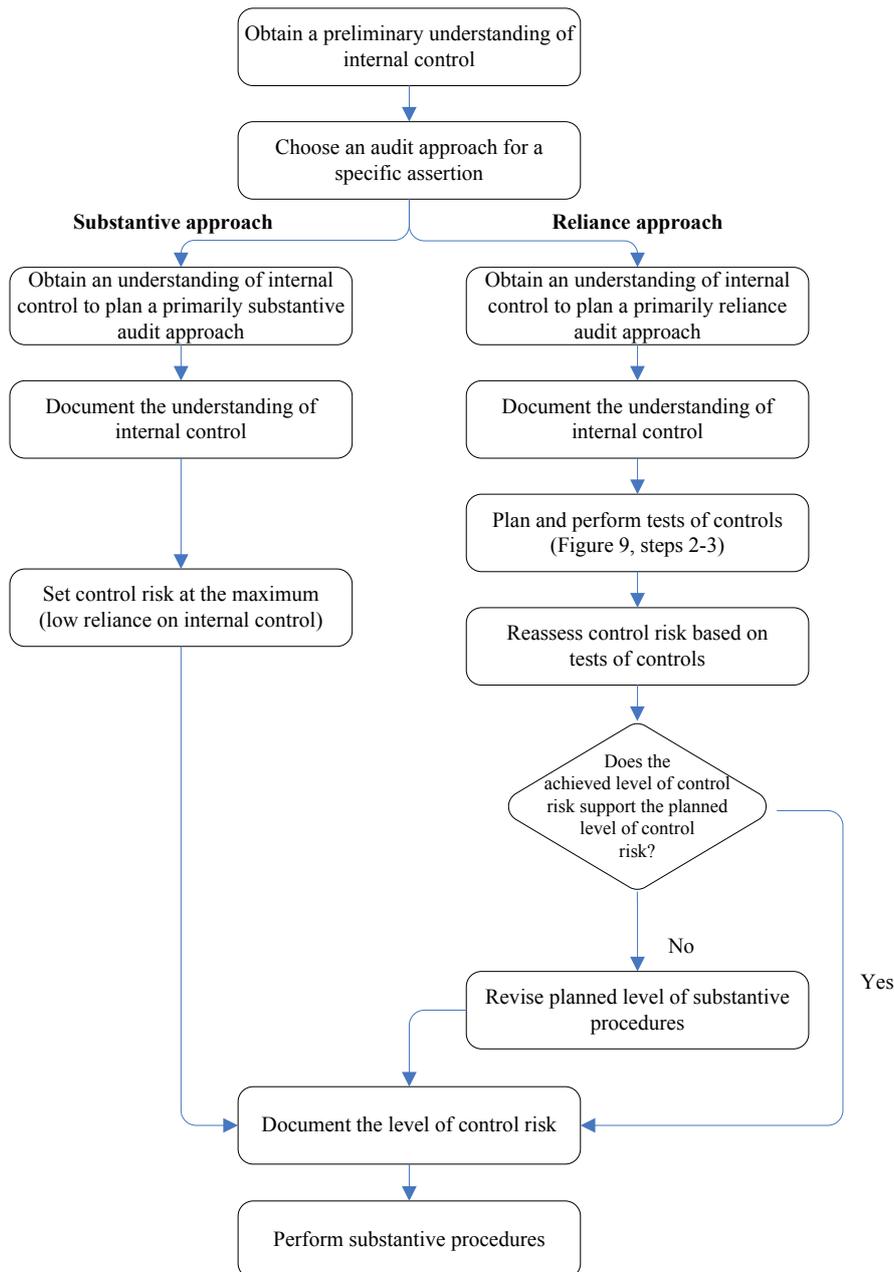
Materiality, together with the auditor's assessment of inherent risks and his/her preliminary assessment of internal controls, provide the basis for the appropriate audit approach. The combined assessment of inherent risk (high or not high) and evaluation of internal control (excellent, good or poor) helps to determine the nature and extent of the audit procedures to be designed and performed (see also the Assurance model, [chapter 2.3.8](#)). In practice, ECA relies primarily on its direct testing of transactions.

Always perform some substantive procedures

Irrespective of the audit approach selected, the auditor **should** design and perform substantive procedures. No matter how strong the controls are found to be, some substantive procedures need to be carried out due to the risk of management override of controls, collusion, etc.

This process can be illustrated as follows:

**Figure 6: Issues to consider regarding the audit approach**



(ii) The level of assurance to be derived from audit procedures

The 95% assurance generally required from ECA's audit tests may be derived mostly from controls, or mostly or entirely from substantive procedures, depending on the auditor's assessment of both inherent and

control risk (see assurance model in [chapter 2.3.8](#)).

#### (iii) The nature of audit procedures

The nature of audit procedures refers to:

their *purpose*: tests of controls or substantive procedures (including tests of details and analytical procedures);

their *type*, i.e. analytical procedures, inspection, observation; enquiry (including confirmation), computation, and re-performance.

The auditor selects the audit procedure that is most appropriate in order to reduce the assessed audit risk to an acceptably low level. The auditor **should** exercise his *professional judgment* to select the procedures, by considering the objectives of the test (i.e. the assertions to cover - see [chapter 1.8](#)), the nature of the population, the assessed risk and the level of reliance on internal controls.

#### (iv) The timing of audit procedures

Timing refers to time at which the audit procedures are performed or the period or date to which the audit evidence applies. When considering the timing of audit procedures, the auditor also considers the following elements:

- the relevant internal controls in place;
- the time at which relevant information is available;
- the nature of the risk (e.g. cut-off);
- specific times where the risk is increased, e.g. peaks of activity, absence of or changes in key personnel, system updates, etc.

The auditor may perform tests of control or substantive procedures at a certain date or period (interim date) or at period end. Certain audit procedures can be performed only *at or after period end*, e.g. agreeing the financial statements to the accounting records for reliability audits. The higher the risk, the more effective it is to perform substantive procedures nearer to, or at, period end rather than at an earlier date.

Performing audit procedures *before period end* may help to identify significant matters at an early stage of the audit, and consequently resolve them with the assistance of management or develop an effective audit approach to address them. If the auditor performs tests of controls or substantive procedures prior to period end, (s)he **should** obtain additional evidence for the remaining period.

#### (v) The extent of audit procedures

The auditor decides on the extent of an audit procedure, i.e. the quantity to test, based on:

the *materiality* level and assessed *risk*;

the degree of *assurance* the auditor plans to obtain;

the most appropriate *sampling* technique for the audit procedure;

the use of Computer-Assisted Audit Techniques (CAATs), which may enable more extensive testing of electronic transactions and account files.

The auditor usually increases the extent of an audit procedure as the risk of material misstatement or non-compliance increases. Minimum sample sizes for 2% materiality and 95% assurance are set out in the assurance model in [chapter 2.3.8](#).

#### (vi) Designing efficient audit procedures

The auditor ensures that there is a clear link between the risk assessment, the evaluation of internal control, and the nature, timing and extent of audit procedures. Audit procedures, which **should** be derived from the audit approach and thus be consistent with it, reflect the decision taken by the auditor as to whether or not to rely on internal controls and the extent of substantive procedures.

The auditor **should** design mutually exclusive and collectively exhaustive audit steps and audit procedures. The audit steps within an audit procedure must be mutually exclusive, meaning that the objectives are different from one another and do not overlap. At the same time, the full range of relevant objectives for the audited area must together be comprehensive in order to gather the evidence needed and cover the related assertion. In this sense, they are collectively exhaustive.

Lastly, audit procedures **should** be specific. In order to maximise efficiency, the auditor can coordinate similar audit procedures. For audit procedures that involve sampling, the auditor can perform numerous tests on the same sample (multipurpose testing), including testing controls, e.g. the auditor can test the amount and test the controls for that area/account.

All auditors performing audit procedures **should** understand how each individual section links to the overall audit approach and contributes to the overall audit assurance to be reached for the audit.

### 2.5.4 Designing tests of controls - nature, timing and extent

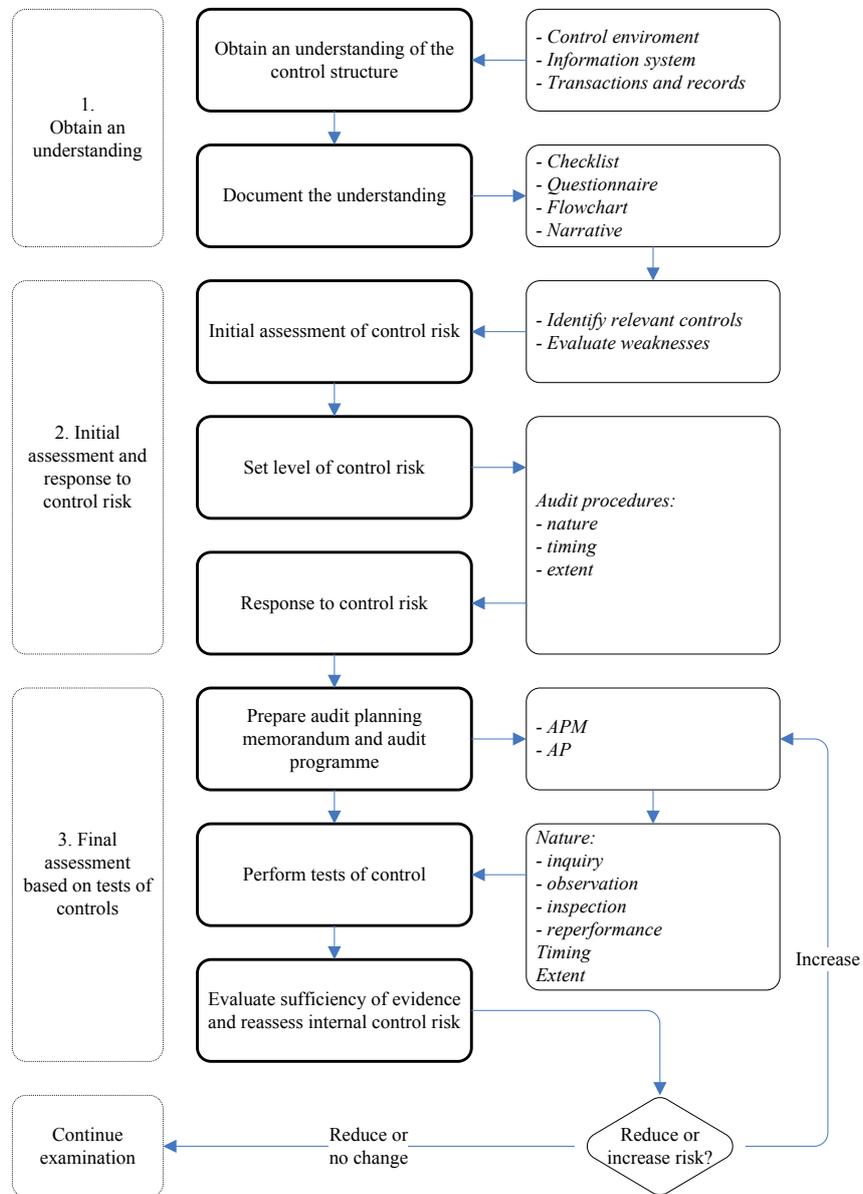
#### If placing reliance on controls

If the plan is to rely on controls to reduce the extent of substantive procedures, the objective of tests of controls is to evaluate whether the key controls, or relevant *compensating controls*, operated effectively and continuously during the period under review. The auditor obtains an understanding of internal control, assesses and responds to control risk by determining appropriate audit procedures, and **should** test those controls<sup>17</sup>:

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<sup>17</sup> In the EU context internal control comprises also the supervisory and control systems of the Member States in order to cover the delegation risk.

**Figure 7: Tests of controls**



**If not placing reliance on controls**

Even if in the planning phase it is decided not to rely on controls (audit objective), the auditor **should** still examine the design of key controls so as to identify and report on weaknesses and propose recommendations for improvement.

**(i) Nature of Tests of Controls**

The nature of a particular control influences the type of audit procedure required to obtain audit evidence about whether the control was operating effectively at relevant times during the period under audit. There are two levels of controls: *high-level controls*, such as monitoring controls, and *low-level controls*, such as authorisation controls, operational controls, physical controls, etc. These can be manual, semi-automated or fully automated. Reliance **should** be placed on the highest-level control possible. Tests of controls can be divided into three main categories, as follows.

**Table 8: Categories of Tests of Controls**

<b>Main Categories of Tests of Controls</b>	
Tests of <b>key controls</b> over individual transactions processed by a system	<p>Key controls are part of transactions processing, often manual or semi-automated, and may include:</p> <ul style="list-style-type: none"> <li>➤ evidence of authorisation of a selected transaction;</li> <li>➤ evidence of review by another official, e.g. correct computation;</li> <li>➤ evidence of check of compliance with budgetary rules, etc.</li> </ul>
Tests of <b>automated application controls</b>	<p>Application controls are built into the auditee's systems and are applied to individual transactions or to batches of similar transactions. The auditor <b>should</b> have a good understanding of the auditee's IT environment. The key application controls are tested since they play a key role in the generation of key reports and the protection of electronic data, and have a significant impact on the financial statements.</p>
Tests of <b>management and monitoring controls</b>	<p>Additional audit evidence may be obtained by testing monitoring controls, which focus on internal control system outputs and are performed on a regular basis. These detection controls are performed after transaction processing and provide management with assurance that a group or class of transactions has been processed completely, accurately and in accordance with the rules. Examples include:</p> <ul style="list-style-type: none"> <li>➤ top level reviews by senior management;</li> <li>➤ review of internal reconciliations/reconciliations with external data;</li> <li>➤ review of management information systems.</li> </ul>

**(ii) Timing of Tests of Controls**

The timing of tests of controls depends on the auditor's objective and determines the period of reliance on those controls. The timing of tests refers both to the period to cover (at a particular time or throughout a period) and to the time when the auditor will perform the test (interim period or period end) or not (reliance obtained in prior audits). For significant risks, the auditor **should** test the controls in the current period. If substantially different controls were used at different times during the period under audit, the auditor **should** consider each one separately.

**Table 9: Timing of Tests of Controls**

Tests of Controls carried out:	Evidence to obtain
at a point in time	the auditor only obtains audit evidence that the controls operated effectively at that time.
throughout the period	the auditor obtains audit evidence that the control operated effectively at relevant times.
during an interim period	additional audit evidence <b>should</b> be obtained for the remaining period about the nature and extent of any significant changes in internal control, e.g. changes in IT or processes.
in prior audits	the auditor <b>should</b> obtain audit evidence whether changes in those specific controls have occurred after the prior audit through enquiry, in combination with observation or inspection.
in prior audits - controls over significant risks	the auditor may not rely on evidence obtained in prior audits for controls that mitigate a significant risk: those controls <b>should</b> be tested in the current period.
in a prior audit, if controls changed since last tested	the operating effectiveness of such controls <b>should</b> be tested in the current audit. Changes may mean there is no basis for continued reliance.
in a prior audit, if controls unchanged since last tested	the auditor <b>should</b> test the operating effectiveness of such controls at least once every third audit, but avoid testing all controls in one audit period with no testing in the others.

**(iii) Extent of Tests of Controls**

The auditor designs tests of controls to obtain sufficient, relevant and reliable audit evidence that they operated effectively throughout the period of reliance. The more (s)he relies on the operating effectiveness of controls in the risk assessment, the greater the extent of tests of controls.

The auditor may consider the following when determining the extent of tests of controls:

- the *frequency* of the performance of the control by the entity during the period;
- the *length of time* during the audit period that the auditor is relying on the control;
- the relevance and reliability of the *audit evidence* of the control's effectiveness;
- the extent of audit evidence from *tests of other controls* related to the assertion;
- the extent of *planned reliance* on the control (reducing substantive procedures);
- the *expected deviation* from the control, an increase in which leads to increased testing of the control: if deviation is expected to be too high, tests of control may not be effective.

In cases where the auditor decides to increase the extent of the audit procedure, the extent of tests of automated controls does not necessarily need to be increased, because of the inherent consistency of IT processing. Once the auditor determines that an automated control is functioning as intended, (s)he will then consider performing tests to establish whether the control still functions effectively.

**Devise tests of controls that provide positive evidence**

When evaluating and testing controls, the auditor **should** carefully consider the inherent limitations of internal controls, as described in [chapter 2.3.3](#), as well as the cost-effectiveness of testing controls. The weakly persuasive and negative nature of evidence is a general problem affecting tests of controls. However, tests of controls can be devised that provide positive evidence that a control is operating as expected, e.g. lists of transactions that were rejected as a result of the key controls, along with the record of the correction and reprocessing of the transactions concerned or periodic reconciliation of bank records to accounting data.

## 2.5.5 Designing substantive procedures - nature, timing and extent

The auditor designs substantive procedures to be responsive to the related risk assessment (e.g. risk of material misstatement or non-compliance). The level of assurance to be obtained from substantive procedures depends both on the risk assessment and on the level of reliance on internal controls. However, irrespective of the assessed risk and level of reliance on internal controls, the auditor **should** design and perform substantive procedures for each *material* item. This is because risk assessment is judgmental and the auditor may not have identified all risks, and there are inherent limitations to internal controls, as previously described.

When the auditor determines that an assessed risk at the assertion level is a significant risk, (s)he **should** perform substantive procedures specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, these **should** include tests of detail.

**(i) Nature of substantive procedures**

There are two categories of substantive procedures: substantive analytical procedures and tests of details. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence for certain assertions, including existence, eligibility and valuation. Depending on the audit evidence to be obtained, the auditor may decide to use a combination of tests of details and analytical procedures.

Substantive analytical procedures are discussed in [chapter 3.4](#).

**(ii) Timing of substantive procedures**

Substantive procedures may be performed either at an interim date or at period end. When substantive procedures are performed at an interim date, the auditor **should** perform appropriate substantive procedures, combined with tests of controls unless the auditor deems it unnecessary, in order to cover the remaining period and reduce the risk that deviations at

period end are not detected. If deviations are detected at an interim date, the auditor **should** modify the risk assessment and consequently the nature, timing and extent of substantive procedures covering the remaining period.

**(iii) Extent of substantive procedures**

The extent of substantive procedures refers to the choice of the nature and size of the sample in order to address all the significant risks in all the relevant audit assertions. The extent of substantive testing is determined when building the audit approach (see [chapter 2.5.3 \(i\)](#) above). Depending on the materiality level and the combined assessment of inherent risk and control risk, the extent of substantive procedures will be either *minimum*, *standard* or *focused* (with reliance based only broadly on substantive tests).

In cases where the auditor has decided not to rely on internal controls, when performing substantive procedures (s)he *cannot assume* that the controls relating to the item are operating effectively or that the data are reliable. Unreliable or untested internal controls **should** require the auditor to check the reliability of the data processed and adjust the extent of substantive testing accordingly.

## 2.5.6 Audit sampling and other means of selecting items for testing

When deciding which items to test, there are three main methods available to the auditor: (i) selecting all items (100% examination); (ii) selecting specific items; and (iii) audit sampling. The choice of method is a matter for the auditor's *professional judgment*, based on risk assessment, materiality, audit efficiency and cost, but the method chosen **should** be effective in meeting the purpose of the audit procedure. The three methods are described below.

**i) Selecting all items**

Selecting all items is appropriate when the number of items is small but of high value, when the risk is high, or when computer-assisted audit techniques (CAATs) allow all items to be tested efficiently. It is more common for substantive testing (tests of details) rather than tests of controls.

**(ii) Selecting specific items**

The auditor selects certain items from a population because of specific characteristics they possess. These are typically high-value or high-risk items (e.g. relatively high or low amounts, negative value items, etc.) or items that represent a large proportion of the area under review. It is useful for tests of controls and substantive testing, and also to gain an understanding of the entity or to confirm the auditor's risk assessment. While an efficient means of gathering audit evidence, it is not audit sampling, and the results cannot be

**(iii) Audit sampling**

projected to the entire population. However, it may play a role as part of an audit approach that provides reasonable assurance without audit sampling.

**ISSAI 1530  
ISA 530**

***The objective of the auditor when using audit sampling is to design and select the audit sample, perform audit procedures on the sample items, and evaluate the results from the sample in a manner that will provide an appropriate reasonable basis for the auditor to draw conclusions about the population from which the sample is drawn.***

### Introduction

#### Chance of selection

Audit sampling is the application of audit procedures to less than 100% of items in a population, so that all individual items in the population ("sampling units") **should** have a *chance of selection*. In order to be able to form conclusions about certain defined characteristics of the population (e.g. eligibility, measurement) without testing the whole population, the sample drawn **should** be *representative* of the population and *free from bias*.

#### Representative & unbiased

#### Consider objectives of audit procedure

When designing the sample, the auditor **should** consider the objectives of the audit procedure and the characteristics of the population. As the objectives of tests of controls and substantive tests are different, different sampling approaches may need to be used.

#### Statistical or non-statistical

Sampling may be statistical (involving random selection and use of probability theory to evaluate results) or non-statistical. The decision whether to use a statistical or non-statistical approach depends on the auditor's judgment. However, only the results of statistical samples can be projected to the population.

The results of non-statistical sampling can only be used as an indication, but cannot be extrapolated to the population. Therefore, only statistical sampling is used for the DAS.

The minimum sample sizes for a 2% materiality threshold and a 95% confidence level are shown in the Assurance Model in [chapter 2.3.8](#), based on the hypothesis that the samples are randomly selected. However, these sample sizes may need to be adjusted, depending on materiality and required confidence in any given case. The sample size **should** be sufficient to allow the auditor to conclude, at an appropriate level of sampling risk<sup>18</sup>, that:

for tests of controls, the total *rate of deviation* does not exceed the tolerable rate of deviation (the rate of deviation the auditor will accept) (see

<sup>18</sup> *Sampling risk* is the risk that the auditor's conclusion based on a sample may be different from the conclusion that would have been reached if the entire population had been tested.

also [Chapter 3.3.2, table 12 of the general part of the manual](#));

for substantive tests of details, the *monetary amount of the deviation* does not exceed that which the auditor is willing to accept.

The auditor performs audit procedures appropriate to the particular audit objective on each item selected; if the audit procedure is not applicable to the selected item, the procedure is performed on a replacement item.

### Designing the sample

Having established the audit objectives to be achieved and the audit procedures which are most likely to achieve them, the auditor **should**

- (a) define what constitutes an error;
- (b) determine the population from which items will be selected;
- (c) explore the nature of the population;
- (d) prepare the population;
- (e) stratify the sample, if appropriate;
- (f) determine the sample size;
- (g) select the sample method.

#### (a) Defining deviations ("errors")

Auditors establish criteria as to what constitutes an error, depending on the type of financial or compliance audit being carried out (see [Compliance parts](#) for ECA-approved definitions). The auditor **should** then make an assessment of the expected rate of error (for tests of control) and expected amount of error (for substantive tests of details). If the expected rate of error is unacceptably high, tests of controls **should** not be performed. If the expected amount of error is high, a larger sample size may be appropriate for substantive tests of details.

#### (b) Determining the sampling population

The population is the entire data set from which the sample will be drawn and about which the auditor wishes to draw conclusions. The items in the population need to be defined, e.g. a transaction, an account balance or a monetary unit.

The population needs to be appropriate, complete and accurate *for the specific audit objectives*; auditors may need to obtain further evidence to ensure completeness and accuracy. As sampling does not provide evidence of completeness, audit work to satisfy this assertion **should** always be supplemented by analytical review and/or evidence of the operation of controls vis-à-vis completeness. Use of computer-audit specialists may be considered if IT systems are involved (contact DQC).

#### (c) Exploring the nature of the population

In order to choose the appropriate sample selection method and the optimal sample size, auditors **should** gain as much information as possible about the population. Auditors investigate the degree of variation in population items, what is known of errors in the population (their nature,

frequency, and distribution throughout the population), the existence of patterns (e.g. more errors at year-end due to increased effort to spend commitments) and the location of items (e.g. multiple Member States).

**(d) Preparing the population**

The population is divided into sampling units (e.g. specific assessments for the SoA). Sampling units may also be regrouped into sub-populations with similar characteristics in such a way as to obtain an efficient and effective sample so as to achieve the particular audit objectives; this is called stratification (see below).

**(e) Stratification**

Stratification means (i) dividing the population into sub-populations, or strata, using *predefined and documented* audit criteria (e.g. monetary value, age of receivables, etc.) so that a sampling unit can belong to one and only one sub-population, and (ii) applying audit procedures to a sample of items from each sub-population (e.g. stratification by value: testing all high-value items and a representative sample of low-value items); focus the audit on interim and final payments which are more prone to risk and put less emphasize on advance payments.

**(f) Determine the sample size**

Given the combined risk assessment and required confidence level, the minimum sample size **should** be determined using ECA's Assurance model (see [chapter 2.3.8](#)). It is clear that the larger the sample size, the greater the accuracy and the likelihood that the sample is representative of the population; the sampling risk is then lower.

A reduction in the confidence level when drawing a representative sample for substantive testing may be envisaged if it is offset by using other substantive procedures (e.g. key and high-value item testing, analytical procedures, third party confirmation).

The assurance model (see [chapter 2.3.8](#)) is also used for monetary unit sampling (MUS). The minimum sample sizes corresponding to the above tolerable error and confidence levels are shown in this model. The minimum statistical sample size to have a robust sample is 30 items for each population or sub-population for which a conclusion is to be drawn (unless the population or sub-population is less than 30, in which case the full population or sub-population is examined). Auditors can contact the CEAD Chamber V for help with sample size calculations.

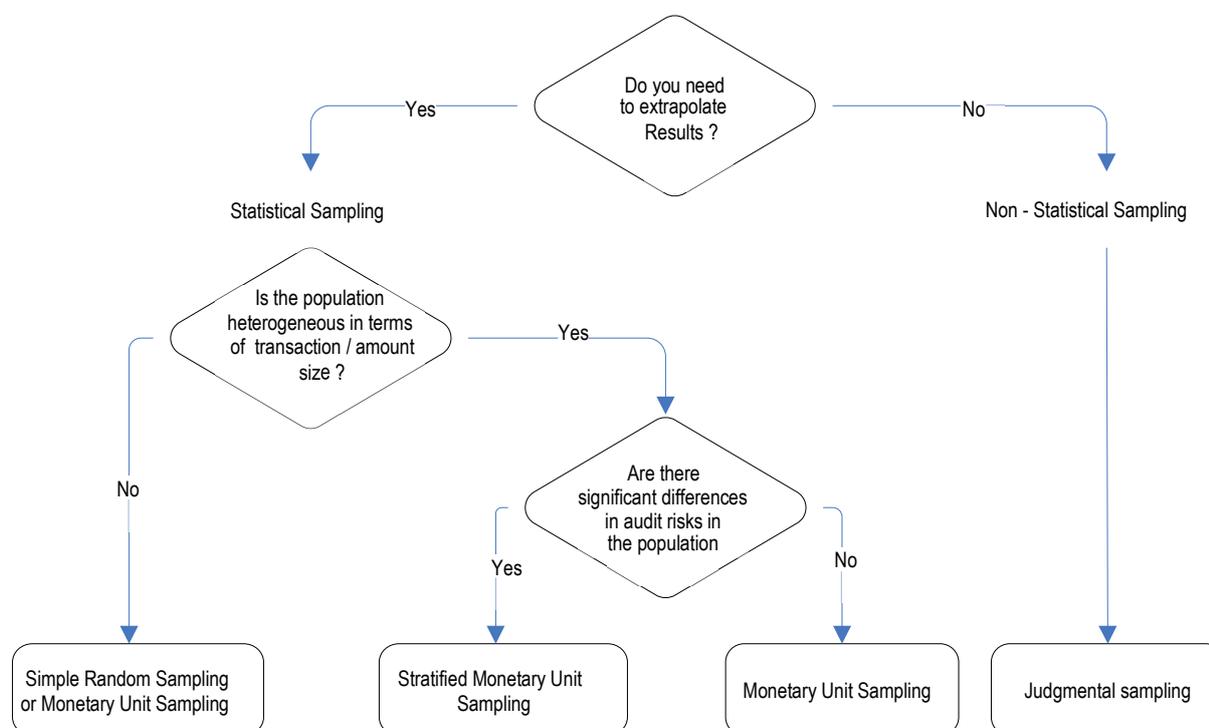
Tools such as Microsoft Excel or ACL, both available at ECA, are used to select samples. Excel, which is more widely used by auditors, has a MUS function. Chamber V can support auditors who need to run MUS sampling on specific populations.

**(g) Select the sample method**

The sampling method to be used **should** match the characteristics of the population. The following flowchart represents the process of arriving at the

most suitable sampling method.

**Figure 8: How to determine the sample selection method**



**Description of sampling methods**

The monetary unit sampling method (MUS) is a method of statistical sampling in which every euro has an equal chance of selection. The practical implementation of the MUS method uses a random starting point and then an average sampling interval (ASI) for progression through the expenditure.

MUS is a form of 'probability proportional to size' (PPS) sampling. Larger transactions involve the payment of a larger number of euros, represent a larger share of potential 'hit euros' and are thus more likely to be tested in the sample.

The ASI is determined by dividing the population total by the planned number *n* of transactions to be audited. The resulting ASI is then used to select *n* evenly spread euros in the population. (ASI = total budget / planned sample size *n*).

The population is thus cut into 'slices' of equal size in euro and for each slice one euro is selected which determines the item to be tested.

These  $n$  euros selected by MUS are called “hit euros”. The transactions to which they belong are called “hit transactions” and collectively they form the sample to be audited.

The individual error rate of an audited “hit transaction” expressed as a percentage is called “tainting  $t$ ”. After the audit of all transactions is finished and when all individual error rates are available, the Most Likely Error (MLE), which is the estimated result for the whole population, **should** be calculated as follows:

$$\text{MLE} = 1/n * \text{sum of } t \text{ (in \%)} \text{ or}$$

$$\text{MLE} = \text{sum of } t * \text{ASI (in €)}$$

For DAS purposes, this sampling method is applied.

*Stratified MUS* divides the population into several sub-groups (strata). The strata have to be pre-defined according to different characteristics within the population e.g. according to risk. The auditor **should** use professional judgement when determining these characteristics including his/her knowledge of the population subject to audit. In each stratum, a number of items is selected with MUS. The number of items to be selected can be different in every stratum.

*Simple random sampling* selects items from across the whole population so that each item has an equal chance of selection. It results in many small amounts to be tested and is likely to produce high standard deviations or a higher sample size. This method is suited to populations where individual items bear a similar level of audit risk. As compared to MUS it is therefore often less efficient.

*Judgmental sampling (e.g. risk-based sampling)* involves selecting items from a population in accordance with pre-determined and documented criteria based on the auditor's judgment. Judgmental or risk-based sampling cannot be used if the objective of the sample is to extrapolate the results, i.e. not relevant for DAS. When reporting results, auditors **should** take care to ensure that readers are not misled into thinking that the results are representative of the population.

*Multi-stage sampling:* One form of multi-stage sampling is *Cluster sampling*. This is generally used where transactions are processed or records held at a number of locations, so that a sample cannot be extracted from across the whole population. In most cases, the locations are too numerous for them all to be visited. Therefore, the auditor first determines the number of locations to be visited, and secondly the number of items to test at those locations. This method can be used together with all sample selection methods.

## 2.6 DRAWING UP THE AUDIT PLANNING MEMORANDUM AND AUDIT PROGRAMME

ISSAI 1300  
[ISA 300]

**The objective of the auditor is to:**

- **establish the overall audit strategy (known at ECA as the Audit Planning Memorandum or APM) and**
- **develop an audit plan (known at ECA as the Audit Programme)**

**in order to plan the audit so that it will be performed in an effective manner.**

2.6.1 Audit Planning Memorandum (APM)

2.6.2 Audit Programme

2.6.3 Changes to planning decisions during the audit

2.6.4 Documentation

### 2.6.1 Audit Planning Memorandum (APM)

The auditor establishes the overall audit strategy in the APM, which sets out the scope, timing and direction of the audit and guides the development of the more detailed audit programme. The APM **should** include the following:

introduction	a short <i>introduction</i> ;
audit field	a description of the <i>audit field</i> , including the regulatory framework for the audit where relevant (accounts being covered by audit, areas of expenditure or revenue being covered by audit, monetary amounts involved, management and payment arrangements, and legal basis), and recent significant changes and developments that may affect the audit;
audit objectives	the <i>audit objectives</i> (the reliability of accounts and main assertions to be addressed; for compliance audits, the objectives depend on the type of audit to be conducted);
audit scope	the <i>audit scope</i> (accounting periods to be covered and locations to be visited; the same for compliance audits, plus control systems to be tested and sample to be audited);
materiality	identification of <i>materiality</i> ;
risks	a preliminary assessment of <i>risks</i> (e.g. changes in the accounting or internal control systems and evaluation of inherent and control risk);
audit approach	the <i>audit approach</i> , including the audit procedures to be carried out in order to provide the necessary audit evidence. This identifies the extent of planned reliance on control systems and the extent of substantive procedures;
organisation	<i>organisation</i> of audit work: <i>resources</i> (including recourse to the work of other auditors and experts), <i>timetable</i> (including the reporting objectives of the audit), <i>budget</i> and <i>documentation</i> in ECA's electronic audit support
quality control arrangements	

system; and

*quality control arrangements* for the direction, supervision and review of the audit.

#### Approval prior to audit work

For SoA audits, the APM **should** be approved by the audit chamber responsible and by Chamber V; for other audits, the APM **should** be adopted by the audit chamber responsible prior to the start of the audit.

## 2.6.2 Audit Programme

#### Sets out nature, timing and extent of planned audit procedures

The audit programme, or audit plan, is a set of instructions to the audit team that lays out in detail the nature, timing and extent of the audit procedures which the auditors are to adopt. It also states the audit objectives and indicates the sample sizes and basis of selection. The results of the audit work done and the conclusions drawn therefrom **should** also be shown.

The relevant standard audit programmes for reliability of accounts audits are available in the library of ECA's electronic audit support system. Auditors can adapt the audit programmes, including those applicable for agencies, to their specific needs.

As regards legality and regularity audits, standard audit programmes are prepared by the audit units to meet the specific characteristics of the area (e.g. MFF/policy area). The audit programmes are then approved by Chamber V, which should also approve any changes made.

## 2.6.3 Changes to planning decisions during the audit

#### Change plan as necessary

The APM and audit programme **should** be updated and changed as necessary during the course of the audit, whether due to unexpected events, changes in conditions or audit evidence obtained. This may have an impact on the planned nature, extent and timing of planned audit procedures. Changes **should** be approved by the Chamber.

## 2.6.4 Documentation

#### Document planning and changes

The APM and audit programme **should** be documented in ECA's electronic audit support system, including significant changes made during the course of the audit and the reasons for such changes. Documentation of the audit programme serves as a record of the proper planning and performance of the audit procedures, which can be reviewed and approved.

**1. GENERAL**

Section 1 - Framework  
Section 2 - Planning  
**Section 3 - Examination**  
Section 4 - Reporting  
Appendices

**PART 1. GENERAL**

**SECTION 3 - EXAMINATION**

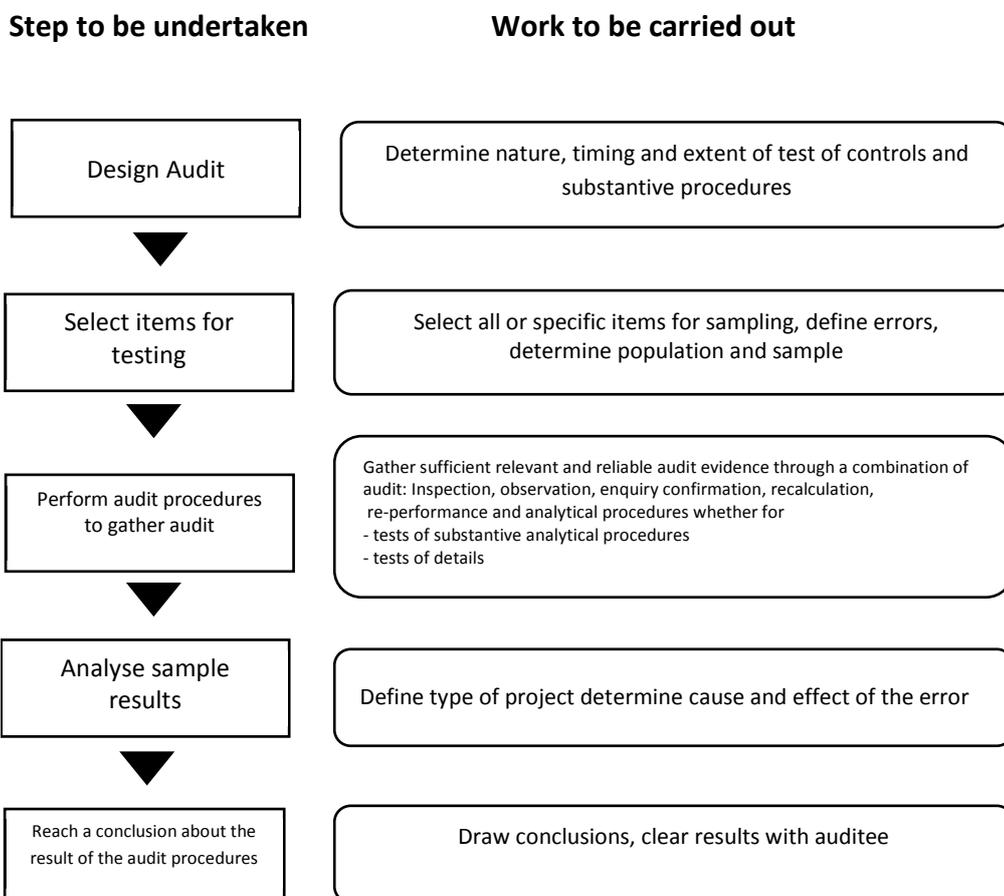
**TABLE OF CONTENTS**

- 3.1 Examination overview**
- 3.2 Performing audit procedures**
- 3.3 Evaluating the results of audit procedures**
- 3.4 Analytical procedures**
- 3.5 Written representations**
- 3.6 Using the work of others**
- 3.7 Other audit procedures**
- 3.8 Clearing audit findings**

### 3.1 EXAMINATION OVERVIEW

The audit examination phase consists of carrying out the audit procedures as planned, modified as necessary during the course of the audit, and evaluating the results thereof, as shown in the shaded areas in Figure 9 below.

**Figure 9: Overview of audit examination process**



## 3.2 PERFORMING AUDIT PROCEDURES

ISSAI 1500 [ISA 500]	<i>The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.</i>
ISSAI 1530 [ISA 530]	<i>The objective of the auditor is to perform audit procedures appropriate to the purpose, on each item selected.</i>

### 3.2.1. Audit procedures to obtain audit evidence

#### 3.2.2 Performing tests of controls

#### 3.2.3 Performing substantive procedures - tests of details

#### 3.2.4 Documenting the results of audit tests

### 3.2.1. Audit procedures to obtain audit evidence

Mixture of tests of controls and substantive procedures

Evidence may be obtained at the audit examination phase by carrying out a mixture of tests of controls (preceded by an evaluation of the internal controls concerned), substantive tests of details and analytical procedures, as well as by using information from other sources such as written representations and the work of others. While the auditor obtains some audit evidence by testing the records (e.g. computation – re-performing calculations or verifying accuracy by performing different calculations - or analysis), this alone is not sufficient audit evidence on which to base an audit conclusion, and other procedures are also used (e.g. inspection, observation, or enquiry and confirmation).

Balance the reliability of evidence against the cost of obtaining it

These audit procedures, or combinations thereof, may be used for tests of controls or substantive procedures. The auditor **should** make a judgment as to which method of obtaining audit evidence will be suitably reliable, and balance the reliability of evidence against the cost of obtaining it.

### 3.2.2 Performing tests of controls

Evaluate continuous effective operation of key controls

The auditor performs tests of controls so as to confirm the preliminary assessment of those key controls upon which (s)he intends to rely. The objective of tests of controls is to evaluate whether those key controls operated effectively and continuously during the period under review.

If the tests of controls confirm that the controls have operated continuously and effectively throughout the period under review, then reliance can be placed on these controls, and minimum substantive testing can be performed.

When these controls are found not to have operated continuously and effectively throughout the period under review, the auditor **should**

reassess the audit approach, and increase the extent of substantive testing to be performed.

The techniques that are generally used to test key controls are observation and enquiry, inspection and computation, or a combination thereof. The following table gives an indication of how to test the operating effectiveness of key controls.

**Table 10: How to test the operating effectiveness of key controls**

Obtain evidence of:	By performing these audit tests:
The <b>quality</b> of the controls and data input.	<p><u>Testing application controls</u></p> <ul style="list-style-type: none"> <li>• Based on mapping of application controls, identify the key processes, master files, interfaces with other modules and systems, the link to the accounting records and management reports. The control objectives (completeness, accuracy, validity, restricted access) addressing the specific risks (access, input, rejection, processing) for each component <b>should</b> be determined.</li> <li>• The key controls designed to meet these control objectives <b>should</b> be tested through enquiry, observation, inspection and some re-performance.</li> </ul>
The <b>completeness</b> and <b>reliability</b> of the transactions the controls are expected to cover.	<p><u>Testing the assertions addressed</u></p> <ul style="list-style-type: none"> <li>• Identify key controls that ensure completeness and reliability of transactions and ensure they are effective through re-performance if needed.</li> </ul>
How controls were <b>applied</b> , and their <b>consistency</b> , at relevant times during the period.	<p><u>Walkthrough testing of controls</u></p> <ul style="list-style-type: none"> <li>• Understand/document the transaction flow and policies &amp; procedures of the control.</li> <li>• Confirm the process, data used for controls and time the control is in place.</li> <li>• Interview individuals performing the control on the type of information they look for, how they detect errors, deviations and/or anomalies, and how they treat them.</li> </ul> <p><u>Testing individual items</u></p> <ul style="list-style-type: none"> <li>• If the auditor cannot obtain sufficient audit evidence using walkthrough testing, then (s)he can use sampling procedures to test individual items.</li> <li>• The sample used is either drawn for controls alone (single purpose testing) or is the same as for substantive testing (multipurpose testing).</li> </ul>
The correction of detected <b>errors</b> .	<ul style="list-style-type: none"> <li>• Review of corrective actions and enquiry about their follow-up.</li> </ul>

<p>The evidence and <b>documentation</b> supporting the application of the controls.</p>	<p><u>Reviewing evidence of controls</u></p> <ul style="list-style-type: none"> <li>• Evidence of authorisation of a selected transaction (signature of the authorising officer, the <i>ex-ante</i> unit, etc.),</li> <li>• Evidence of review by another official (of correct data computation, etc.),</li> <li>• Evidence of check of compliance with budgetary rules, legality/regularity, and documentation.</li> </ul>
<p>The <b>sensitivity</b> of management and monitoring controls.</p>	<p><u>Testing management and monitoring controls.</u></p> <ul style="list-style-type: none"> <li>• Ensure that management and monitoring controls have been operating regularly and consistently during the period under review.</li> <li>• Check that management analysed results of the controls and took corrective action.</li> </ul>

### 3.2.3 Performing substantive procedures - tests of details

The substantive procedures were designed during the planning phase to be responsive to the related risk assessment; their purpose is to obtain audit evidence to detect material misstatements or non-compliance at the assertion level. However, irrespective of the assessed risk and level of reliance, the auditor **should** design and perform substantive procedures (tests of details) for each material area (e.g. class of transactions, account balance and disclosure).

#### Types of substantive procedures

Substantive procedures are concerned with monetary amounts and are of two types:

- tests of details - test procedures applied to selected individual items;
- substantive analytical procedures.

This chapter only deals with tests of details, as substantive analytical procedures are dealt with in [Chapter 3.4](#).

Tests of details that may typically be performed include:

**Table 11: Substantive procedures**

Computation	<p>Reliability audit</p> <p>Check of the arithmetical accuracy of the accounts and budget reports</p> <p>Verification of correct consolidation and elimination of intra-group transactions, where appropriate</p> <p>Arithmetical checks of off-balance sheet commitments</p>	Compliance audit
Analysis (excl. analytical review)	<p>Analyses and reconciliations of accounts and/or balances</p> <p>Analysis of significant movements in individual accounts</p>	<p>Reperformance of calculations regarding claims, grants, etc.</p> <p>Analysis of findings of work by internal and other auditors</p> <p>Analysis of legal basis, legal and budgetary commitments, eligibility, tendering procedures</p>
Re-performance		<p>Re-performance of already inspected/audited transactions</p>
Inspection	<p>Examination of any modifications to the accounting rules</p> <p>Substantive tests of commitments, payments and certain balance sheet items</p> <p>Verification of execution of payments - that selected transactions have been correctly entered in the accounts and the corresponding payments have been made to the designated beneficiary, for the correct amount and according to the procedure laid down in the regulations</p> <p>Follow-up of reports by IAS concerning the reliability of the accounts</p> <p>Examination of reports drawn up regarding outstanding commitments</p> <p>Verification that the opening balance sheet of the current year corresponds to the closing balance sheet of the previous year</p> <p>Check of the consistency of the balance sheet and economic outturn account with the trial balance</p> <p>Check of the consistency of segment reporting with the economic outturn account</p> <p>Inspection of the correct recording and valuation of pre-financing and invoices/cost statements not paid at year-end and related guarantees received</p> <p>Check of cut-off operations (especially accrued charges)</p>	<p>Physical assets</p> <p>Contracts</p> <p>Claims</p> <p>Ex-ante and ex-post control reports</p> <p>Audit reports (internal and external)</p> <p>Monitoring reports</p> <p>Supporting documents, e.g. invoices, public procurement documents, cost-benefit analysis, records by animals and manure, orthophotos, records of beneficiaries and land parcels</p>
Enquiry and confirmation	<p>Enquiry of auditee management and staff</p> <p>Confirmation of bank balances</p> <p>Confirmation-of receivables</p>	<p>Enquiry of auditee management and staff</p> <p>Confirmation of bank balances</p> <p>Confirmation of receivables</p>
Observation		<p>On-the-spot checks</p>

The auditor **should** carry out tests of details as designed in the planning phase, *unless* the evaluation of the results of tests of controls requires her/him to reconsider the nature, timing and/or extent of the tests of details.

When performing tests of details, the auditor may find that:

**Scenarios**

a selected item is *not appropriate* for the application of the audit procedure:

in this case, the audit procedure may be performed on a replacement item. For example, a voided cheque may be selected when testing for evidence of payment authorisation. If the auditor is satisfied that the cheque had been properly voided such that it does not constitute an error, an appropriately chosen replacement is examined;

(s)he is *unable to apply* the designed audit procedures to a selected item because, for instance, documentation relating to that item has been lost. If suitable alternative audit procedures cannot be performed on that item, the auditor ordinarily considers that item to be in error. (S)he also considers whether the reasons for the inability to apply appropriate audit procedures have implications for the assessed inherent or control risk or for reliance on management representations.

### 3.2.4 Documenting the results of audit tests

The result of audit testing **should** be recorded accurately, with discrepancies and outstanding issues discussed with the auditee and differences resolved before reaching conclusions for the individual tests of details.

## 3.3 EVALUATING THE RESULTS OF AUDIT PROCEDURES

ISSAI 1450  
[ISA 450]

*The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.*

ISSAI 1530  
[ISA 530]

3.3.1 Nature and cause of errors in general

3.3.2 Projecting and evaluating sample results in general

3.3.3 Tests of controls - nature and cause of errors, and projecting and evaluating results

3.3.4. Substantive tests of details - nature and cause of errors, and projecting and evaluating results

### 3.3.1 Nature and cause of errors in general

Consider effect on objective of audit procedure

When testing controls, an error is a control deviation and the total errors are expressed as a *rate of deviation or frequency of deviation*. When performing substantive tests of details, an error is a misstatement or non-compliance of a monetary amount, and is expressed as a *projected rate of error*. In all circumstances, the auditor **should** investigate the nature and cause of errors identified and their possible effect on the objective of the particular audit procedure and on other areas of the audit.

Type and causes of errors:

When analysing errors that have been discovered, whether as a result of tests of controls or substantive tests of details, the auditor may observe the following causes and types of errors:

- common feature

Some errors may have a *common feature*, e.g. type of transaction, location, or time period. In such circumstances, the auditor may decide to identify those items in the population that possess the common feature, and extend audit procedures in that stratum.

- an anomaly

In *extremely rare circumstances*, a misstatement or non-compliance may be an anomaly (i.e. demonstrably not representative of misstatements or non-compliance in the population). For a misstatement or non-compliance to be considered as an anomaly, the auditor **should** have a high degree of certainty that it is not representative of the population. The auditor obtains this certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the error does not affect the remainder of the population.

- causes of error

- Errors may result from *management override* of a control, in which case, the auditor **should** question the preliminary assessment of internal controls.

The error may be caused by the following reasons which may appear individually or in any combination:

- Accidental (clerical, insufficient care),

- Deliberate Intentional (suspicion of fraud: to be sent to OLAF),
- Deficient legal framework,
- Due to inadequate knowledge of bad application of the rules/regulations
- Due to the weak design of the supervisory and control systems,
- Deficiencies in the functioning of the supervisory and control systems, or
- Due to failure of the key controls of the supervisory and control systems Deliberate management decision to accept some expenditure as eligible (management interpretation of rules).

The consideration of the causes of errors can facilitate the drafting of clear and cost-effective recommendations.

### 3.3.2 Projecting and evaluating sample results in general

Once the audit tests are performed, the auditor **should** review all errors identified and consider whether the audit evidence enables the auditor to reach an appropriate conclusion about the population for each audit test.

The auditor **should** evaluate, separately for misstatements, instances of non-compliance, and control deviations, whether they are material, individually or in aggregate.

#### Three possible scenarios

Three scenarios are possible with regard to the rate of deviation or projected rate of error resulting from the audit tests and interpretation thereof:

**Table 12: Possible scenarios resulting from audit tests and their interpretation**

<b><i>The rate of deviation (tests of controls) or projected rate of error plus known error(s) (tests of details):</i></b>	<b><i>Interpretation</i></b>
is below the materiality threshold set by the auditor.	- the controls can thus be relied upon - the assertions are deemed to have been satisfied
is less than but close to the materiality threshold.	- the auditor considers the persuasiveness of sample results in light of other audit procedures, and may obtain additional audit evidence
exceeds the materiality threshold set by the auditor.	- controls are assessed as not operating effectively - the assertions are not satisfied, and thus there is a risk of material misstatement or non-compliance

If the evaluation of sample results indicates that the assessment of the relevant characteristic of the population needs to be revised, the auditor may:

request management to investigate identified errors and the potential for further errors, and to make any necessary adjustments; and/or

modify the nature, timing and extent of further audit procedures. For example, for tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

### 3.3.3 Tests of controls - nature and cause of errors, and projecting and evaluating results

#### The nature and cause of errors

The concept of effectiveness of the operation of controls recognises that some errors may occur in the way controls are applied by the entity. An error is a control deviation and the total errors are expressed as a *rate of deviation*.

When considering the errors identified, the auditor **should** determine whether the tests of controls performed provide an appropriate basis for use as audit evidence, whether additional tests of controls are necessary, or whether the potential risks of misstatement or non-compliance need to be addressed using substantive procedures.

#### Projecting the errors

No explicit projection of errors is necessary for tests of controls, since the sample error rate is also the projected rate of error for the population as a whole.

#### Evaluating the results of tests of controls

The auditor **should** evaluate the results of controls testing at the level of each individual key control in order to reach an overall assessment of the effectiveness of the controls. Evaluating the results of controls testing requires a high degree of professional judgment as they have an impact on the audit approach. An unexpectedly high sample error rate in the tests of controls may lead to an increase in the assessed risk of material misstatement or non-compliance, unless further audit evidence substantiating the initial assessment is obtained.

The auditor **should** also assess whether management has detected the errors and deviations and the response and remedial actions they have taken to address them.

The result of the evaluation of controls has three possible impacts:

#### Possible impacts

controls *operated effectively, consistently and continuously* during the period under review, which implies that the auditor can place reliance on

controls and continues to apply the planned audit approach and its level of reliance on controls;

*weaknesses are noted* in the effectiveness and continuity of the control but the *overall system is not considered as unreliable*. In this case, the auditor can only place reduced reliance on controls and the preliminary assessment of internal controls and the level of control risk **should** be revised;

*controls are unreliable*, i.e. they have not operated as expected and/or they have not operated continuously during the period under review and/or they could not be tested. In such cases, a system-based approach cannot be applied and audit assurance **should** be obtained from substantive procedures. If necessary, the preliminary assessment of internal controls and the level of control risk **should** be revised.

Assessment of the performance of the supervisory and control systems must be corroborated by substantive testing.

### 3.3.4. Substantive tests of details - nature and cause of errors, and projecting and evaluating results

#### Analysing and classifying errors

Errors found when performing tests of details **should** be accurately recorded, especially when testing a statistical sample, so that the audit results can be *projected* or *extrapolated*. The auditor **should** understand the nature and cause of the errors found, in order to answer the following questions:

What is the cause of the error? How did it arise?

Is it an anomaly, or could it have arisen systematically for similar transactions or transactions processed at the same time?

The auditor **should** then classify the error by analysing whether the error:

is *quantifiable*, i.e. it has a direct and measurable financial impact on the amount of the item tested. The percentage error and the monetary value of the quantifiable error are calculated in relation to the *recorded value* of the transaction at the level concerned;

is *not quantifiable*, i.e. the error is not related directly to the audited item, or because its effect is not measurable, in which case the whole amount of the item concerned is considered when determining the seriousness of the error;

*material by value* (exceeding the materiality threshold), *nature* or *context*, based on the above;

is an *anomaly* or is systematic.

**“Known errors”**

Errors identified during supplementary work outside the scope of representative samples are to be considered as “known errors”. These errors are only taken into account if they relate to transactions covered by the audit scope (audit population). They are not projected to the entire population, but are taken into consideration on the basis of the absolute amounts (de minimis threshold for reporting known errors is €10 000 ).

**Projecting monetary errors**

For tests of details, the auditor **should project all monetary errors** found in the sample to the population and consider the effect of the projected error on the particular audit objective and on other areas of the audit. For non-statistical samples, the auditor **should** make a judgment about the likely misstatement or non-compliance in the population.

The auditor projects the total error for the population to obtain a broad view of the scale of errors, and to compare this indicator of best estimate to the materiality threshold (*tolerable error*) set by ECA.

For tests of details (test procedures applied to selected individual items), tolerable error is the tolerable misstatement or non-compliance, and will be an amount less than the auditor’s materiality threshold used for the individual class of transactions or account balances being audited.

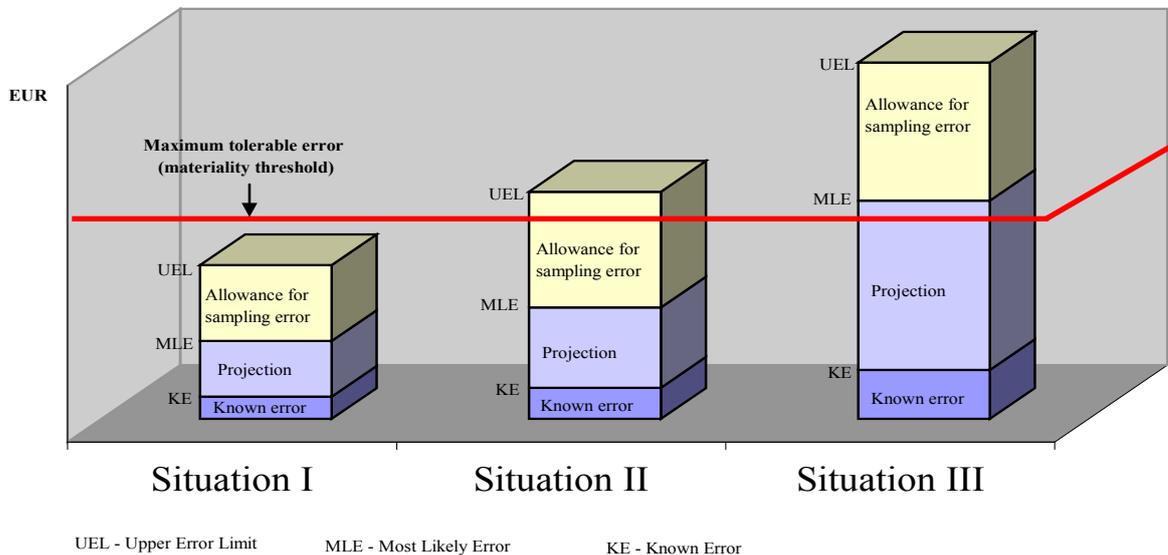
When a misstatement or compliance deviation is considered an anomaly, it is considered not to be representative of misstatement or non-compliance in the population. Therefore, it may be excluded from projection. However, its effect, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements or compliance deviations.

**Evaluating the results of tests of details**

Evaluating the overall results of tests of details requires professional *judgment*, as the auditor **should** understand the nature and cause of the errors and consider both the quantitative aspects, as obtained above, and the qualitative aspects of misstatements or non-compliance in order to reach a conclusion as to whether the population tested is fairly stated.

The projection and evaluation of the results of substantive tests of details can be represented as follows (it **should** be understood that the projection is an interval and not a figure):

**Figure 10: Evaluation of the overall results of substantive tests of details**



Conclusions to be drawn:

Situation I: The upper error limit and the most likely error are less than the materiality threshold. This is a clear result.

Situation II: The upper error limit exceeds the materiality threshold but the most likely error is lower than the materiality threshold. This is a result, for which the auditor **should** consider:

- requesting the audited entity to investigate the deviations;
- carrying out further testing; and
- using alternative audit procedures to obtain additional assurance.

Situation III: The most likely error exceeds the materiality threshold error. As the lower error limit is below the materiality threshold, the auditor **should** consider:

- requesting the audited entity to investigate the deviations;
- carrying out further testing; and
- using alternative audit procedures to obtain additional assurance

The lower error limit (LEL) can be either below or above the sum of known errors. Therefore, it is not shown in the diagram.

Situation IV (not shown in the diagram): The lower error limit and the most likely error exceed the materiality threshold. This is a clear result requiring no further consideration.

In practice, timing constraints mean that ECA is usually obliged to use the third of these possibilities – alternative audit procedures providing additional assurance – to obtain additional assurance.

## 3.4 ANALYTICAL PROCEDURES

ISSAI 1520  
[ISA 520]

*The objective of the auditor is to apply analytical procedures where appropriate to help in assessing risk, providing audit evidence, and arriving at an overall audit conclusion.*

3.4.1 Definition of analytical procedures

3.4.2 Process for using analytical procedures

3.4.3 When to use analytical procedures

3.4.4 Analytical procedures as substantive procedures during the examination phase

3.4.5 Analytical procedures in the overall review at the end of the audit

### 3.4.1 Definition of analytical procedures

Analytical procedures are audit procedures used to help conduct a more economic, efficient and effective audit. They consist of studying plausible relationships between both financial and non-financial data, whether within the same period and entity and/or from different periods and entities. Analytical procedures, which are used more for audits of reliability than compliance, may be used to:

**Analyse or predict**

*analyse relationships* for consistency with each other and with the auditor's knowledge of the organisation and its activities; or

*predict values* which may be compared to actual values.

The term also includes the *investigation* of identified fluctuations and relationships that are inconsistent with other information or deviate significantly from predicted amounts.

**in a strong control environment**

The auditor **should** bear in mind that analytical procedures are more reliable in a strong control environment with effective internal controls and good external data. However, such procedures require comprehensive and up-to-date information concerning financial and other data, which may not be the case in significant fields of EU activity.

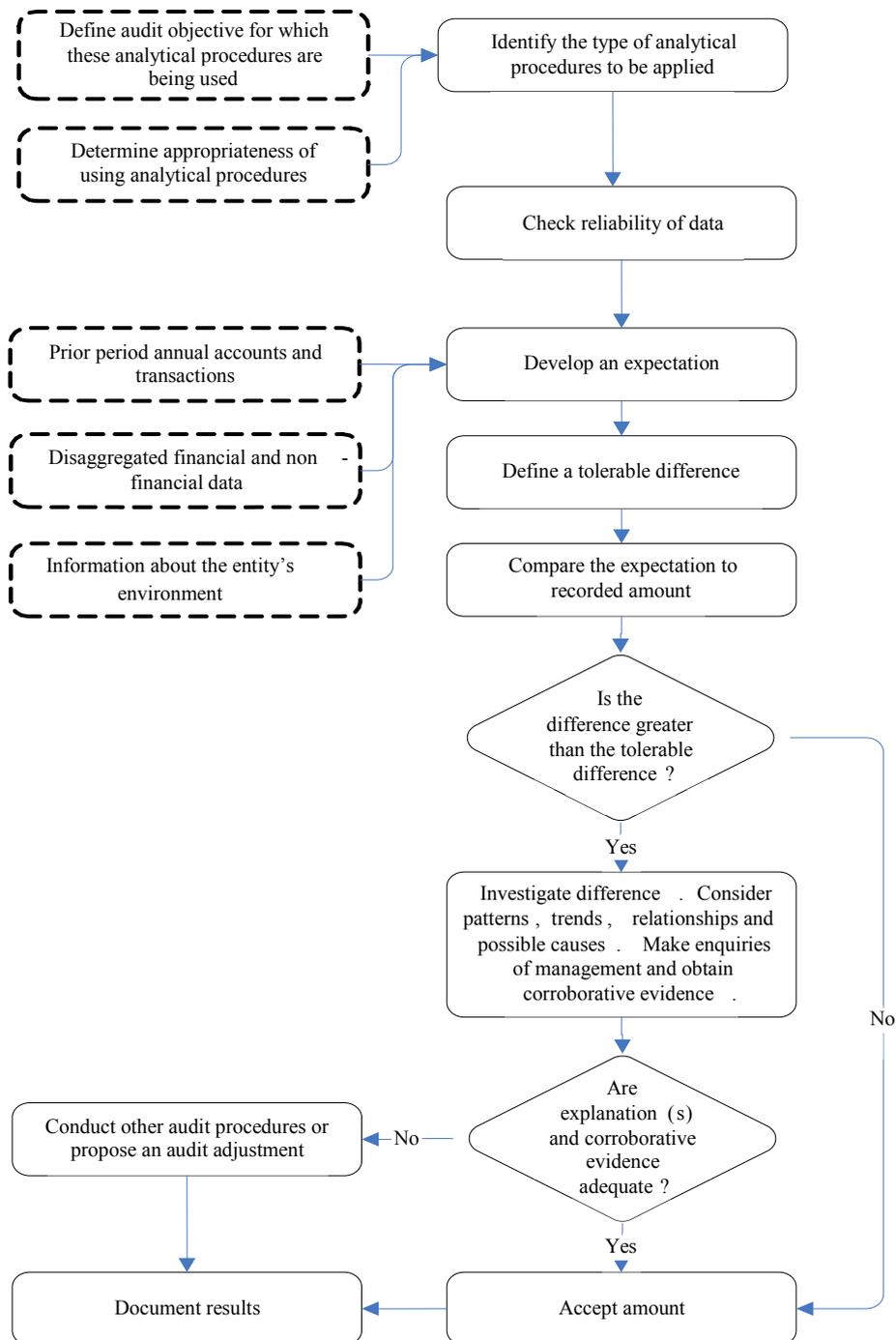
Various methods may be used when performing analytical procedures. These range from simple comparisons to complex analyses using advanced statistical techniques, for which appropriate computer software may be necessary. The auditor's choice of procedure is a matter of *professional judgment*.

In general, analytical procedures provide a warning that something appears to be wrong, rather than providing positive, persuasive evidence of what (if anything) is wrong, and thus on their own do not normally provide sufficient, relevant and reliable audit evidence.

### 3.4.2 Process for using analytical procedures

The use of analytical procedures involves acquiring information from various sources in order to determine what is expected; comparing the actual situation with that expectation; investigating the reasons for any discrepancies arising; and evaluating the results, as follows:

**Figure 11: Analytical review process**



### 3.4.3 When to use analytical procedures

Analytical procedures **should** be used at the following phases of the audit:

**Table 13: Using analytical procedures at different phases of the audit**

Audit phase	Reasons for using analytical procedures
Planning	as <i>risk assessment procedures</i> , in order to identify areas of potential risk and help design further audit procedures (see <a href="#">chapter 2.3.1</a> )
Examination	as <i>substantive procedures</i> , when their use can be more efficient than tests of details and can provide corroboration
	as part of the <i>overall review</i> at the end of the audit, to help assess if external information is consistent with audit findings

### 3.4.4 Analytical procedures as substantive procedures during the examination phase

In addition to performing tests of details, the auditor may also employ substantive analytical procedures as part of his/her substantive procedures in order to reduce risk to an acceptably low level. Substantive analytical procedures are used to *predict* values, based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the risk of forming an incorrect conclusion may be higher for substantive analytical procedures than for tests of details because of the former's extensive use of the auditor's judgment. Accordingly, *quality control* is of critical importance.

**Quality control vital**

Predictive testing of this sort **should** only be undertaken on revenue or expenditure streams that are themselves highly predictable *and* where *reliable data* are readily available so that the predictions can be made, e.g. interest paid/received on lending and borrowing operations, payments of salaries and allowances to staff, etc.

**Reliable data needed**

While substantive analytical procedures *will not normally on their own provide sufficient, relevant and reliable substantive audit evidence*, it may be possible to use predictive testing as part of the overall substantive testing strategy for material account balances and transaction streams. For example, when, say, 60% of the transactions (by value) are high-value items, these might be tested in detail while a predictive test is used for the

**Use as part of substantive testing strategy**

remaining 40% of (low-value) transactions. Or, when a small proportion, by value, of transactions is processed at a geographical location which it is not possible or efficient to visit, predictive testing may be used for that location.

Examples of the use of predicted versus actual values:

the study of changes in an account balance over prior periods leading to a prediction for the current period (e.g. regular payment of a loan over x years);

computations that give a prediction of a given value, e.g. using farm data to predict per hectare payments per farmer.

### 3.4.5 Analytical procedures in the overall review at the end of the audit

#### Corroborate conclusions

The auditor **should** apply analytical procedures at or near the end of the audit when forming an overall conclusion. The conclusions drawn from the results of such analytical procedures are intended to *corroborate conclusions* formed during the audit of individual components and assist in arriving at the overall conclusion and, if required, an opinion.

Analytical procedures used at the overall review stage can be the same as those used during the planning phase and hence can be compared against each other. The review may indicate that additional evidence is required.

## 3.5 WRITTEN REPRESENTATIONS

ISSAI 1580  
[ISA 580]

*The objective of the auditor is to corroborate, by means of written representations:*

*(a) that management or, where appropriate, those charged with governance believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor; and*

*(b) other audit evidence relevant to the financial statements or specific assertions.*

*Further, the objective is c) to respond appropriately to written representations provided or not provided.*

### 3.5.1 Introduction

### 3.5.2 Written acknowledgement by management of its responsibilities

### 3.5.3 Specific written representations on material matters

### 3.5.4 Evaluating the reliability of written representations

### 3.5.1 Introduction

While management and other entity personnel make many statements, or representations, during the course of an audit, whether unsolicited or in response to specific inquiries, the following representations are of particular interest to the auditor:

#### Management responsibilities

(i) written acknowledgement by management of its *responsibilities*;

#### Particular assertions

(ii) specific written representations of *particular assertions*, whether from management, those charged with governance or employees with specialised knowledge.

#### Sufficient appropriate audit evidence still required

Such representations do *not* negate the auditor's responsibility to obtain *sufficient appropriate audit evidence* in support of the audit conclusion and, if required, an audit opinion. The auditor **should** seek corroborative evidence from inside and outside the entity, and evaluate whether the written representations appear reasonable and consistent with other audit evidence obtained, including other representations. Representations that are to be used as audit evidence **should** be confirmed in writing and signed.

### 3.5.2 Written acknowledgement by management of its responsibilities

Representations by management of its responsibilities provide necessary audit evidence about the validity of the premises concerning management's responsibilities, on which basis an audit is conducted. The auditor **should** obtain audit evidence that management:

#### Fair presentation of accounts/compliance

(i) acknowledges its responsibility for the fair presentation of the accounts (reliability audits) or for compliance with applicable laws and regulations

Internal control	(compliance audits);
All relevant information made available	<p>(ii) acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent or detect and correct material misstatement or non-compliance, and states whether it believes the internal control is adequate for that purpose;</p> <p>(iii) believes all information relevant to the audit has been made available to the auditor.</p> <p>Examples are (i) the representation letter for the Consolidated Annual Accounts of the European Union, signed by the Accounting Officer; (ii) the Annual Activity Report and declaration by each Director-General; and (iii) the Commission's Annual Management and Performance Report (AMPR).</p>

### 3.5.3 Specific written representations on material matters

To corroborate other evidence	A specific written representation may be necessary to <i>corroborate other audit evidence</i> , particularly where judgment, intent or completeness is involved. The auditor <b>should</b> determine whether specific written representations for specific assertions are necessary.
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### 3.5.4 Evaluating the reliability of written representations

<p>Consider impact if:</p> <p>- inconsistency with other evidence</p>	<p>If the written representation is inconsistent with other audit evidence, the auditor <b>should</b> determine the reasons for the inconsistency and, if unconvinced, reconsider the reliability of any other written representations that may have been obtained and take appropriate action (e.g. revise the risk assessment and audit procedures).</p>
<p>- doubts about management's integrity</p>	<p>Where the auditor has doubts with respect to management's commitment to competence, communication and enforcement of integrity and ethical values, or diligence, the auditor <b>should</b> assess the effect on the reliability of written representations.</p>
<p>- representations not provided</p>	<p>When relevant parties do not provide the general representations regarding management's responsibilities or any specific representations requested, the auditor <b>should</b> determine the reasons; discuss with management; reconsider the assessment of the integrity of those involved; and take appropriate action, including determining the effects on the auditor's report.</p>
<p>- representations unreliable</p>	<p>If (s)he deems the written representations regarding management's responsibilities not to be reliable, the auditor <b>should</b> consider the effect on the auditor's report.</p>
<p>Disclaimer</p>	<p>The auditor shall disclaim an opinion on the financial statements if:</p>

- (a) the auditor concludes that there is sufficient doubt about the integrity of management such that the written representations are not reliable; or
- (b) management does not provide the written representations

## 3.6 USING THE WORK OF OTHERS

ISSAI 1600

[ISA 600]

*Using the work of another auditor*

ISSAI 1610

[ISA 610]

*Using the work of an internal auditor*

ISSAI 1620

[ISA 620]

*Using the work of an auditor's expert*

3.6.1 Introduction

3.6.2 Using the work of another auditor

3.6.3 Considering the internal audit function

3.6.4 Using the work of an auditor's expert

### 3.6.1 Introduction

The auditor may use the work of another auditor, internal audit (including the Internal Audit Service), or an auditor's expert during the planning and examination phases of the audit, as follows:

#### Planning

(i) at the *planning* phase, reports prepared by others can provide information that warns the auditor of potential weaknesses in systems of control or of a history of serious errors that have arisen in the audit field. The auditor **should** consider the independence, objectivity and competence of such parties; whether their objectives and methods coincide with those of the audit; and whether their conclusions were based upon sufficient appropriate evidence;

#### Examination

##### - audit evidence

(ii) during the *examination* phase, the work of others can be used to provide a part of the audit evidence deemed necessary to achieve the audit objectives, thus reducing the amount of work undertaken by ECA. The overriding principle is that, if intending to rely on the work of others, the auditor **should** ensure that such work provides sufficient, appropriate and cost-effective evidence for the purposes of the audit;

##### - corroborate findings

(iii) the reports of others can also help to corroborate the auditor's findings or conclusions, or to cast doubt upon them. In the latter case, the auditor **should** investigate the discrepancy; satisfy him/herself of the audit evidence which (s)he has obtained; reconsider whether his/her analysis and interpretation of the audit evidence was reasonable, and clearly document such discrepancies that remain.

The main decisions and conclusions with regard to reliance on others' work **should** be documented in the audit working papers.

Each of these three parties - other auditors, internal auditors, and experts - is dealt with separately hereunder.

### 3.6.2 Using the work of another auditor

**ISSAI 1600**     ***The objective of the auditor is to determine, when the work of another auditor is used, how the work of the other auditor will affect the audit.***  
**[ISA 600]**

**Definition of "other auditors"**

In general, "other auditors" means a public or private auditor called upon to express a professional opinion about systems, transactions, and/or accounts. ECA distinguishes between two categories of such auditors:

*(i) Those obliged by EU legislation (regulatory or contractual obligation) to present their audit opinion.* These form an integral part of the internal control systems and **should** be audited as such. An absence of such audits, or deficiencies in relation to the work of such other auditors are considered as weaknesses in the internal control system and reported as such<sup>19</sup>.

Other auditors as part of the internal control systems are:

- Certifying bodies in a Member State
- Internal audit units of paying agencies in a Member State
- Audit authorities in a Member State
- Commission ex-post control units
- Ex-post control units of agencies
- Ex-post control units of third countries or of international organisations
- Ex-post controls performed by contracted external auditors

The assessment of the system of other audits (typically carried out by private-sector auditors on behalf of the entity) will be based on:

- the entity's strategy documents and annual audit programmes;
- the selection procedure, terms of reference, presentation of the audit report and follow-up by the entity regarding the other auditors;
- the quality of audits performed. This assessment will be supported by a review of a sample of audit reports, randomly selected to be as representative as possible.

*(ii) Those not bound by the EU legal framework.* They include the Supreme Audit Institutions (SAIs) which, according to Article 287(3) of the TFEU, operate in the Member States in liaison with the Court of Auditors. They also include (i) the national authorities' audit departments (the internal audit departments of the authorities which disburse funds and the audit departments of the various Ministries of Finance); and (ii) private-sector auditors working under a legal mandate (statutory auditors) or on a contractual basis (auditors). Their work *may* be taken into account as corroborative evidence for ECA's audits, where relevant and appropriate. If so, the auditor **should** perform audit procedures to determine the extent to which reliance may be placed on the work of the other auditors. (S)he **should** determine how the work of such other auditors will affect the audit,

<sup>19</sup> Some SAIs may carry out audits as part of the internal control system (e.g. the UK NAO as the CAP certifying body). In this case, the NAO falls into category (i) for this purpose.

e.g. (s)he may identify, for the locations to be visited for the audit, whether there are observations in the reports of other auditors that relate to his/her audit objectives. If so, the auditor may request additional information from the body concerned.

#### Two scenarios

There are two possible scenarios, depending on whether the work of other auditors is obligated by EU legislation or not. Under either scenario, the audit procedures will focus on reviewing the other auditor's audit conclusions and opinions on:

- the design, implementation and working of key compliance controls; and/or
- compliance, e.g. the legality and regularity of underlying transactions.

Such procedures may comprise a review of the working methods employed; examination of files; and consideration of the relevance of results, so as to evaluate their reliability as audit evidence and the actual contribution they can make to the audit conclusion.

However, irrespective of the category into which the work of other auditors falls, the principles as set out hereunder are applicable.

#### Use of another auditor's work

When using the work of other auditors, the auditor **should**:

consider the independence and objectivity of the other auditor;

take account of the other auditor's professional competence for the specific audit;

consider the scope of the other auditor's work;

determine the cost-effectiveness of using such work;

perform procedures to obtain sufficient appropriate audit evidence that the work of the other auditor is adequate for ECA's purposes in the context of the specific audit (which may require access to the other auditor's working papers); and

consider the significant findings of the other auditor when analysing and interpreting the results of that work. Where these findings are significant to the opinion, ECA's auditor **should** discuss these findings with the other auditor and consider whether it is necessary to carry out additional audit testing him/herself.

#### Constraints on using the work of other auditors

(a) The other auditors falling outside the scope of the internal control systems have their own terms of reference and in practice enjoy almost complete operational independence vis-à-vis the European institutions. As their work on EU finances is not always repeated, cooperation may sometimes be difficult. Thus, it may prove difficult to carry out the

assessment necessary to be able to use their work as audit evidence. Therefore, this problem **should** be addressed at the planning stage of the audit so that, if such use proves not to be possible, alternative audit procedures can be planned to ensure that sufficient, reliable audit evidence is obtained.

(b) When considering using the work of an SAI of one of the Member States, ECA's auditor **should** bear in mind that, in many cases, the rights of access granted to the European Court of Auditors are more extensive than those available to the SAIs. It may thus be the case that an SAI does not have the powers fully to carry out the audit in question. Furthermore, when the work of an SAI is used or a joint or coordinated audit with an SAI is undertaken, ECA's auditor **should** follow the principles and/or procedures for cooperation with SAIs established by the Contact Committee of Presidents and/or meetings of Liaison Officers of the ECA and the SAIs.

(c) When using the work of external auditors from the private sector, ECA's auditor **should** carefully consider that, in strict interpretation of the relevant auditing standards, the external auditor may only recognise a duty of care to the addressee of the audit report. For example, beneficiaries of certain EAGGF-Guidance programmes which involve capital expenditure may be required to submit auditors' reports certifying that the amounts claimed correspond to expenses incurred. ECA's auditor will determine the reliability of these auditors' reports as audit evidence when they are addressed to the final beneficiary of the EU programme rather than to the relevant paying agency.

### 3.6.3 Considering the internal audit function

**ISSAI 1610  
[ISA 610]** *The objective of the external auditor is to obtain an understanding of the internal audit function and determine whether its activities are relevant to planning and performing the audit and, if relevant, the effect on the procedures performed by the external auditor.*

**Obtaining an understanding of the internal audit function**

The external auditor **should** obtain an understanding of the internal audit function, including its organisational status and scope, when obtaining an understanding of internal control.

**Planning to use the work of internal audit**

When considering using the work of internal audit, including the Internal Audit Service, the auditor **should** evaluate the following, bearing in mind the materiality and risk involved, and the subjectivity of audit evidence:

- the objectivity and technical competence of internal audit staff;
- whether internal audit work is carried out with due professional care;

**Using the work of internal audit**

the effect of any constraints placed on internal audit by management.

When using internal audit work, the external auditor **should** perform procedures to evaluate its adequacy, while considering the scope of work and whether the evaluation of the internal audit function remains appropriate. In particular, the external auditor evaluates:

- the skills and expertise of those performing the work;
- whether there is supervision, review and documentation of the work;
- if sufficient, relevant and reliable audit evidence is obtained;
- whether conclusions reached are appropriate and reports are consistent with the work done;
- whether exceptions and unusual matters identified by internal audit are properly resolved.

*Internal Audit Service (IAS)*

The auditor **should**:

- obtain and examine the IAS work plan for the year in order to evaluate whether the results of some of their audits could be taken into consideration, thus avoiding overlapping;
- review reports drawn up by the IAS on certain aspects of the accounts, where appropriate, and examine the extent to which the auditee has taken the necessary measures in order to follow up recommendations;
- explore whether the IAS has planned resources in order to cooperate with ECA in the execution of audit work for the annual accounts. Should this be the case, the auditor will supervise the IAS's work in order to ensure compatibility with his/her own work, and will validate the audit results.

The Financial Regulation requires the internal auditor to issue independent opinions<sup>20</sup>. In addition, the IAS's Mission Charter requires the Commission's Internal Auditor to provide annual an overall opinion on the state of financial management in the Commission. Also, as an input for the AAR of the Authorising Officer of each DG or service, the Commission's Internal Auditor is required to provide an opinion or conclusion on the 'state of internal control' in the DG/service ('negative assurance') based on the audit work carried out in the last three years.

**in the case of compliance audits**

In addition, compliance audits may focus on the role of the IAS and IAC as part of the auditee's internal control system, with the objective of analysing progress achieved from previous years as regards the ability of the internal

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<sup>20</sup> Article 99 of the Financial Regulation states: "The internal auditor shall advise his/her institution by issuing independent opinions on the quality of management and control systems and by issuing recommendations for improving the conditions of implementation of operations and promoting sound financial management".

control systems to manage compliance risks. For example, the review of the IAS may focus on the planning and execution of their work programmes in light of its risk assessment and priority setting.

### 3.6.4 Using the work of an auditor's expert

ISSAI 1620  
[ISA 620]

**The objectives of the auditor are:**

- (i) to determine whether to use the work of an auditor's expert; and**
- (ii) if so, to determine whether that work is adequate for the purposes of the audit.**

#### Reasons for using auditor's experts

Auditor's experts are used in order to make available to the audit team the technical knowledge or skills required to achieve the audit objectives.

#### Conditions for appointing and using experts

The selection of experts and the procedure for awarding them contracts is subject both to the usual rules governing the proper use and sound financial management of Union funds and to the availability of those funds. The DQC Director is the authorising officer for the budget line concerned and auditors **should** liaise with this Directorate as soon as the need to employ an expert has been identified.

#### Planning the use of an auditor's expert

If technical expertise is required that is not available within the audit team or ECA, the auditor **should** determine whether to engage an auditor's expert, and:

- evaluate whether the expert has the necessary capabilities, competence and objectivity (including no conflicts of interest) for purposes of the audit;
- understand the expert's area of expertise sufficiently to determine the nature, scope and objectives of work to be performed, and to evaluate its adequacy;

- agree, in writing, the nature, scope and objectives of the work to be performed, the roles of expert and auditor, and the communication between both parties, including any report.

It is emphasised that procurement rules **should** be followed.

#### Evaluating the adequacy of the expert's work

The auditor **should** evaluate the adequacy of the expert's work for audit purposes, including:

- the relevance and reasonableness of the expert's findings, and whether they are consistent with other audit evidence;

- if significant to the auditor's use of the expert's work, the relevance and reasonableness of assumptions and methods, and the completeness, relevance and accuracy of source data.

If the auditor deems the expert's work to be inadequate, the auditor **should**

References to the auditor's expert  
in the auditor's report

agree on further work to be performed, or perform other audit procedures that are appropriate.

The report that is issued as a result of an audit task on which an expert is employed remains a report of ECA. The role of the expert is typically to assist the audit team, which remains responsible for forming and putting an audit opinion to the ECA. Thus, when issuing an unmodified ("clean") audit opinion, the auditor **should not** refer to the expert's work. However, if reference to the work of an auditor's expert is relevant to understanding a modification to the auditor's opinion, the auditor's report **should** indicate that such reference does not diminish the auditor's responsibility for that opinion.

Confidentiality

Experts employed by ECA are bound by requirements of confidentiality. Auditors who are working with experts **should** make themselves familiar with these requirements (as laid down in the Staff Regulations and in ECA decisions) and be prepared to advise experts accordingly. In addition, it is the responsibility of the DQC to ensure that appropriate confidentiality clauses are systematically included in experts' contracts of employment.

## 3.7 OTHER AUDIT PROCEDURES

This chapter discusses related party requirements, which are of relevance to both financial and compliance audits. The reliability and compliance parts discuss subsequent events, in the differing contexts of financial and compliance audit. The reliability part also deals with accounting estimates and external confirmations.

### 3.7.1 Related parties

ISSAI 1550  
[ISA 550]

***The objective of the auditor is to perform audit procedures designed to obtain sufficient, relevant and reliable audit evidence regarding the identification and disclosure by management of related parties and the effect of material related-party transactions.***

EU accounting rule

#### **Related-party requirements in the financial reporting framework**

To promote accountability and transparency, the European Union (EU), as the controlling and reporting entity, requires the disclosure of (i) the existence of related parties in all cases where control exists, irrespective of whether there have been transactions between the related parties, and (ii) information about transactions between the EU and its related parties in

certain circumstances<sup>21</sup>. Such disclosure includes, other than for normal arm's-length transactions:

- the *nature* of the related-party relationships;
- the *types of transactions* that have occurred; and
- a *description* of the transactions, e.g. class of transactions, volume, terms and conditions, and amounts.

Examples of situations where related-party transactions may lead to disclosures include:

- purchases or transfers/sales of property and other assets;
- leasing arrangements;
- transfer of research and development;
- license agreements;
- finance (including loans, capital contributions, grants); and
- guarantees and collateral.

In its consolidated annual accounts, the European Union includes a Note to the accounts on related parties, which concerns the remuneration and financial entitlements of key management staff of the EU consolidated entities.

#### Definitions

Related party - a party is related to an entity if it fulfils the following criteria in terms of the *substance* of the relationship, and not merely the legal form:

(a) directly, or indirectly through one or more intermediaries, the party:

has the ability to *control*, or is controlled by, or is under common control with the entity, control being the power to govern the financial and operating policies so as to benefit from its activities, e.g. institutions controlled by the EU; or

exercises *significant influence* over the entity in making financial and operating decisions, i.e. the power to participate in the financial and operating policy decisions of an entity, but not to control those policies;

(b) the party is an *associate* of the entity - the entity has significant influence and the party is neither controlled by nor a joint venture of the entity.

Related-party transactions comprise a transfer of resources or obligations between related parties, regardless of whether a price is charged. Related-party transactions exclude transactions with another entity that is a related party solely because of its economic dependence on the reporting entity or the government of which it forms part. Many related-party transactions are in the normal course of business and carry no higher risk than transactions with unrelated parties.

<sup>21</sup> European Union accounting rule no 15.

**Management responsibilities**

Management is responsible for the identification and disclosure of related parties and transactions with such parties, including implementing internal control to ensure that such transactions are appropriately identified in the information system and disclosed.

**Auditor's responsibilities**

The auditor has a responsibility to perform procedures to identify, assess and respond to the risks of material misstatement or non-compliance arising from the entity's failure appropriately to account for or disclose related-party relationships, transactions or balances.

The auditor needs to be aware of related parties and transactions between such parties because:

- they may require *disclosure* in the financial statements;
- greater *reliance* may generally be placed on evidence from *unrelated* third parties;
- such relationships may expose an entity to *risks* not existing otherwise;
- such transactions may be motivated by reasons such as potential *fraud*.

**Considerations when performing the audit**

In responding to the assessed risks, the auditor undertakes appropriate audit procedures to address the risk of third-party relationships and transactions. If significant transactions outside the normal course of business are uncovered during the audit, the auditor **should** obtain an understanding of whether they involve third parties, and obtain evidence that such transactions have been approved. Examples include transactions:

- having abnormal terms of trade or lacking an apparent logical business reason;
- where substance differs from form;
- which are processed in an unusual manner or unrecorded;
- which are of high volume or value with certain customers or suppliers.

Furthermore, the auditor **should** be alert for information indicating the existence of potential related parties and transactions not identified by management, including reviewing bank and legal confirmations and minutes of meetings of those charged with governance. In such instances, the auditor asks management to identify transactions with the newly-identified related parties, enquire as to why the controls did not identify or disclose these, and perform further audit procedures.

**Disclosure of related-party relationships and transactions**

As the EU financial reporting framework requires disclosure of the existence of related parties where control exists, the auditor **should** obtain sufficient, relevant and reliable audit evidence as to whether the identified related-party transactions have been properly recorded and disclosed. (S)he **should** also consider whether the related-party relationships and

transactions could lead to the accounts failing to achieve fair presentation or transactions to be misleading.

**Written representations**

The auditor **should** obtain a written representation from management that:  
 they have disclosed to the auditor the identity of related parties, relationships, and transactions of which they are aware;  
 they have properly accounted for and disclosed such relationships and transactions.

If the auditor is unable to obtain sufficient, relevant and reliable audit evidence with regard to related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor **should** modify the auditor's opinion appropriately.

### 3.8 CLEARING AUDIT FINDINGS

*The objectives of the auditor are:*

*(a) to communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;*

ISSAI 1260  
[ISA 260]

*(b) to obtain from those charged with governance information relevant to the audit;*  
*(c) to provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and*

*(d) to promote effective two-way communication between the auditor and those charged with governance.”*

The auditor **should** communicate significant findings, including material weaknesses in internal control, on a timely basis to management.

**Statement of Preliminary Findings**

The findings after having been reviewed by Chamber V, are presented to the auditee in the clearing letter. The purpose of the clearing letter is to clear the facts, which then provide the raw material for the final report. Properly cleared facts are the basis of a soundly-based report, and thus reduce the time required to agree the final report with the auditee.

An clearing letter setting out the findings **should** be sent to the auditee upon completion of a mission, within ECA's standard timeframes. The auditee is required to respond to the clearing letter. The auditor **should** analyse this response, ensuring that valid issues raised by the auditee are taken into account when drafting the final report.

**1. GENERAL**

Section 1 - Framework  
Section 2 - Planning  
Section 3 - Examination  
**Section 4 - Reporting**  
Appendices

**PART 1. GENERAL**

**SECTION 4 - REPORTING**

**TABLE OF CONTENTS**

- 4.1 Reporting overview**
- 4.2 ECA's Statement of Assurance – Forming an opinion**
- 4.3 Unmodified opinion**
- 4.4 Modified opinion**
- 4.5 Emphasis of matter and Other matters paragraphs**
- 4.6 Considerations related to suspected fraud**

## 4.1 REPORTING OVERVIEW

### 4.1.1 Introduction

#### 4.1.2 Types of audit reports

#### 4.1.3 Qualities of good audit reports

#### 4.1.4 Users of ECA's reports

#### 4.1.5 Naming of third parties in ECA's reports

### 4.1.1 Introduction

#### Communicate results to stakeholders

Audit reports are ECA's main product. The purpose of audit reports is to communicate the results of ECA's work to the discharge authority, the auditee and the general public. By publishing reports, ECA helps to improve the financial management of the European Union and assists the discharge authority in exercising its power of control over the implementation of the budget.

#### effectively

The key to a good report is effective communication, with the report clearly and objectively setting out the main findings and conclusions on the audit objectives, allowing the reader to understand what was done, why and how, and providing practical recommendations. A properly conceived and implemented audit provides the basis for a good report.

#### Reporting process

The reporting phase begins with the drafting of the preliminary observations and ends with the publication of the report. It thus includes drafting, approval of the preliminary observations by the Chamber and the ECA, the adversarial procedure with the auditee, adoption of the final report by the ECA, its translation, presentation to the discharge authority and publication.

### 4.1.2 Types of audit reports

There are three types of financial and compliance audit reports issued by ECA: annual, specific annual and selected reports.

#### Annual report

The TFEU and Financial Regulation oblige ECA to draw up an *Annual Report* after the close of each financial year.

In addition, ECA is required to provide the European Parliament and the Council with a Statement of Assurance as to the reliability of the consolidated annual accounts of the European Union and the legality and regularity of the underlying transactions for the financial year. The Financial Regulation<sup>22</sup> requires that, the final consolidated accounts be published in the Official Journal, together with the Statement of Assurance.

<sup>22</sup> Article 148(6).

The Statement of Assurance may be supplemented by specific assessments for each major area of Union activity. Current practice is for the Statement of Assurance and related material to be included in the Annual Report. Such material includes information supporting the Statement of Assurance, specific assessments, and conclusions on the Commission’s internal control system.

An Annual Report and a Statement of Assurance must also be produced for the European Development Funds (EDFs).

**Specific Annual Reports**

The ECA produces *Specific Annual Reports* for its recurrent annual financial and compliance audits of other EU bodies, offices and agencies. The TFEU and regulations of such entities require ECA to audit the reliability of their accounts and the legality and regularity of the underlying transactions.

**Special Reports**

The ECA may also, at any time, submit observations, particularly in the form of *Special Reports*, on specific matters selected by the ECA. These Special Reports are discussed in the Compliance part of the manual.

The following table summarises these three different types of reports:

**Table 14: Types of reports published by ECA**

	<b>Annual Reports</b>	<b>Specific Annual Reports</b>	<b>Special Reports**</b>
<i>Subject</i>	Final Consolidated annual accounts of the European Union and the underlying transactions Annual accounts of the European Development Funds and the underlying transactions	Annual accounts of other EU bodies, offices and agencies and the underlying transactions	Specific management topic or budgetary area
<i>Basis</i>	Obligation of the ECA stated in the TFEU	Obligation of the ECA stated in the TFEU or regulations of the bodies, offices and agencies	Right of the ECA stated in the TFEU, initiated as a ECA decision
<i>Frequency</i>	Annual	Annual	As decided by the ECA
<i>Opinion</i>	Statement of Assurance	Statement of Assurance*	Non-standard
<i>Scope of the opinion</i>	Reliability Legality and regularity -	Reliability Legality and regularity -	- Compliance Performance

\*except the European Central Bank.

\*\* Special reports (including quick special reports ) can cover the results of compliance and performance audits alike. Compliance special reports are dealt with in the Compliance part of this manual.

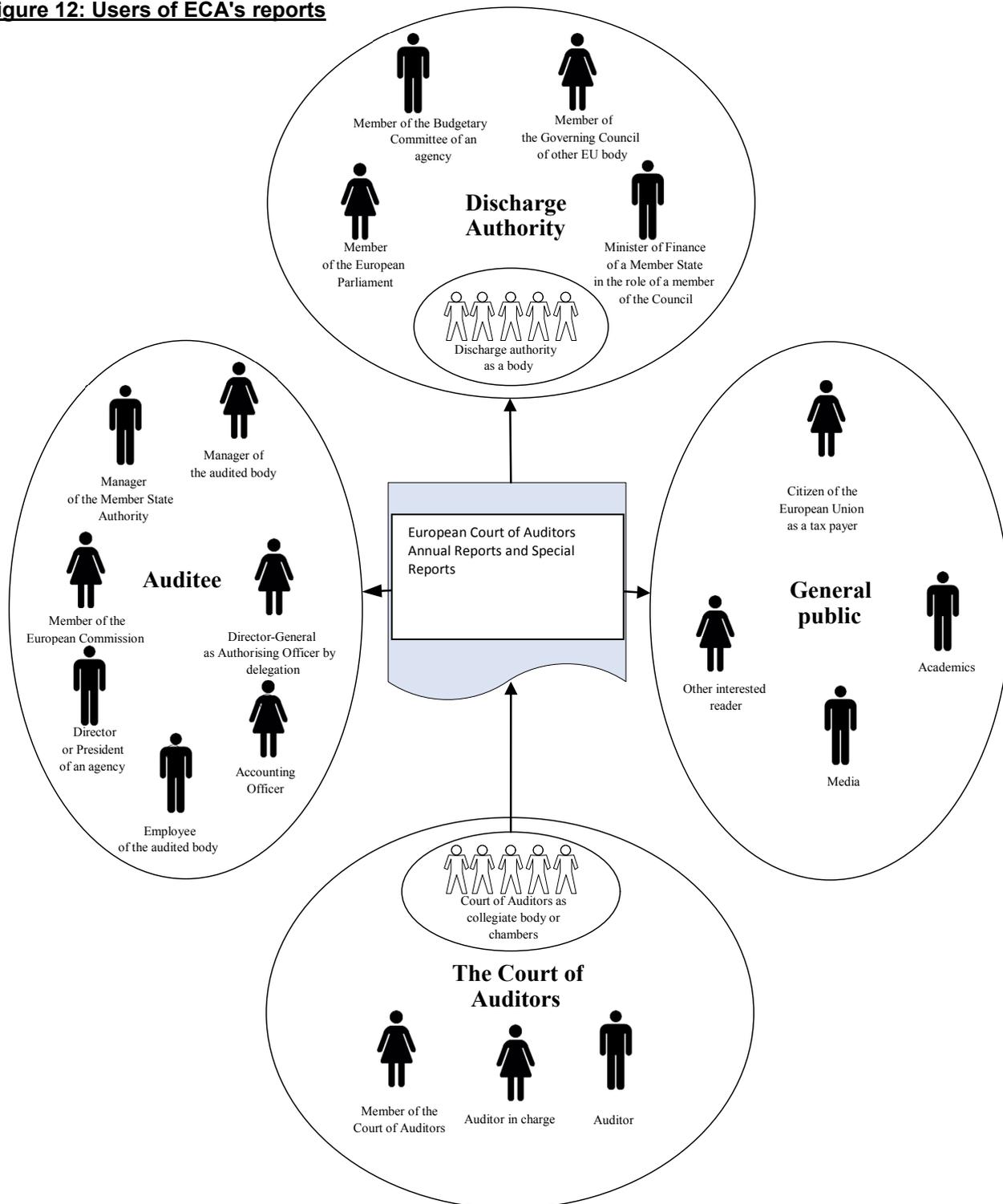
### 4.1.3 Qualities of good audit reports

Audit reports produced by ECA **should** have the following qualities:

<b>Quality</b>	<b>How to achieve</b>
<i>objective</i>	judge actual performance against objective criteria
<i>complete</i>	include relevant aspects of the matters reported
<i>clear</i>	use straightforward language and a clear structure and headings
<i>convincing</i>	present arguments persuasively, with illustrative examples
<i>relevant</i>	ensure contents are important and timely for the report's users
<i>accurate</i>	ensure findings are correctly portrayed to ensure credibility
<i>constructive</i>	be balanced
<i>concise</i>	use short and simple sentences and paragraphs

### 4.1.4 Users of ECA's reports

**Figure 12: Users of ECA's reports**



### 4.1.5 Naming of third parties in ECA's reports

As regards the *naming of third parties* in ECA's reports, the judgment in the Ismeri case<sup>23</sup> was that the Court of Auditors is allowed to mention by name in its reports persons who in principle are not subject to its supervision, but only where:

#### 3 conditions for naming third parties

*specific circumstances* exist, due for example to the seriousness of the facts or the risk of confusion liable to harm the interests of third parties;

the naming of those persons is *necessary and proportionate* in view of the objective pursued by publication of the report; and

such persons are afforded a *right to be heard*, meaning that they must be given the opportunity to make observations on those points in such reports which refer to them by name, *before* those reports are definitively drawn up.

#### Duty of care

Thus, it is imperative that a heightened *duty of care* be exercised in verifying the facts and interpreting them, in those instances where third parties are either directly named in a ECA report or can be easily identified by the reader. Auditors **must** also ensure that the third party is given the opportunity to make such observations prior to adoption of the report.

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<sup>23</sup> Case C-315/99 P *Ismeri Europa Srl. v. Court of Auditors* [2001] ECR I-5281 concerning criticisms made against Ismeri by the Court in Special Report No 1/96 on the MED programmes.

## 4.2 ECA'S STATEMENT OF ASSURANCE - FORMING AN OPINION

[ISA 700]	<i>The objectives of the auditor are to:</i>
ISSAI 1701 [ISA 701]	<i>Form an opinion on the annual accounts and the underlying transactions based on an evaluation of the conclusions drawn from the audit evidence obtained; and</i>
ISSAI 1720 [ISA 720]	<i>Express clearly that opinion through a written report that explains the basis of the opinion.</i>
	<i>The objectives of the auditor are to determine key audit matters and communicate them in the auditor's report.</i>
	<i>Key audit matters are those which, in the auditor's professional judgement, were of most significance in the audit of the financial statements.</i>

4.2.1 Legal requirements and scope of the Statement of Assurance

4.2.2 Form and content of the Statement of Assurance

4.2.3 Supplementary and other information

4.2.4 Determining key audit matters

4.2.5 Communicating key audit matters

### 4.2.1 Legal requirements and scope of the Statement of Assurance

In accordance with the TFEU<sup>24</sup>, a Statement of Assurance **should** be produced for audits of the reliability of the accounts and the legality and regularity of the underlying transactions concerning the general EU budget, EDFs, and EU agencies, offices and similar bodies. Each Statement of Assurance **should** be published in the Official Journal.

The Statement of Assurance contains ECA's opinion on the reliability of the consolidated annual accounts of the EU and on the legality and regularity of the underlying transactions. The term "Statement of Assurance" corresponds to the term "Independent Auditor's Report" as used in the International Standards on Auditing; however, its scope is broader than that set out in the ISAs, due to the inclusion of the legality and regularity aspects. The main objectives of the Statement of Assurance are to inform the discharge authority whether:

ECA's opinion on

- reliability

the annual accounts of the auditee present fairly, in all material respects, the financial position, operations and cash flows of the auditee and were prepared in accordance with the applicable financial reporting framework;

- legality and regularity

the transactions underlying the annual accounts comply with the applicable legal and regulatory framework.

In the case of the general budget of the European Union, the opinion on

<sup>24</sup> Article 287(1) of the Treaty on the Functioning of the European Union.

legality and regularity in the Statement of Assurance is based on the specific assessments for each major cluster, comprising MFF headings, of EU activity.

## 4.2.2 Form and content of the Statement of Assurance

### Stand-alone document

Since the Statement of Assurance (SoA) may (and, in the case of our SoA, must) be published together with the auditee's accounts, without the other parts of the annual or Specific Annual Report, the auditor **should** structure the Statement of Assurance in such a way that it can be read as a *stand-alone document*.

### Address information required by auditing standards

Furthermore the Statement of Assurance **should** be *confined only to the elements required by auditing standards*. The information not specifically required by the standards (e.g. explanatory material and commentary) **should** be included in other parts of the report (e.g. general introduction, information in support of the Statement of Assurance or specific assessments). The Statement of Assurance **should** be confined to material appropriate to an independent auditor's report.

The Statement of Assurance **should** consist of the following sections, as detailed hereunder:

#### (i) Title

"The ECA's Statement of Assurance provided to the European Parliament and the Council – Independent Auditor's Report" **should** be the official title used.

#### (ii) Addressee(s)

The ECA's Statement of Assurance **should** be addressed as required by the circumstances of the audit and the underlying legal basis for the audit.

Addressees of ECA's Reports are in most cases the European Parliament and the Council. In the case of certain other EU bodies, offices and agencies, the addressees could also include other supervisory bodies.

#### (iii) Introductory paragraph

The introductory paragraph in the Statement of Assurance serves to highlight the audit subject, and in particular **should**:

identify the entity whose annual accounts and underlying transactions have been audited;

state that the annual accounts and the underlying transactions have been audited;

identify those parts of the annual accounts and types of underlying transactions which have been audited;

refer to the summary of significant accounting policies and other explanatory notes for audits of reliability;

specify the date or period of the annual accounts and underlying transactions.

It **should** include a reference to the legal basis for ECA's responsibility, which includes auditing and reporting the results of audits. In the case of

the consolidated annual accounts of the European Union and the underlying transactions, ECA's responsibility is defined in the TFEU<sup>25</sup> and the Financial Regulation. Other legal bases, e.g. the regulation establishing the body or the financial regulation of the body, may be relevant for certain other EU bodies, offices and agencies.

(iv) Definition of management's responsibility

This section **should** be entitled "Management's responsibility". It **should** include reference to the legal basis for management's responsibility. In the case of the consolidated annual accounts of the European Union and the underlying transactions, this is the TFEU (Articles ~~340~~ 317 to ~~325~~318) and the Financial Regulation. Other legal bases may be relevant for certain other EU bodies, offices and agencies.

For audits of reliability, this section **should** also include a definition of the applicable financial reporting framework of the auditee. For audits of legality and regularity, this section **should** also include a definition of the applicable legal and regulatory framework of the auditee.

The reliability of the accounts and the legality and regularity of the underlying transactions are two areas of management's responsibility to be described under this heading.

(v) Definition of the Auditor's responsibility

This section **should** be headed "Auditor's responsibility".

The ECA's auditing responsibilities, as set out in the legal framework, are described in Chapter 1 of this manual. ECA's reporting responsibilities are also included in these legal bases.

*The ECA's responsibility related to the opinion on the reliability of the annual accounts*

The Statement of Assurance **should** describe an audit related to the reliability of the accounts by stating that:

1. an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the annual accounts;
2. the procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the annual accounts, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of the annual accounts in order to design audit procedures that are appropriate in the circumstances; and
3. an audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by management, as well as the overall presentation of the annual accounts.

<sup>25</sup> Article 287(1) of the Treaty on the Functioning of the European Union.

*The ECA's responsibility related to the opinion on the legality and regularity of the underlying transactions*

The Statement of Assurance **should** describe an audit of the legality and regularity of the underlying transactions by stating that:

1. an audit involves performing procedures to obtain audit evidence about the legality and regularity of the underlying transactions;
2. the procedures selected depend on the auditor's judgment, including the assessment of the risks of material non-compliance by the underlying transactions with the requirements of the applicable legal and regulatory framework, whether due to fraud or error. In making those risk assessments, the auditor considers internal control and supervisory and control systems implemented to ensure the legality and regularity of underlying transactions, in order to design audit procedures that are appropriate in the circumstances; and

The Statement of Assurance **should** state that the ECA believes that the audit evidence which it has obtained is sufficient and appropriate to provide a basis for its opinion.

The description of the ECA's responsibility **should** include a reference to International Standards on Auditing and/or INTOSAI International Auditing Standards and Codes of Ethics. According to ISA 200, the auditor **should not** represent compliance with ISAs unless the auditor has complied with all of the ISAs relevant to the audit. In the public sector, according to ISSAI 1200, "in compliance with ISAs" means full compliance with all relevant ISAs and if relevant, with the additional guidance set out in the INTOSAI Practice Notes to the ISAs.

(vi) ECA's opinions

The Statement of Assurance **should** contain opinions on the reliability of the accounts, and on the legality and regularity of the underlying transactions.

*Opinion on the reliability of the consolidated annual accounts*

Reliability

The Statement of Assurance **should** include a section with the heading "Opinion on the reliability of the accounts".

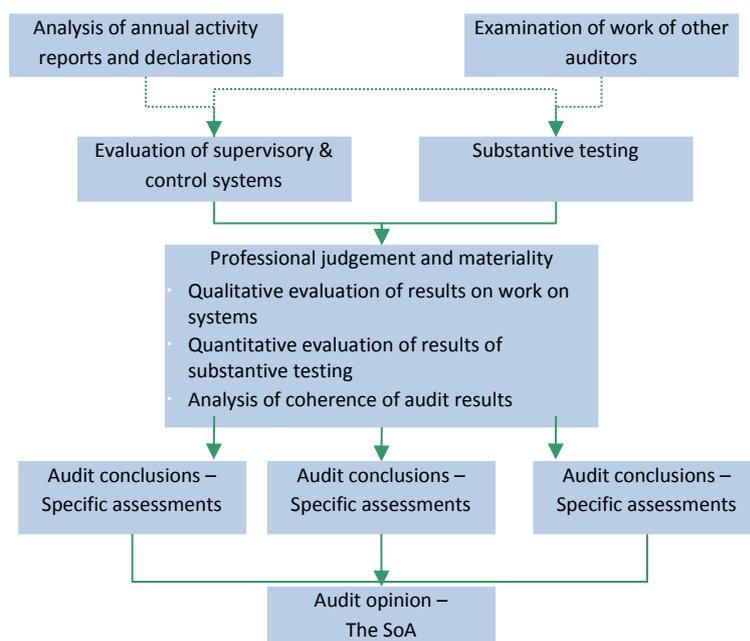
*Opinion on the legality and regularity of the underlying transactions*

Legality and regularity

The Statement of Assurance **should** include a section with the heading "Opinion on the legality and regularity of the underlying transactions".

The ECA's opinion is a consolidation and based on the conclusion in the specific assessments regarding legality and regularity of underlying transactions.

**Figure 13: Forming audit conclusions and an audit opinion**



**(vii) Other matters**

The ECA may be required, or may consider it appropriate, to elaborate on matters that provide further explanation of ECA’s responsibilities with respect to the audit of the consolidated annual accounts or the legality and regularity of underlying transactions, or of the Statement of Assurance thereon. Such matters **should** be addressed under the heading “Other matters”, which follows the Opinion sections.

The ECA’s responsibilities with regard to reporting on fraud and irregularities, the safeguarding of assets and sound financial management could be described here.

**(vii) Date of Statement of Assurance**

The Statement of Assurance **should** be dated no earlier than the date on which ECA obtained sufficient appropriate evidence on which to base its opinion on the reliability of the consolidated annual accounts and the legality and regularity of the underlying transactions.

**(viii) Name and signature**

The ECA’s Statement of Assurance **should** be signed by the President on behalf of the ECA.

**(ix) ECA’s address**

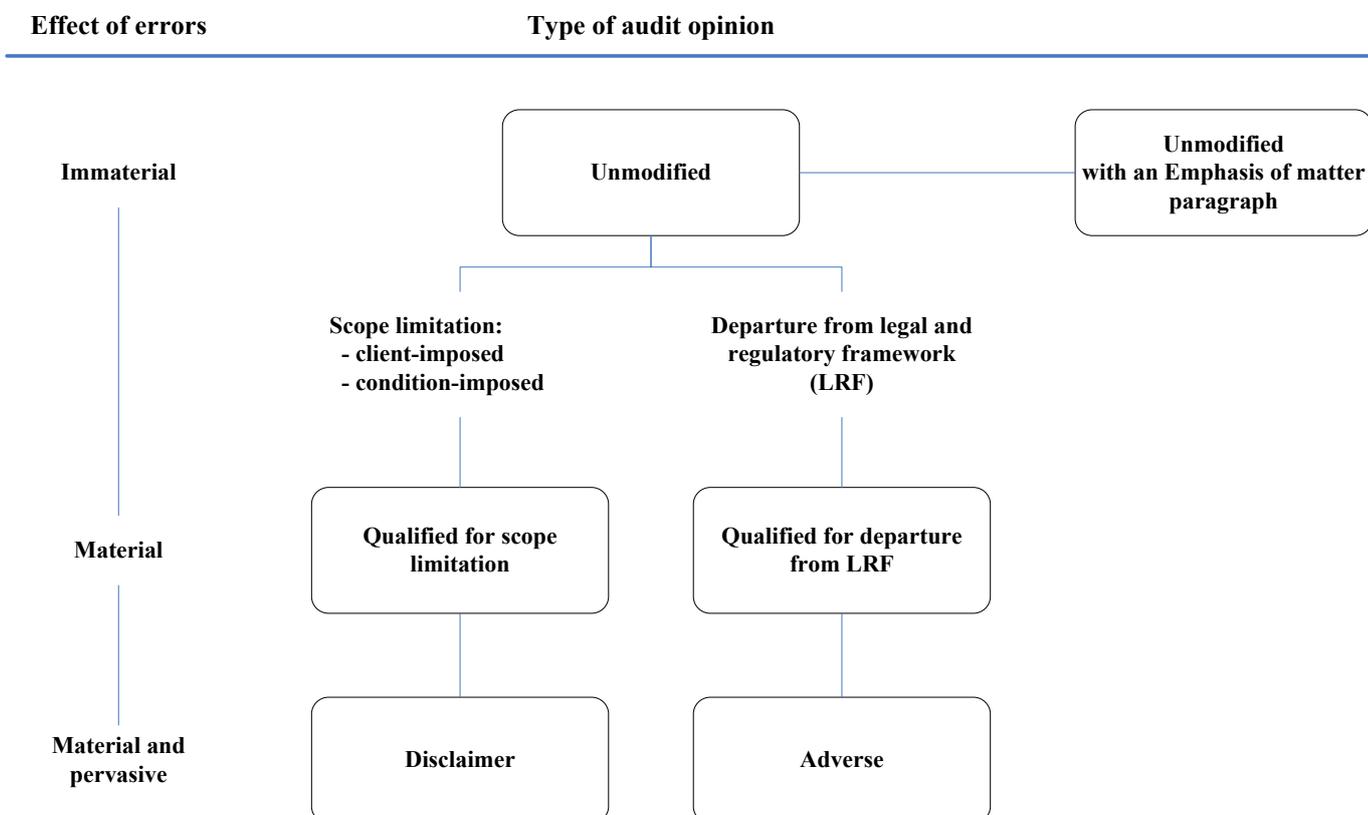
The Statement of Assurance **should** contain the official address of the ECA.

**Types of opinions**

As described in this section, the auditor has several options for the audit opinion on the annual accounts.

The following diagram illustrates the main types of audit opinions that may be given:

**Figure 14: Overview of types of opinions**



### 4.2.3 Supplementary and other information

The auditor may need to comment on supplementary and other information that is not required by the applicable financial reporting framework but which the audited entity chooses to present together with the annual accounts:

#### Supplementary information

*Supplementary information* is information that provides further explanation of specific items in the annual accounts, and is normally presented as supplementary schedules or additional notes. If, because of its nature and presentation, it cannot be clearly differentiated from the audited annual accounts, it is considered an integral part thereof and, accordingly, is covered by the auditor's opinion.

If, however, supplementary information is *not* an integral part the annual accounts and is *not* intended to be covered by the auditor's opinion, the auditor **should** evaluate whether it is clearly differentiated from the audited annual accounts.

**Other information**

*Other information* is other financial or non-financial information, which is included in a document containing audited annual accounts (e.g. principal events and key points).

**Read to identify inconsistencies**

The auditor **should** read supplementary information not subject to audit and other information so as to identify material inconsistencies with the audited annual accounts and misstatements of fact, which may undermine the credibility of the annual accounts.

**If amendment necessary to annual accounts**

If, on reading such supplementary and other information, the auditor identifies a material inconsistency, (s)he **should** determine whether the audited annual accounts or the other information needs to be amended. If an amendment to the audited annual accounts is necessary and the entity refuses to make the amendment, the auditor **should** express either a qualified or adverse opinion on those annual accounts. If an amendment to the other information is necessary and the entity refuses to make the amendment, the auditor **should** either include in the Statement of Assurance an Other Matter(s) paragraph describing the material inconsistency or take other appropriate action.

**Misstatement of fact**

If the auditor becomes aware of a *misstatement of fact* in such supplementary and other information, the auditor **should** discuss the matter with the entity's management. If the auditor concludes that there is a misstatement of fact in such supplementary or other information which management refuses to correct, the auditor **should** consider reporting the matter to the discharge authority.

#### 4.2.4 Determining key audit matters

consolidated accounts, communicate those matters by describing them in the auditor's report. Auditors should take into account areas of higher assessed risk of material misstatement, significant auditor judgements or the effect of significant events or transactions during the period audited.

#### 4.2.5 Communicating key audit matters

The auditor shall describe each key audit matter in a separate section of the auditor's report, noting that the auditors do not provide a separate opinion on those matters. The auditor shall not communicate a matter in the key audit matters section of the opinion if the auditor would be required to modify the opinion as a result of that matter.

## 4.3 UNMODIFIED OPINION

4.3.1 When is it appropriate to issue an unmodified opinion?

4.3.2 Form of unmodified opinion on the reliability of accounts

4.3.3 Form of unmodified opinion on the legality and regularity of the underlying transactions

### 4.3.1 When is it appropriate to issue an unmodified opinion?

#### Fair presentation framework

The financial framework used by European institutions, bodies, offices and agencies is a *fair presentation framework* (Article 152 of the Financial Regulation). A fair presentation framework is a financial reporting framework that requires compliance with the specific requirements of the applicable financial reporting framework and acknowledges that, to achieve fair presentation, it may be necessary for management to (i) provide disclosure beyond these requirements, or (ii) in very rare circumstances, to depart from these requirements.

#### Unmodified opinion

The auditor **should** express an *unmodified opinion* on the reliability of the accounts when the auditor concludes that the annual consolidated accounts of the European Union have been prepared, in all material respects, in accordance with the applicable financial reporting framework. In order to form that opinion, (s)he shall conclude as to whether (s)he has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

### 4.3.2 Form of unmodified opinion on the reliability of accounts

When expressing an unmodified opinion on annual accounts prepared and presented in accordance with a fair presentation framework, the Court's opinion **should** use the following phrase:

**"In our opinion, the [consolidated annual accounts] of [the auditee] for [the year ended] present fairly, in all material respects, the financial position of [the auditee] as [the date] and the results of their operations, its ~~and~~ cash flows, and the changes in net assets for the year then ended, in accordance with the [the applicable financial reporting framework]."**

In the case of the consolidated annual accounts of the European Union, the applicable financial reporting framework consists of the provisions of the Financial Regulation and the accounting rules adopted by the Commission's Accounting Officer, which are based on IPSASs.

### 4.3.3 Form of unmodified opinion on the legality and regularity of the underlying transactions

#### Unmodified opinion

The auditor **should** express an *unmodified opinion* on the legality and regularity of the underlying transactions when the auditor concludes that the underlying transactions comply, in all material respects, with the legal and regulatory framework applicable to such transactions.

When expressing an unmodified opinion on the legality and regularity of underlying transactions based on the legal and regulatory framework applicable to the underlying transactions of the auditee, the Court's opinion **should** use the following phrase:

**“In our opinion, [the transactions underlying the consolidated annual accounts] of [the auditee] for the [period] are legal and regular in all material respects.”**

Examples of an unmodified Statement of Assurance for the reliability of the accounts and the legality and regularity of the underlying transactions, both for the consolidated annual accounts of the European Union and for the annual accounts of an agency, are included in [Appendix III](#).

## 4.4 MODIFIED OPINION

ISSAI 1705  
[ISA 705]

**The objective of the auditor is to express clearly an appropriate modified opinion on the annual accounts and the underlying transactions that is necessary:**

**(a) when the auditor concludes that the annual accounts are not free from material misstatement or the underlying transactions do not comply in all material respects with the applicable legal and regulatory framework; or**

**(b) when the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the annual accounts are free from material misstatement or that the underlying transactions comply in all material respects with the legal and regulatory framework.**

4.4.1 Definition of modified opinion and when it is appropriate to use it

4.4.2 Description of the three types of modified opinions

4.4.3 Nature and consequence of an inability to obtain sufficient appropriate audit evidence

4.4.4 Definition of pervasive

4.4.5 Basis for Modification paragraph

4.4.6 Form of the Modification paragraph

4.4.7 Consequential changes to description of auditor's responsibility

4.4.8 Communication with those charged with governance

4.4.9 Illustrations of Statements of Assurance with modifications to the opinion

4.4.10 No piecemeal opinions

### 4.4.1 Definition of modified opinion and when it is appropriate to use it

It is the auditor's responsibility to issue an appropriate Statement of Assurance. In certain circumstances, a modified auditor's opinion will be required. This is either because the auditor (i) concludes that the accounts are not free from material misstatement or the underlying transactions do not comply in all material respects with authorities; or (ii) is unable to obtain sufficient appropriate audit evidence.

#### Three types of modified opinions

There are three types of modified opinions, namely, a *qualified opinion*, an *adverse opinion*, and a *disclaimer of opinion*. The decision as to which type of modified opinion is appropriate depends upon:

- a) the *nature of the matter* giving rise to the modification; and
- b) the *auditor's judgment* about the *pervasiveness* of the effects or possible effects of the matter on the annual accounts or the underlying transactions.

## 4.4.2 Description of the three types of modified opinions

### Qualified opinion

The auditor **should** express a *qualified opinion*:

(a) when the auditor has obtained sufficient appropriate audit evidence and concludes that misstatements or instances of non-compliance, individually or in the aggregate, are material, but not pervasive, to the annual accounts or the underlying transactions; or

(b) when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the annual accounts or underlying transactions of undetected misstatements are material but not pervasive.

### Adverse opinion

The auditor **should** express an *adverse opinion* when (s)he has obtained sufficient appropriate audit evidence and concludes that misstatements or instances of non-compliance that are material individually or in the aggregate are pervasive to the annual accounts or the underlying transactions.

### Disclaimer of opinion

The auditor **should** *disclaim an opinion* on the financial statements when (s)he is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the annual accounts or the underlying transactions of undetected misstatements are both material and pervasive.

In extremely rare cases involving multiple uncertainties, the auditor, despite having obtained sufficient appropriate audit evidence regarding each of the uncertainties, might conclude that it is not possible to form an opinion and should thus disclaim an opinion.

These types of opinions can be summarised as follows:

**Table 15: Types of modified opinions**

Nature of matter giving rise to the modification	Auditor's judgment about the pervasiveness of the effects or possible effects on the annual accounts or underlying transactions	
	Material but not pervasive	Material and pervasive
Annual accounts are materially misstated, or underlying transactions do not comply, in all material respects, with the legal and regulatory framework	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence on which to base the opinion	Qualified opinion	Disclaimer of opinion

### 4.4.3 Nature and consequence of an inability to obtain sufficient appropriate audit evidence

#### Reasons for lack of evidence

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

- (a) *Circumstances beyond the control of the entity*
- (b) *Circumstances relating to the nature or timing of the auditor's work*
- (c) *Limitations imposed by management*

An inability to perform a specific procedure does not constitute a scope limitation if the auditor can obtain sufficient appropriate audit evidence by performing alternative procedures. Limitations imposed by management may have other implications for the audit, e.g. for the auditor's assessment of fraud risks.

#### Legal right to access information

The TFEU (Article 287) and the Financial Regulation (Article 161) give the Court the right to access any document or information necessary to carry out its task. These legal bases give ECA the power to request and obtain sufficient appropriate audit evidence and do not afford much opportunity for auditee management to impose a limitation on ECA's audit. In the rare event that, during the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit which the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion, the auditor **should** request the removal of the limitation.

#### Procedures to follow

If management refuses the auditor's request to remove a limitation that management has imposed on the scope of the audit, the auditor **should** communicate the matter with those charged with governance. When a limitation on the scope of the audit imposed by management is not removed, the auditor **should** determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence on which to base an unmodified opinion.

#### Implications

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor **should** determine the implications as follows:

- a) if the possible effects of the scope limitation are material but not pervasive to the annual accounts or underlying transactions, the auditor **should** qualify the opinion;
- b) if the possible effects of the scope limitation are both material and pervasive to the annual accounts or underlying transactions so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor **should** disclaim an opinion.

#### 4.4.4 Definition of pervasive effects

##### Definition of pervasive effects

Where the auditor finds a material level of error, or is prevented from finding sufficient appropriate audit evidence for a material part of the balance sheet, revenue, or expenditure, (s)he must determine the impact on the audit opinion. This requires the auditor to determine whether the errors, or the absence of audit evidence, are “pervasive” or not. In doing so, the auditor applies the guidance contained in ISSAI 1705 (extending this guidance to apply to issues of legality and regularity, in accordance with ECA’s wider mandate). Where errors are material and pervasive, the auditor presents an adverse opinion: where errors are material but not pervasive, the auditor presents a qualified opinion (“except for”).

Pervasive effects are those that, in the auditor’s judgment, are not confined to specific elements, accounts or items of the financial statements (i.e. they are spread throughout the accounts or transactions tested), or, if they are so confined, they represent or could represent a substantial proportion of the financial statements, or relate to disclosures which are fundamental to users’ understanding of the financial statements. ECA only presents audit opinions at the overall level of the underlying transactions recorded in the accounts, not at that of the individual chapters of MMF headings. Determining whether errors are pervasive is also done at the level of the overall opinion<sup>26</sup>.

#### 4.4.5 Basis for Modification paragraph

##### Separate heading for Basis for Modification paragraph, to be placed before Opinion paragraph

When the auditor modifies the opinion on the annual accounts or underlying transactions, (s)he **should** include a paragraph in the auditor’s report that provides a description of the matter giving rise to the modification. The primary basis for a modified opinion is clearly specified errors identified during the audit. The auditor **should** place this paragraph immediately before the opinion paragraph in the auditor’s report and use the heading “Basis for Qualified Opinion,” “Basis for Adverse Opinion,” or “Basis for Disclaimer of Opinion,” as appropriate.

##### Quantify effects where possible

If a material misstatement of the annual accounts or error in the underlying transactions relates to specific amounts, the auditor **should** include in the Basis for Modification paragraph a description and quantification of the effects of the misstatement or error, unless impracticable. If it is not

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<sup>26</sup> Thus, the question whether error is pervasive in the sense used by the standards within a MMF heading does not arise, and so the conclusions in the individual chapters of the Annual Report do not include any reference to pervasive effects.

practicable to quantify the effects, the auditor **should** state as much in the Basis for modification paragraph.

**Disclosure of information**

If there is a material misstatement of the annual accounts that relates to narrative disclosures, the auditor **should** include in the Basis for Modification paragraph an explanation of how the disclosures are misstated.

**Non-disclosure of information**

If there is a material misstatement of the annual accounts or the underlying transactions that relates to the non-disclosure of information that is required to be disclosed, the auditor **should** discuss the matter with those charged with governance, describe in the Basis for Modification paragraph the nature of the omitted information and, unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

**Lack of sufficient appropriate audit evidence**

If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor **should** include in the Basis for Modification paragraph the reasons for that inability.

**Description of other matters requiring modification**

Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the annual accounts or the underlying transactions, the auditor **should** describe in the Basis for Modification paragraph the reasons for any other matters that would have required a modification to the opinion, and the effects thereof.

#### 4.4.6 Form of the Modification paragraph

When the auditor modifies the audit opinion, the auditor **should** use the heading “Qualified Opinion,” “Adverse Opinion,” or “Disclaimer of Opinion,” as appropriate, for the opinion paragraph.

**Expressing a “Qualified Opinion”**

When the auditor expresses a qualified opinion, (s)he **should** formulate the opinion along the following lines:

A qualified opinion on the reliability of the annual accounts:

**“In our opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph, the [consolidated annual accounts] of [the auditee] present fairly, in all material respects, the financial position of [the auditee] as of [the date] and the results of their operations and cash flows for the year then ended, in accordance with the provisions of [the applicable financial reporting framework].”**

A qualified opinion on the legality and regularity of the underlying

transactions:

**“In our opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph, [the transactions underlying the consolidated annual accounts] of [the auditee] for the [period] are legal and regular in all material respects.”**

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor **should** use the corresponding phrase “*except for the possible effects of the matter(s) ...*” for the modified opinion.

#### Expressing an “Adverse Opinion”

When the auditor expresses an adverse opinion, the auditor **should** formulate the opinion as follows:

An adverse opinion on the reliability of the annual accounts:

**“In our opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph, the [consolidated annual accounts] of [the auditee] do not present fairly, in all material respects, the financial position of [the auditee] as of [the date] and the results of their operations and cash flows for the year then ended, in accordance with the provisions of [the applicable financial reporting framework].”**

An adverse opinion on the legality and regularity of underlying transactions:

**“In our opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph on the legality and regularity of [the transactions underlying the annual accounts] paragraph, [the transactions underlying the annual accounts] for the [period] are materially affected by error.”**

#### Expressing a “Disclaimer of Opinion”

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor **should** formulate the opinion as follows:

A disclaimer of opinion on the reliability of the annual accounts:

**“Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion and, accordingly, we do not express an opinion on the consolidated annual accounts.”**

A disclaimer of opinion on the legality and regularity of the underlying transactions:

**“Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain**

**sufficient appropriate audit evidence to provide a basis for an audit opinion and, accordingly, we do not express an opinion on the underlying transactions.”**

#### 4.4.7 Consequential changes to description of auditor’s responsibility

**In the case of a qualified or adverse opinion**

When the auditor expresses a qualified or adverse opinion, (s)he **should** amend the description of the auditor’s responsibility to state that (s)he believes that the audit evidence (s)he has obtained is sufficient and appropriate to provide a basis for his/her modified audit opinion.

**In the case of a disclaimer of opinion**

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, (s)he **should** amend the introductory paragraph of the Statement of Assurance to state that (s)he was engaged to audit the annual accounts or underlying transactions. The auditor **should** also amend the description of the auditor’s responsibility and the description of the scope of the audit to state only the following: **“Our responsibility is to express an opinion on the consolidated annual accounts (or the underlying transactions) based on conducting the audit in accordance with International Standards on Auditing. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.”**

#### 4.4.8 Communication with those charged with governance

When the auditor expects to modify the opinion in the Statement of Assurance, (s)he **should** communicate with those charged with governance the circumstances that lead to the expected modification and the proposed wording of the modification.

Communicating with those charged with governance the circumstances that lead to an expected modification to the auditor’s opinion and the proposed wording of the modification enables:

the auditor to give notice to those charged with governance of the intended modification(s) and the reasons or circumstances for the modification(s);

the auditor to seek the concurrence of those charged with governance with regard to the facts of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with management as such; and

those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

## 4.4.9 Illustrations of Statements of Assurance with modifications to the opinion

The practical illustration in [Appendix III](#) provides an example of an adverse opinion.

### 4.4.10 No piecemeal opinions

#### Opinions on accounts/ transactions as a whole

Both the opinion on the reliability of the accounts and on the legality and regularity of the underlying transactions **should** be given on the accounts of the auditee *as a whole* and the underlying transactions *as a whole*. The corollary is that the opinion is not given on part of the annual accounts or part of the underlying transactions.

#### No piecemeal opinions

Moreover, if the auditor expresses an adverse opinion or disclaims an opinion on the annual accounts or the underlying transactions as a whole, (s)he **should not** express an unmodified opinion on one or more specific elements, accounts, items or transactions of the annual accounts or the underlying transactions in the same report and with respect to the same applicable financial reporting or legal and regulatory framework (a “piecemeal opinion”).

#### But separate conclusions or opinions by policy group for SoA legality and regularity

However, with regard to the opinion on the *legality and regularity* of the underlying transactions for the EU budget, separate conclusions are presented for individual MFF headings, as this provides better decision-making information for the budgetary authority and such conclusions or opinions are supported by sufficient audit work in each area. This approach is supported by Article 287 TFEU<sup>27</sup> which allows for specific assessments. In addition, ISSAI 4000<sup>28</sup> allows ECA to define its forms of reporting according to its mandate.

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<sup>27</sup> Article 287(1) of the Treaty on the Functioning of the European Union.

<sup>28</sup> See ISSAI 4200 "Compliance Audit Related to the Audit of Financial Statements", paragraph 146 and Appendix 7.

## 4.5 EMPHASIS OF MATTER AND OTHER MATTERS PARAGRAPHS

ISSAI 1706  
[ISA 706]

*The objective of the auditor is to include clear additional communication in the auditor's report when, in the auditor's judgment, such communication is necessary to draw users' attention to a matter presented or disclosed in the annual accounts or related to the legality and regularity of the transactions underlying the accounts, or to any other matter which may be relevant to his/her understanding of the annual accounts, the underlying transactions or the audit.*

4.5.1 Emphasis of matter paragraph

4.5.2 Other Matter(s) in the auditor's report

4.5.3 Illustrations of Statements of Assurance with Emphasis of Matter paragraph

### 4.5.1 Emphasis of matter paragraph

Rare circumstances only

*In rare certain circumstances*, the auditor may use an Emphasis of Matter paragraph to draw readers' attention to a matter of such importance that it is fundamental to users' understanding of the accounts. Such a paragraph **should** only refer to information presented or disclosed in the annual accounts, *not* to information included in the auditor's report.

Obtain evidence that matter is not misstated or non-compliant

The auditor **should** use an Emphasis of Matter paragraph *only* if (s)he has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the annual accounts or the stated matter corresponds, in all material respects, with the legal and regulatory framework.

Depends on auditor's judgment

Whether or not to include an Emphasis of Matter paragraph, which is *not* an alternative to a modified opinion, depends on the judgment of the auditor.

Placement and wording of paragraph

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor **should**:

- (a) position it taking into account the nature of the information to be communicated and the auditor's judgment as to the relative significance of such information to intended users compared to other elements required to be reported in accordance with ISA 700 (Revised).
- (b) use the heading "Emphasis of Matter;"
- (c) include in the paragraph a clear reference to the matter being emphasised; and
- (d) indicate that the auditor's opinion is not modified in respect of the matter emphasised.

#### 4.5.2 Other Matter(s) in the auditor's report

When the auditor considers it appropriate to communicate matters other than those that are presented or disclosed in the annual accounts or related to the legality and regularity of transactions underlying the accounts, (s)he **should** use an Other Matter(s) paragraph. The section "Other Matter(s)" is placed taking into account the nature of the information to be communicated and the auditor's judgment as to the relative significance of such information to intended users compared to other elements required to be reported in accordance with ISA 700 (Revised).

When the auditor expects to include an Emphasis of Matter or an Other Matter(s) paragraph in the auditor's report, the auditor **should** communicate with those charged with governance regarding this expectation, and the proposed wording of this paragraph.

#### 4.5.3 Illustrations of Statements of Assurance with Emphasis of Matter paragraph

The practical illustration in [Appendix III](#) provides an example for an Emphasis of Matter paragraph.

## 4.6 CONSIDERATIONS RELATED TO SUSPECTED FRAUD

- [ISA 240]** (a) *identify and assess the risks of material misstatement of the financial statements due to fraud;*
- (b) *obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and*
- (c) *respond appropriately to fraud or suspected fraud identified during the audit.*
- ISSAI 4000<sup>29</sup>** *The auditor shall consider the risk of fraud throughout the audit process, and document the result of the assessment.*
- Where ECA has discretion to select the coverage of compliance audits it shall identify areas that are of significance for the intended user(s).*

Due to the nature of fraud, and the inherent limitations of an audit, there is an unavoidable risk that fraud may occur and not be detected by audit work. Fraud may consist of acts designed intentionally to conceal its existence. There may be collusion between management, employees or third parties, or falsification of documents. For example, it is not reasonable to expect the auditor to identify forged documentation in support of claims for grants and benefits, unless they are obvious forgeries.

Furthermore, ECA's auditors do not have investigative powers, while only a court of law can determine if a particular transaction is fraudulent. Although the auditor does not legally determine if fraud has occurred, (s)he does have a responsibility to assess whether the transactions concerned are in compliance with relevant authorities.

Fraudulent transactions are, by their nature, not in compliance with relevant regulations. The auditor may also determine that transactions where fraud is suspected, but not yet proven, are not in compliance with authorities.<sup>30</sup> Fraud can result in qualification of the compliance opinion in the auditor's report.

If suspicion of fraudulent activity arises during the audit, the auditor notifies the appropriate levels of management and those charged with governance, where appropriate, unless they may be implicated. The auditor **should** also report the suspicion to his/her superior for appropriate follow-up and response. This is reported to the Legal Service, which provides the information to the President who then informs OLAF, the Commission's Anti-Fraud Office.

<sup>29</sup> Paragraphs 58 and 64.

<sup>30</sup> Authorities may include rules, laws and regulations, budgetary resolutions, policies etc. See ISSAI 400, paragraphs 28 – 32 for further explanation.

## APPENDIX I - INHERENT RISK FACTORS

The risk factors listed below are not applicable to all types of audits. The auditor **should** always consider inherent risk related to fraud and irregularity, for which relevant inherent risk factors are shown in *italics*.

### 1. Inherent risk factors associated with activities/programmes

*complexity of programmes;*  
*modification to existing programme's funding or eligibility rules*  
*complex, unusual or high-value transactions;*  
*activities involving the handling of large amounts of cash or high-value attractive goods - embezzlement or theft*  
*activities of a nature traditionally considered to be particularly prone to fraud or corruption (e.g. public works and technical contracts, contracts for the delivery of food aid from long-term EU storage);*  
*urgent operations (e.g. emergency aid)/operations not fully subject to usual controls;*  
*historical evidence of a high incidence of intentional irregularities;*  
 eligibility criteria inconsistent with objectives (too wide, too restrictive, not relevant);  
 administration of the activity such that the valuation of assets or the costing of goods and services received is difficult (e.g. price adjustment formulae in contracts);  
 priorities of Union and Member States differ to a significant degree;  
 no additionality: Union funds replace national government expenditure;  
 activities that are uninsurable and/or subject to risks arising from political, economic, financial, ecological (etc) instability;  
 particular points mentioned in internal and external audit reports, in reports by the European Parliament, in the press, etc.

### 2. Inherent risk factors associated with the operating structure

geographically dispersed organisation, or organisation operating in areas where communications are difficult;  
 unclear division of responsibilities between Commission/Member States' authorities;  
 activities or projects involving numerous partners (coordination problems, weaknesses in management and communications structures);  
 activities involving transfrontier operations (exchange rate risks; linguistic and political (etc) problems) and/or numerous administrative levels;  
 particular points mentioned in internal and external audit reports, in reports by the European Parliament, in the press, etc.

### 3. Inherent risk factors associated with beneficiaries

operations where the conduct of beneficiaries is difficult to check, or where the ultimate beneficiaries may be different from the apparent recipient;  
 beneficiaries highly dependant on Union funds;  
 activities which entail several levels of subcontracting, making the identification of eligible beneficiaries difficult;  
 historical evidence of a high incidence of intentional irregularities;  
 political/administrative pressure exerted by beneficiaries/participants in the activity;  
 beneficiaries' accounting systems and/or policies incompatible with Union systems (e.g. research sector);  
 unwanted responsibilities imposed on organisations, administrations or beneficiaries;

<p>particular points mentioned in internal and external audit reports, in reports by the European Parliament, in the press, etc.</p>
<p><b>4. Inherent risk factors associated with economic or technical circumstances</b></p>
<p>abnormal trends and ratios;            results that are intangible or difficult to evaluate;            activities starting up or coming to an end, or subject to rapid technological change;            beneficiaries or industries subject to a high failure rate (e.g. new technologies);            unstable sources of supply and variable prices of inputs (raw materials, etc);            over-dependence on one supplier (e.g. supplier of equipment has exclusive maintenance contract, is sole supplier of parts and materials, software, etc);            particular points mentioned in internal and external audit reports, in reports by the European Parliament, in the press, etc.</p>
<p><b>5. Inherent risk factors associated with the audited entity</b></p>
<p>frequent conflicts over pay, working conditions, social matters;            lack of turnover/mobility of personnel and/or <i>personnel not taking holidays</i> in a sensitive department/area (e.g. finance, accounting and control services);            activities with which the audited entity has no or limited experience;            activities that are highly dependent upon a small number of key personnel;            rapid turnover of personnel and, in particular, of staff working in finance, accounting and control departments;            insufficient staff, staff/management under-qualified, inexperienced, poorly motivated;            peaks and troughs in work patterns and information flows;            utilisation of obsolete information technology systems;            particular points mentioned in internal and external audit reports, in reports by the European Parliament, in the press, etc.</p>
<p><b>6. Inherent risk factors associated with the audited entity's management policies and practices</b></p>
<p>badly defined or unrealistic objectives;            management, supervision and control functions poorly suited to the activity;            lack of management information system and/or cost accounting system;            unclear division of responsibilities within and between the various departments;            strong pressure upon management to produce unrealistic results, achieve unrealistic objectives, meet unrealistic deadlines, achieve high rates of budgetary utilisation at the year-end;            short-term budgetary pressures (e.g. delay in undertaking necessary maintenance imposes greater costs at a later stage);            particular points mentioned in internal and external audit reports, in reports by the European Parliament, in the press, etc.</p>

## APPENDIX II - DETAILS RELATING TO INTERNAL CONTROL COMPONENTS

<i>Component</i>	<i>Component elements</i>	<i>How to gain understanding</i>
Control environment	<p>The pervasive nature of the control environment requires the auditor to consider whether the following elements provide an appropriate foundation for, or conversely, undermine the effectiveness of, the other internal control components:</p> <ul style="list-style-type: none"> <li>• communication/enforcement of integrity/ethical values</li> <li>• commitment to competence</li> <li>• participation by those charged with governance</li> <li>• management philosophy and operating style</li> <li>• organisational structure</li> <li>• assignment of authority and responsibility</li> <li>• human resource policies and practices</li> </ul>	<p>Inquiries</p> <p>Observation</p> <p>Inspection of documents, e.g. Code of Conduct</p>
Entity's risk assessment process	<p>As the basis of the auditor's own risk assessment, (s)he considers how management manages business risk, and in particular how it:</p> <ul style="list-style-type: none"> <li>• identifies risks relevant to financial reporting &amp; compliance</li> <li>• estimates its significance</li> <li>• assesses the likelihood of occurrence</li> <li>• decides upon actions to manage it.</li> </ul>	<p>Review of the entity's risk-assessment process and documents such as the AMP and AAR</p>
Information systems and Communication	<p>As the repository of all the entity's records and transactions, it is crucial that the auditor acquires an understanding of:</p> <ul style="list-style-type: none"> <li>• significant classes of transactions</li> <li>• procedures to initiate, record, process and report transactions</li> <li>• accounting records</li> <li>• financial reporting process</li> <li>• processing of exceptionally large or unusual transactions</li> <li>• reprocessing of rejected transactions</li> </ul>	<p>Inquiries as to how transactions are originated and processed</p> <p>Walk-through</p> <p>Inspection</p>
Control activities	<p>The auditor's focus is on how control activities, individually or in combination, reduce risk, with a particular emphasis on:</p> <ul style="list-style-type: none"> <li>• authorisation</li> <li>• performance reviews</li> <li>• information processing</li> <li>• physical controls</li> <li>• segregation of duties</li> </ul>	<p>Inquiries</p> <p>Observation</p>
Monitoring of controls	<p>By assessing how well the entity monitors controls, and takes corrective action where necessary, the auditor gains insight into how effective internal control is within the entity. Aspects to be considered include:</p> <ul style="list-style-type: none"> <li>• management and supervisory activities</li> <li>• internal audit</li> <li>• information from third parties (e.g. complaints)</li> <li>• evaluations</li> </ul>	<p>Inspection of sources of monitoring information</p> <p>Inquiries</p>

## APPENDIX III - THE COURT'S STATEMENT OF ASSURANCE 2015

### THE COURT'S STATEMENT OF ASSURANCE PROVIDED TO THE EUROPEAN PARLIAMENT AND THE COUNCIL – INDEPENDENT AUDITOR'S REPORT

I. We have audited:

(a) the consolidated accounts of the European Union which comprise the consolidated financial statements<sup>31</sup> and the aggregated reports on the implementation of the budget<sup>32</sup> for the financial year ended 31 December 2015, approved by the Commission on [11 July 2016]; and

(b) the legality and regularity of the transactions underlying those accounts,

as required by Article 287 of the Treaty on the Functioning of the European Union (TFEU).

#### *Management's responsibility*

II. In accordance with Articles 317 to 318 of the TFEU and the Financial Regulation, the Commission is responsible for the preparation and fair presentation of the consolidated accounts of the European Union on the basis of internationally accepted accounting standards for the public sector and for the legality and regularity of the transactions underlying them. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error. The Commission bears the ultimate responsibility for the legality and regularity of the transactions underlying the accounts of the European Union (Article 317 of the TFEU).

#### *Auditor's responsibility*

III. Our responsibility is to provide, on the basis of our audit, the European Parliament and the Council with a statement of assurance as to the reliability of the accounts and the legality and regularity of the transactions underlying them. We conducted our audit in accordance with the IFAC International Standards on Auditing and Codes of Ethics and the INTOSAI International Standards of Supreme Audit Institutions. These standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the consolidated accounts of the European Union are free from material misstatement and the transactions underlying them are legal and regular.

IV. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated accounts and the legality and the regularity of the transactions underlying them. The procedures selected depend on the auditor's judgment, including an assessment of the risks of material misstatement of the consolidated accounts and of material non-compliance of the underlying transactions with the requirements of the legal framework of the European Union, whether due to fraud or error. In making those risk assessments, internal control relevant to the preparation and fair presentation of the consolidated accounts and legality and regularity of underlying transactions, is considered 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 internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made, as well as evaluating the overall presentation of the consolidated accounts.

V. For revenue, our examination of Value Added Tax and Gross National Income-based own resources takes as its starting point the relevant macroeconomic aggregates on which these are calculated, and assesses the Commission's systems for processing these until the contributions of the Member States have been received and recorded in the consolidated accounts. For traditional own resources, we examine the accounts of the customs authorities and analyse the flow of duties until the amounts are received by the Commission and recorded in the accounts.

VI. For expenditure, we examine payment transactions when expenditure has been incurred, recorded and accepted. This examination covers all categories of payments (including those made for the purchase of assets) other than

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<sup>31</sup> The consolidated financial statements comprise the balance sheet, the statement of financial performance, the cashflow statement, the statement of changes in net assets and a summary of significant accounting policies and other explanatory notes (including segment reporting).

<sup>32</sup> The aggregated reports on implementation of the budget comprise the aggregated reports on implementation of the budget and explanatory notes.

advances at the point they are made. Advance payments are examined when the recipient of funds is required to provide or provides justification for their proper use and the advance payment is cleared or becomes recoverable.

VII. We consider that the audit evidence obtained is sufficient and appropriate to provide a basis for our opinions.

### **Reliability of the accounts**

#### *Opinion on the reliability of the accounts*

VIII. In our opinion, the consolidated accounts of the European Union for the year ended 31 December 2015 present fairly, in all material respects, the financial position of the Union as at 31 December 2015, the results of its operations, its cash flows, and the changes in net assets for the year then ended, in accordance with the Financial Regulation and with accounting rules based on internationally accepted accounting standards for the public sector.

### **Legality and regularity of the transactions underlying the accounts**

#### **Revenue**

#### *Opinion on the legality and regularity of revenue underlying the accounts*

IX. In our opinion, revenue underlying the accounts for the year ended 31 December 2015 is legal and regular in all material respects.

#### **Payments**

#### *Basis for adverse opinion on the legality and regularity of payments underlying the accounts*

X. Expenditure recorded in 2015 under the multi-annual financial framework headings covering operational spending<sup>33</sup> is materially affected by error. Our estimated level of error for payments underlying the accounts is 3,8 %. Our overall conclusion is driven by the higher estimated level of error for spending on a reimbursement basis<sup>34</sup> and is corroborated by the Commission's analysis of amounts at risk presented in the Annual Management and Performance Report for the EU budget.

#### *Adverse opinion on the legality and regularity of payments underlying the accounts*

XI. In our opinion, because of the significance of the matters described in the basis for adverse opinion on the legality and regularity of payments underlying the accounts paragraph, the payments underlying the accounts for the year ended 31 December 2015 are materially affected by error.

#### *Other information*

XII. The Financial Statement Discussion and Analysis is not a part of the financial statements. The information given in the Financial Statement Discussion and Analysis is consistent with the financial statements.

[XX14 July 2016

Vítor Manuel da SILVA CALDEIRA  
President

European Court of Auditors  
12, rue Alcide De Gasperi, Luxembourg, LUXEMBOURG

<sup>33</sup> These headings (1 to 4) are covered by chapters 5 to 8 of our annual report for 2015.

<sup>34</sup> 82,7 billion euro. We provide further information in paragraphs 1.21 to 1.24 of our annual report for 2015.

Table 1: DAS 2010 Results - Policy groups as in Annual Report 2010			
	Payments in 2010	% of total payments	Material level of error
Agriculture and Natural Resources	56 841,00	47%	x
Cohesion, Energy and Transport	40 630,00	33%	x
External Aid, Development and Enlargement	6 543,00	5%	
Research and other Internal Policies	8 953,00	7%	
Administrative and other expenditure	9 264,00	8%	
Total	122 231,00	100%	
Indicator for the term "confined": Material level of error affects x out of y policy groups			2/5 (40%)
Indicator for the term "substantial": Material level of error affects policy groups representing z% of total payments			80%

Table 2: DAS 2010 Results - Policy groups as foreseen for Annual Report 2011 <sup>(1)</sup>			
	Payments in 2010	% of total payments	Material level of error
Agriculture	43 990,00	36%	
Rural Development, Environment, Fisheries and Maritime Affairs, Health and Consumer Protection	12 851,00	11%	x
European Regional Development Fund, Energy and Transport	33 554,00	27%	X
European Social Fund	7 076,00	6%	
External Aid, Development and Enlargement	6 543,00	5%	
Research and other Internal Policies	8 953,00	7%	
Administrative and other expenditure	9 264,00	8%	
Total	122 231,00	100%	
Indicator for the term "confined": Material level of error affects x out of y policy groups			2/7 (29%)
Indicator for the term "substantial": Material level of error affects policy groups representing z% of total payments			38%

<sup>(1)</sup> The extrapolation of the results of the DAS 2010 audit of transactions on the basis of the new structure foreseen for the Annual Report 2011 does not provide sufficient appropriate audit evidence for being able to determine, with reasonable assurance, whether the policy groups Agriculture and European Social Fund are affected by a material level of error or not. The present hypothetical scenario is based on most likely error rates, independently of the level of confidence achieved.

Table 3: Hypothetical results - Policy groups as foreseen for Annual Report 2011						
	Payments in 2010	% of total payments	Material level of error			
Agriculture	43 990,00	36%	x			
Rural Development, Environment, Fisheries and Maritime Affairs, Health and Consumer Protection	12 851,00	11%				
European Regional Development Fund, Energy and Transport	33 554,00	27%		x		
European Social Fund	7 076,00	6%			x	
External Aid, Development and Enlargement	6 543,00	5%			x	x
Research and other Internal Policies	8 953,00	7%			x	x
Administrative and other expenditure	9 264,00	8%			x	x
Total	122 231,00	100%				
Indicator for the term "confined": Material level of error affects x out of y policy groups			1/7 (14%)	1/7 (14%)	4/7 (57%)	3/7 (43%)
Indicator for the term "substantial": Material level of error affects policy groups representing z% of total payments			36%	27%	26%	20%

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<b>Total</b>	<b>122 231,00</b>	<b>100%</b>	
Indicator for the term "confined": Material level of error affects x out of y policy groups			2/7 (29%)
Indicator for the term "substantial": Material level of error affects policy groups representing z% of total payments			38%

<sup>(1)</sup> The extrapolation of the results of the DAS 2010 audit of transactions on the basis of the new structure foreseen for the Annual Report 2011 does not provide sufficient appropriate audit evidence for being able to determine, with reasonable assurance, whether the policy groups Agriculture and European Social Fund are affected by a material level of error or not. The present hypothetical scenario is based on most likely error rates, independently of the level of confidence achieved.

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European Regional Development Fund, Energy and Transport	33 554,00	27%		x		
European Social Fund	7 076,00	6%			x	
External Aid, Development and Enlargement	6 543,00	5%			x	x
Research and other Internal Policies	8 953,00	7%			x	x
Administrative and other expenditure	9 264,00	8%			x	x
<b>Total</b>	<b>122 231,00</b>	<b>100%</b>				
Indicator for the term "confined": Material level of error affects x out of y policy groups			1/7 (14%)	1/7 (14%)	4/7 (57%)	3/7 (43%)
Indicator for the term "substantial": Material level of error affects policy groups representing z% of total payments			36%	27%	26%	20%



FINANCIAL AND  
COMPLIANCE AUDIT MANUAL

Introduction

1 - General

**2 - Reliability of Accounts**

3 - Compliance with Applicable

Laws and Regulations

Glossary and Acronyms

## 2. RELIABILITY OF THE ACCOUNTS

### TABLE OF CONTENTS

Section 1 - Framework

Section 2 - Planning

Section 3 - Examination

Section 4 - Reporting

Appendix I - Audits of reliability conducted by the ECA

Appendix II - Example of a representation letter regarding the reliability of the financial statements (provisional annual accounts 2016)



FINANCIAL AND  
COMPLIANCE AUDIT MANUAL

## PART 2. RELIABILITY

### 2. RELIABILITY

#### Section 1 - Framework

#### Section 2 - Planning

#### Section 3 - Examination

#### Section 4 - Reporting

#### Appendices

# SECTION 1 - FRAMEWORK

## TABLE OF CONTENTS

### 1.1 Accounts to be audited

### 1.2 Definition of reliability

### 1.3 Applicable financial reporting framework

### 1.4 Professional conduct

### 1.5 General objective of an audit of reliability

### 1.6 Audit assertions for reliability

*The objective of an audit of the financial statements is to enable the auditor to express an opinion as to whether the accounts are prepared, in all material respects, in accordance with the applicable financial reporting framework.*

ISSAI 1200  
[ISA 200]

*The objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with his/her findings*

## 1.1 ACCOUNTS TO BE AUDITED

### Elements of accounts

The TFEU (Article 287) requires an audit to be performed, and an opinion (Statement of Assurance) to be given, on the reliability of the accounts, which comprise the financial statements and the report(s) on implementation of the budget for the financial year. Such audits are conducted in respect of the European Union (EU) and institutions, European Development Funds (EDFs), agencies, joint undertakings, European Schools, and any other relevant body set up by the Union insofar as the relevant constituent instrument does not preclude such examination. A list of such audits, the form of audit report required and the legal base for the audit is included in [Appendix I](#).

### Accruals basis

In accordance with the Financial Regulation, the financial statements are prepared on an *accruals basis*, adapted to the specific environment of the Union, while the reports on implementation of the budget are primarily based on cash accounting.

## 1.2 DEFINITION OF RELIABILITY

### Free from material misstatement and bias

Reliability requires that the accounts be *free from material misstatement and bias*, and that they can be depended upon by users to represent faithfully that which they claim to represent or could reasonably be expected to represent. Faithful representation requires that transactions and other events are:

### Faithful representation

- presented in accordance with their *substance* and not merely their legal form;
- *neutral* or free from bias;
- *prudent*, so that assets or revenue are not overstated and liabilities or expenses are not understated;
- *complete* in all material respects; and
- *comparable* over time and between entities.

The financial statements for a given year must completely and accurately report the cash flows and financial results for that particular year; the

assets and liabilities at year-end must be properly recorded in order faithfully to reflect the financial position; and the notes to the accounts must disclose all relevant information.

## 1.3 APPLICABLE FINANCIAL REPORTING FRAMEWORK

The accounting rules applied by EU institutions and entities<sup>35</sup> are derived from the International Public Sector Accounting Standards (IPSASs) issued by the International Federation of Accountants (IFAC) or, in their absence, International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) of the International Accounting Standards Board.

## 1.4 PROFESSIONAL CONDUCT

The auditor **should**:

- |                      |  |
|----------------------|--|
| Ethics               | <ul style="list-style-type: none"> <li>• comply with relevant <i>ethical requirements</i></li> </ul>   |
| Scepticism           | <ul style="list-style-type: none"> <li>• plan and perform an audit with an attitude of <i>professional scepticism</i>, recognising that the accounts may be materially misstated;</li> </ul> |
| Reasonable assurance | <ul style="list-style-type: none"> <li>• obtain sufficient appropriate audit evidence to have <i>reasonable assurance</i> regarding the audit conclusion and opinion.</li> </ul>             |

## 1.5 GENERAL OBJECTIVE OF AN AUDIT OF RELIABILITY

Present fairly in all material respects

The general audit objective for reliability is to determine whether the accounts *present fairly, in all material respects*, the financial position, results and cash flow for the year, in accordance with the applicable financial reporting framework. For example, in the case of the annual accounts of the European Union, this framework consists of the provisions of the Financial Regulation and the accounting rules developed by the Commission's Accounting Officer, which are derived from the International Public Sector Accounting Standards (IPSASs) issued by the International Federation of Accountants (IFAC) or, in their absence, International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) of the International Accounting Standards Board.

These accounting rules **should** only diverge from the requirements of IPSASs where necessary, to give a true and fair view of the activities of the European Union.

<sup>35</sup> The accounting rules are applicable to those institutions and entities included in the consolidation perimeter.

## 1.6 AUDIT ASSERTIONS FOR RELIABILITY

### 1.6.1 Specific elements of the accounts to be audited

By representing that the annual accounts are reliable, management implicitly or explicitly makes *assertions* regarding the various elements of the accounts. In planning the audit, the auditor seeks to ensure that sufficient, relevant and reliable audit evidence will be collected so as to be able to draw conclusions about the extent to which these assertions are satisfied.

The specific objectives, or assertions, for which the auditor **should** draw conclusions are:

#### Transactions/events for the period

#### **(a) Assertions about classes of transactions and events for the period under audit**

*Occurrence*—transactions and events that have been recorded have occurred and pertain to the entity.

*Completeness*—all transactions and events that should have been recorded have been recorded.

*Accuracy*—amounts and other data relating to recorded transactions and events have been recorded appropriately.

*Cut-off*—transactions and events have been recorded in the correct accounting period.

*Classification*—transactions and events have been recorded in the proper accounts.

*Legality and regularity*—budgetary appropriations are available<sup>36</sup>.

#### Transactions/events at period-end

#### **(b) Assertions about account balances at period-end**

*Existence*—assets, liabilities, and equity interests exist.

*Rights and obligations*—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

*Completeness*—all assets, liabilities and equity interests that should have been recorded have been recorded.

*Valuation and allocation*—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any

<sup>36</sup> An illegal and irregular transaction is not declared as affecting the reliability of the accounts if it has been correctly entered in the accounts. However, the financial impact or risks of irregularities must be disclosed adequately.

resulting valuation or allocation adjustments are appropriately recorded.

## Presentation and disclosure

### (c) Assertions about presentation and disclosure

*Occurrence and rights and obligations*—disclosed events, transactions, and other matters have occurred and pertain to the entity.

*Completeness*—all disclosures that should have been included in the financial statements have been included.

*Classification and understandability*—financial information is appropriately presented and described, and disclosures are clearly expressed.

*Accuracy and valuation*—financial and other information is disclosed fairly and at appropriate amounts.

## 1.6.1 Specific elements of the consolidated annual accounts to be audited

The specific elements of the consolidated annual accounts to be audited are as follows:

### (i) *Statement of Financial Performance:*

The audit procedures for the Economic Outturn Account are designed to check that the income and expenses occurred, are accurate, complete and correctly recorded in the proper year, and are properly presented and disclosed.

### (ii) *Statement of Financial Position*

The audit procedures for the Balance Sheet should allow for the verification of the following financial statement items and assertions (examples):

- (a) contributions from the Member States (completeness and valuation);
- (b) debtors (existence, rights and obligations, completeness, valuation);
- (c) pre-financing (existence, rights and obligations, completeness, and valuation);
- (d) cash and cash equivalents (existence, rights and obligations, completeness, and valuation);
- (e) funds and reserves (completeness and valuation);
- (f) outstanding invoices (completeness and valuation);
- (g) accrued charges - provision for invoices to be received (rights and obligations, completeness and valuation);
- (h) fixed assets (existence, rights and obligations, completeness, and valuation).

### (iii) *Cashflow Statement*

The audit procedures for the Statement of Cash Flows are designed to determine whether the Statement correctly discloses the cash movements (contributions, income, expenses disbursed and cash position) for the year.

*(iv) Notes to the accounts*

Audit procedures for the Notes to the accounts are designed to verify the presentation and disclosure assertions, i.e. that each significant section of the financial statements is duly commented on in the Notes, including off-balance sheet items such as guarantees.

*(v) Statement of Changes in Net Assets*

The audit procedures regarding the Statement of Changes in Net Assets aim to ensure that changes in net assets are correctly recorded and reported.

*(vi) Reports on budgetary implementation*

Audit procedures for the reports on budgetary implementation should address the following:

- (a) changes in the consolidated resources are coherent with changes in the reserves, funds and capital as disclosed in the Balance Sheet;
- (b) the amounts of financial commitments, the individual legal commitments, and the payments (per instrument, policy area, etc.) are supported by appropriate documentation;
- (c) the financial information is reliable;
- (d) the Notes thereto ensure proper presentation and disclosure.



FINANCIAL AND  
COMPLIANCE AUDIT MANUAL

## PART 2. RELIABILITY

### 2. RELIABILITY

[Section 1 - Framework](#)

**[Section 2 - Planning](#)**

[Section 3 - Examination](#)

[Section 4 - Reporting](#)

[Appendices](#)

# SECTION 2 – PLANNING

## TABLE OF CONTENTS

[2.1 Planning - Overview](#)

[2.2 Determining materiality](#)

[2.3 Identifying and assessing risks through understanding the entity and its environment, including its internal control](#)

[2.4 Considering the sufficiency, relevance and reliability of audit evidence](#)

[2.5 Designing audit procedures](#)

[2.6 Drawing up the audit planning memorandum and audit programme](#)

## 2.1 PLANNING – OVERVIEW

**ISSAI 1300**  
**[ISA 300]**

*The objective of the auditor is to plan the audit so that it will be performed in an effective manner.*

[2.1.1 The basis of the auditor's approach to the audit of reliability](#)

### 2.1.1 The basis of the auditor's approach to the audit of consolidated annual accounts

The auditor plans to undertake the following steps in the audit of reliability of the consolidated annual accounts, in order to be able to reach a conclusion about the above general and specific audit objectives:

- *Identify and assess the risk of material misstatement* through understanding the auditee and its environment. The auditor needs to obtain a broad understanding that is sufficient to enable the identification of the classes of transactions or groups of accounts that may be significantly affected by the entity's activities, and to determine the level of inherent risk associated with the assertions which are most likely to induce a material misstatement of the accounts.
- *Form a preliminary assessment of control risk*

The auditor obtains an understanding of internal control, including the accounting systems, the annual accounts closing process and the procedures that are in place to ensure that the accounts comply with the financial reporting framework. This enables the auditor to identify the relevant controls which best address the assertions that are most likely to induce a material misstatement and to make a preliminary assessment of control risk in relation to the reliability of the accounts.

- *Design audit procedures*

The auditor then plans the nature, timing and extent of audit procedures to be performed - whether tests of controls combined with substantive procedures or focused on substantive procedures only - in order to reduce to an acceptably low level the audit risk of material misstatement.

- *Perform audit procedures* as designed during the planning phase, with appropriate changes thereto if required, based on the results of audit tests undertaken.
- *Report on reliability*

The ECA issues an opinion on the reliability of the consolidated annual accounts which is separate to its opinion on the transactions underlying the accounts.

## 2.2 DETERMINING MATERIALITY

ISSAI 1320  
[ISA 320]

*The objective of the auditor is to determine, and reconsider as the audit progresses, an appropriate materiality level or levels to enable the auditor to plan and perform the audit.*

### 2.2.1 Materiality levels

#### 2.2.2. Quantitative and qualitative materiality regarding reliability

#### 2.2.3. Material items in the accounts

### 2.2.1 Materiality levels

#### Financial statement level

When planning the audit, the auditor considers what would make the accounts materially misstated. (S)he considers materiality at both the overall annual accounts level and in relation to classes of transactions, account balances and disclosures. Different materiality levels may be used, depending on the aspect of the accounts being considered. The auditor's assessment of materiality helps him/her to decide such questions as what items to examine and whether to use sampling and employ analytical procedures as substantive procedures.

#### Classes of transactions, account balances and disclosures

### 2.2.2 Quantitative and qualitative materiality regarding reliability

#### Quantitative

The auditor needs to assess the point at which the aggregate value of uncorrected misstatements identified during the audit is such that (s)he would consider the accounts to be unreliable. For example, if the estimate of total error in the annual accounts is so high that, if users were aware of it, they would consider the accounts to be unreliable, then that level of error must be considered as *quantitatively material*. In addition, the auditor needs to consider the possibility of misstatements of relatively small amounts that cumulatively could have an effect on the accounts.

#### Qualitative

Certain types of misstatements, while not in themselves quantitatively material, may be *qualitatively material*, i.e. material by nature or context. This means that they are so significant, by virtue of their nature or context, that they have an impact on the draft audit opinion that is prepared. Examples would be the inadequate or improper description of an accounting policy such that it is likely that a user of the accounts would be misled, or, where relevant, the omission of an entity in a list of consolidated entities.

## 2.3 IDENTIFYING AND ASSESSING RISKS THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT, INCLUDING ITS INTERNAL CONTROL

**ISSAI 1315**  
**[ISA 315]**

*The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the annual accounts and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.*

[2.3.1 Audit risk](#)

[2.3.2 Understanding the entity's business so as to identify and assess inherent risk](#)

[2.3.3 The entity's internal control](#)

[2.3.4 Identifying and assessing control risk](#)

[2.3.5 Examples of risks of misstatements](#)

### 2.3.1 Audit risk

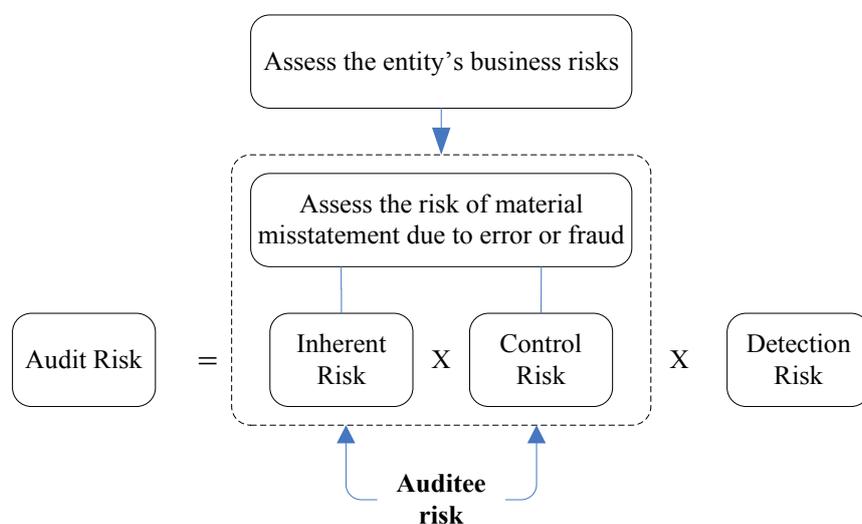
#### Definition of audit risk

*Audit risk* for reliability is the risk that the ECA may express an inappropriate audit opinion when the accounts are materially misstated. Audit risk is a function of the:

- risk of material misstatement - the risk that the accounts may be materially misstated prior to the audit; this risk has two components - inherent risk and control risk; and
- the risk that the auditor will not detect such misstatement (detection risk).

This can be represented as follows:

**Figure 1: Components of audit risk**



**Assessing the risk of material misstatement**

The auditor **should** identify and *assess the risks of material misstatement* at the consolidated annual accounts level, and at the assertion level for classes of transactions, account balances, and disclosures. For this purpose, the auditor:

- *identifies risks* during the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the consolidated annual accounts;
- relates the identified risks to *what can go wrong* at the assertion level;
- considers whether the risks are of a magnitude that could result in a *material* misstatement of the consolidated annual accounts;
- considers the *likelihood* that the risks could result in a material misstatement; and
- determines which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (called "*significant risks*").

**Significant risks**

Risks of material misstatement may be greater for risks relating to:

*(i) significant non-routine transactions arising from matters such as the following:*

- greater management intervention to specify the accounting treatment;
- greater manual intervention for data collection and processing;
- complex calculations or accounting principles;
- the nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risk.

*(ii) significant matters of judgment that require the development of accounting estimates, arising from matters such as the following:*

- valuation methods for accounting estimates or revenue recognition may be subject to differing interpretation (e.g. accruals);
- required judgment may be subjective, complex or require assumptions about the effects of future events (e.g. provisions).

**Conditions and events that may indicate risks of material misstatement**

The following are examples, albeit not necessarily exhaustive ones, of conditions and events that may indicate the existence of a risk of material misstatement:

**Table 1: Examples of conditions/events that may indicate a risk of material misstatement**

<i>Area</i>	<i>Examples</i>
Entity structure	<ul style="list-style-type: none"> <li>• Changes in the entity such as reorganisation or unusual events</li> <li>• Complex alliances or joint ventures</li> </ul>
Transactions	<ul style="list-style-type: none"> <li>• Significant transactions with related parties</li> <li>• Significant amount of non-routine or non-systematic transactions at period-end</li> </ul>
Accounting	<ul style="list-style-type: none"> <li>• Application of new accounting rules or pronouncements (e.g. introduction of accrual accounting)</li> <li>• Accounting measurements that involve complex processes</li> <li>• Events or transactions involving significant measurement uncertainty, including accounting estimates</li> </ul>
Personnel	<ul style="list-style-type: none"> <li>• Lack of personnel with appropriate accounting and financial reporting skills</li> <li>• Changes in key personnel, including departure of key executives, staff rotation</li> </ul>
Information Technology (IT)	<ul style="list-style-type: none"> <li>• Changes in the I.T. environment</li> <li>• Installation of significant new IT systems for financial reporting (e.g. ABAC)</li> <li>• Insufficient controls over data transfer between IT systems</li> </ul>
Past or current problems	<ul style="list-style-type: none"> <li>• History of misstatements or significant adjustments at period-end</li> <li>• Weaknesses in internal control, especially those not addressed by management</li> <li>• Enquiries into the entity by regulatory or government bodies</li> <li>• Pending litigation and contingent liabilities</li> </ul>

**Risk-assessment procedures**

The auditor **should** carry out risk-assessment procedures (analysis, enquiries, inspection) to obtain the required understanding of the entity's level of inherent risk and control risk. Much useful information may be obtained from the auditee's own risk-assessment procedures. For example, the Commission's Directorates-General (DGs) have established accounting correspondents in each DG who are responsible for identifying and assessing accounting risk. In all cases, the auditor **should** exercise professional scepticism with regard to risk assessments performed by the auditee.

**2.3.2 Understanding the entity's business so as to identify and assess inherent risk**

**Background**

The extent of the auditor's work to obtain a sufficient understanding of the entity and its environment will depend on the complexity of the operations and the related accounting processes; the auditor's previous experience of the entity; and the degree of change, if any, that has taken place since previous audits.

In all cases, the audited entity retains responsibility for ensuring the

reliability of the consolidated annual accounts and proper disclosure in the consolidated annual accounts. In particular, in the case of the Commission, the Accounting Officer is directly responsible for the consolidated annual accounts, with the authorising officers by delegation (Directors-General) being indirectly responsible. For other EU institutions, it is the Accounting Officer who is responsible.

#### Areas of focus

Understanding the entity and its environment encompasses an understanding of:

- *the nature of the entity*, including the types of transactions undertaken, the financial statement and budgetary items included in the accounts, and the chain of responsibilities involved in the accounting process;
- *the entity's objectives and strategies* and the related business risks that may result in a material misstatement of the annual accounts;
- *the financial reporting framework* (see [chapter 1.3](#)), including the accounting rules adopted and the *regulatory provisions* of the TFEU, Financial Regulation and its Implementing Rules, under which the annual accounts are prepared. The financial reporting framework and other regulations include those set out in the specific legislation establishing the audited entity and determining its activities. Such understanding also covers presentation of the annual accounts, including the disclosure of material matters, terminology used, the classification of items, and the basis of the amounts;
- *the entity's selection and application of accounting policies* - the auditor considers if these are appropriate and consistent with the financial reporting framework. Obtaining an understanding includes the methods of accounting for significant and unusual transactions, establishing accounting estimates, changes in accounting policies or changes in international accounting standards that may affect the entity, and whether entity management appears to follow aggressive or conservative accounting policies;
- *how the entity measures and reviews its financial performance*, whether through performance indicators (e.g. budgetary execution), variance analysis, or other means; such measures may indicate to the auditor a risk of misstatements in the accounts.

#### The consolidated annual accounts

The consolidated annual accounts comprise:

- the *financial statements*, which consist of:
  - the Balance Sheet (Statement of financial position);
  - the Statement of Financial Performance;

- the Cashflow Statement;
- the Statement of Changes in Net Assets;
- the Notes to the financial statements;
- the *report(s) on implementation of the budget*

Some of the main items in the accounts are:

#### Pre-financing

*Pre-financing*: This is intended to provide the beneficiary with a float, and is a largely-used contractual provision in the Union's various domains of intervention. The pre-financing advanced to a project remains the property of the Union until it is cleared after the beneficiary has provided justification for the use of the funds. Until it has been cleared, the net value of pre-financing remains disclosed in the balance sheet assets.

#### Outstanding invoices

*Outstanding invoices*: In the Union's accounting environment, "invoices" is the generic term used to designate cost claims received from project beneficiaries, cost statements from Member States, commercial invoices, audited statements of expenses in a co-financed project, etc. Receiving, analysing the eligibility of, and paying invoices are intrinsic to the very nature of the Union's intervention. Invoices are included in "current payables" in the liabilities section of the balance sheet when they have not yet been paid at year-end.

#### Accrued charges

*Accrued charges*: Under accrual-based accounting, the Union recognises at year-end those liabilities to project contractors for the portion of works executed at year-end but for which no invoice has yet been received. This is commonly referred to as *cut-off*. Establishing the cut-off of accrued charges at year-end is a complex process, because it is largely an estimation exercise.

The risk of misstatement is increased due to the enormous number of projects financed by the Union, the amounts at stake, the multiple models of project life-cycles, the specific accounting schemes, the diverse nature of contracts, the nature and reliability of the information available for each project and, in the case of the DAS and EDFs, the different DGs' business models.

#### Identifying and assessing inherent risk

The auditor **should** make a preliminary assessment of inherent risk at the overall level (i.e. for the activity/entity as a whole) in order to identify risk areas specific to the audit that must be taken into account when planning and carrying out audit procedures. The auditor may assess inherent risk to be *High or Not High*.

Examples of inherent risks could include significant changes in terms of accounting and information technology, the complexity of accounting rules and processes to be applied, and the number of institutions and/or

departments involved, in addition to material areas such as pre-financing, invoices/cost statements and cut-off.

**Significant risks**

The auditor **should** determine which of the inherent risks identified are, in the auditor's judgment, risks that require *special audit consideration* (significant risks) and **should** obtain an understanding of the related internal controls.

### 2.3.3 The entity's internal control

**Internal control of reliability**

Internal control regarding reliability is designed to address risks and provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of the accounts.

Some controls cover the accounting processes throughout the year (e.g. accounting review activities, and development of accounting risk analysis in the Commission). Other controls relate specifically to the year-end closing process.

**Relevant controls**

Controls that are relevant to an audit of the reliability of the accounts pertain to the entity's objective of preparing accounts for external purposes that are presented fairly, in all material respects, in accordance with the applicable financial reporting framework and the management of risk that may give rise to a material misstatement in those accounts.

It is a matter of the auditor's *professional judgment* as to whether a control, individually or in combination with others, is relevant in this context. In exercising that judgment, the auditor considers materiality, the nature of the entity's business, the diversity and complexity of the entity's operations, and the nature and complexity of the internal control systems.

When considering the accounting control environment, special attention **should** be given to those controls that have a direct impact on the accounts assertions.

**Control systems to be considered:**

The *main control systems to be considered* with regard to reliability are the controls, checks, and measures undertaken by the Accounting Officer and, where relevant, the DGs themselves, as follows:

**- general**

- the measures taken by the auditee to present annual accounts in compliance with the applicable accounting rules and standards and reporting deadlines;
- the auditee's identification of its own accounting processes (this is a pre-requisite to the accounting risk analysis);
- the auditee's process for establishing and validating its own risk analysis;

- the key accounting procedures and manuals which govern the recording and quality of individual financial information throughout the year;
- implementation of controls on final balances;
- implementation of a customised accounting manual;
- valuation and control methods specifically developed for a significant group of accounts (e.g. estimates of cut-off of accrued charges or provisions);

**- organisation**

- the chain of responsibilities involved in the validation of figures presented in the annual accounts (e.g. Authorising Officer, accounting correspondent, and ultimately the Accounting Officer);
- the organisation of the accounting function (staff, training, assignment of responsibilities);

**- closing process**

- the specific controls during the year-end closing process to ensure and review the quality of the accounting records (e.g. to ensure completeness and valuation);
- the relevance, appropriateness and consistency of cut-off methodology applied to accrued charges;
- reconciliation between cut-off budgetary information and data included in systems;
- internal controls over the annual accounts closing process;
- the process for arriving at significant accounting estimates and disclosures;
- whether closing instructions are received in time and properly applied;
- correct and timely implementation of procedures, and compliance with deadlines;

**- IT**

- the accounting IT systems and their interaction (e.g. ABAC, SAP);
- coherence between data in local (e.g. local systems of the DGs, institutions or agencies) and central systems (e.g. ABAC/SAP) and validation of the local systems;

**- reviews**

- accounting reviews performed by the entity (e.g. DGs, agencies);
- the quality of data entry, and the extent of review of the data entered in

the accounting system;

- the accounting review deriving from the DG's accounting risk analysis;
- the extent of review by the accounting officer of the quality of the financial information received from the authorising officer to produce the annual accounts;
- final validation by the Director-General of his/her DG's accounts.

Work on reliability in this regard entails updating the descriptions and evaluating the procedures relating to the significant accounting processes and systems and the application of the accounting rules, including those regarding cut-off, that lead to the annual accounts. In the case of audit work at the Commission, this includes work on the functioning of the central accounting system (ABAC) as well as the various local accounting systems. Where relevant, procedures for gathering and verifying data which have to be shown in the accounts, but are not yet recorded, must be examined to ensure they are complete.

### 2.3.4 Identifying and assessing control risk

The auditor **should** make a preliminary assessment of control risk by process (expenses/invoices, pre-financing, etc.), assessing it as *Low*, *Medium* or *High*, in order to help identify the nature, timing and extent of audit procedures to be carried out.

At the Commission, the DGs establish their own accounting risk analysis per process and per audit assertion. This represents a substantial input to the work of the auditor who **should**, however, exercise professional scepticism in assessing the auditee's risk analysis.

### 2.3.5 Examples of risks of misstatements

Risks of misstatements may arise at assertion level for the following main balance sheet headings:

#### Pre-financing:

Existence: pre-financing may be wrongly accounted for as an asset (instead of an expense) if the contract has no provision for an advance of funds or part of the pre-financing should have been cleared through expenditure incurred, resulting in an overstatement of the entitlement of the Union.

Completeness: the amount of pre-financing in the balance sheet is incomplete if some advances were wrongly accounted for as expenses rather than advance payments.

Valuation: pre-financing may be wrongly accounted for by being valued differently from the contract provisions. The net amount of pre-financing may be wrongly valued due to an incorrect amount of incurred expense or accrued charges being recorded.

Presentation: there may be an inaccurate split in the balance sheet between long term pre-financing and short term pre-financing, or accrued charges on pre-financing may be wrongly disclosed under liabilities in the balance sheet.

#### Invoices to be paid:

Rights and obligations: a liability may be wrongly accounted for when the amount recorded does not correspond to (i) the face value of the invoice, or (ii) the real liability to the third party.

Completeness: the amount of invoice liabilities may be incomplete if, for example, the DG or the agency does not have a proper system ensuring at year-end that all physical invoices received had been encoded by the operational units in the accounting system.

Valuation: inaccurate amounts of invoice liabilities result from the incorrect calculation of eligible amounts, recognition of the total amount of a cost-claim rather than just the Union's part in a co-financing arrangement, etc.

Presentation: an error in the presentation in the balance sheet may result from the erroneous classification of the invoice in the account group "other creditors" rather than "current payables".

Existence: accrued charges may be calculated for a project which has already been closed, or which never incurred actual expenses.

Completeness: the total amount of accrued charges is incomplete if not all the population of contracts was used as a basis for calculation.

**Accrued charges:**

Valuation: the methodology or the definition of the parameters of the methodology may be not pertinent, e.g. the establishment of the pro-rata temporis or the evaluation of the decommitment rate. The calculation of the parameters themselves may be inaccurate, e.g. wrong contract start and/or end dates, or wrong decommitment rate.

Presentation: there may be confusion in the accounting presentation of accrued charges, since the part that clears the project's existing pre-financing is shown as a negative amount on the assets side of the balance sheet (as a deduction from pre-financing), whereas the normal accrued charges are disclosed in the liabilities (under accounts payable).

## 2.4 CONSIDERING THE SUFFICIENCY, RELEVANCE AND RELIABILITY OF AUDIT EVIDENCE

**ISSAI 1500**  
**[ISA 500]**

*The objective of the auditor is to design and perform audit procedures so as to be able to obtain sufficient, relevant and reliable audit evidence.*

[2.4.1 Relationship between the consolidated annual accounts, audit evidence and the audit report](#)

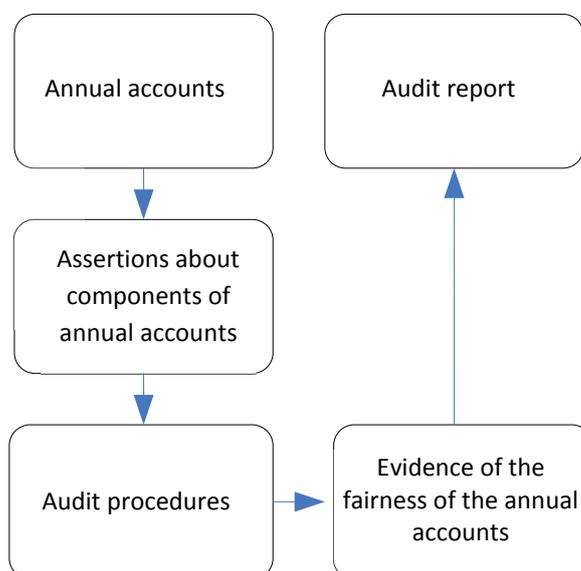
[2.4.2 Sources of audit evidence](#)

[2.4.3 Audit procedures to obtain audit evidence](#)

### 2.4.1 Relationship between the consolidated annual accounts, audit evidence and the audit report

Audit evidence obtained from the audit procedures is the basis for the auditor's conclusion and opinion on the reliability of the accounts, as follows:

**Figure 2: Relationship between accounts, evidence and audit report**



## 2.4.2 Sources of audit evidence

Audit evidence for reliability may emanate from the following sources:

- *internal* to the entity: the accounts themselves, as well as information from databases and documents produced by the entity;
- *external* to the entity, such as external third-party confirmations or reports of auditor's experts;
- *produced by the auditor*, such as analytical review of financial statements or of individual accounts, e.g. debtors, pre-financing or contingent assets.

## 2.4.3 Audit procedures to obtain audit evidence

1. The audit procedures employed to obtain audit evidence regarding reliability include:

Computation	<ul style="list-style-type: none"> <li>- arithmetic check of the accounts</li> <li>- verification of the correctness of consolidation, where appropriate</li> <li>- check figures in the balance sheet and notes to the output of the underlying IT systems and/or supporting documentation used as the basis for the figures in the accounts</li> <li>- agree figures, e.g. to trial balance and general ledger</li> </ul>
Analysis	<ul style="list-style-type: none"> <li>- analytical review of the consistency of the accounts</li> <li>- analysis of reconciliations performed by the entity, e.g. bank reconciliations</li> <li>- analysis of accounting rules and policies</li> <li>- analysis of valuation methods</li> <li>- analysis of budgetary execution</li> </ul>
Inspection	<ul style="list-style-type: none"> <li>- records and documents</li> <li>- tangible assets</li> </ul>
Confirmations	<ul style="list-style-type: none"> <li>- confirmation (circularisation) of bank balances, debtors, creditors</li> <li>- confirmation with third parties (e.g. legal counsel for outstanding court cases that may need to be disclosed as contingencies)</li> </ul>

## 2.5 DESIGNING AUDIT PROCEDURES

**ISSAI 1330**  
**[ISA 330]**

*The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.*

[2.5.1 Relating the assessed risk of material misstatement to audit procedures](#)

[2.5.2 Designing tests of control](#)

[2.5.3 Designing analytical procedures as substantive procedures](#)

[2.5.4 Designing tests of details](#)

[2.5.5 Audit sampling](#)

### 2.5.1 Relating the assessed risk of material misstatement to audit procedures

#### Risk as basis of audit procedures

Having identified the risk of material misstatement, as described in [Chapter 2.3](#), this is then used as the basis for determining the audit procedures considered necessary in order to reduce the audit risk of material misstatement to an acceptably low level.

To obtain sufficient appropriate audit evidence to substantiate the assertions concerning reliability, the auditor **should** perform tests of control, whenever reliance is to be placed on the control systems, and substantive procedures. The extent of the substantive procedures will depend on the auditor's assessment of the effectiveness of the design of systems and the extent to which tests of those controls support an assessment of moderate to low risk. Depending on the preliminary assessment of control risk, the auditor may decide to undertake tests of controls, for the following reasons:

- Where the preliminary assessment of control risk is low or medium, the auditor **should** test the controls to confirm this assessment, if (s)he intends to rely on these controls.
- Where the preliminary assessment of control risk is high, the auditor **should** not rely on systems but *may* test the controls to support findings to be reported to management or the discharge authority concerning system weaknesses.

### 2.5.2 Designing tests of control

Tests of controls typically performed when auditing the reliability of the accounts:

- the accounting control environment (including risk analysis, review activity and accounting manual);
- analysis of the systems for recording data (e.g. ABAC and local systems for recording, pre-financing, guarantees);
- the functioning of key budgetary and accounting procedures;

- the accounts closing process, especially relating to cut-off, invoices, pre-financing, guarantees, RAL (*reste à liquider*), commitments, payments, off-balance sheet items;
- reconciliations;
- DGs' controls of closure files supporting the final beneficiaries;
- review of applicable reports of the IAS (Internal Audit Service) and APC (Audit Progress Committee).

### 2.5.3 Designing analytical procedures as substantive procedures

Analytical procedures to be performed include analytical checks of the consistency and reasonableness of the accounts in comparison to previous years and budgets.

### 2.5.4 Designing tests of details

Tests of details to be performed may include:

- comparison of the opening balance sheet with the closing balance sheet of the previous year;
- arithmetic check of the accounts;
- verification of the correctness of the consolidation of the accounts and budget implementation, where appropriate (e.g. elimination of intra-group transactions, consolidation entries and arithmetical accuracy);
- check of the consistency of the closing balance sheet and economic outturn account with the trial balance (including off-balance sheet commitments);
- audit of the reconciliation between the budgetary outturn and the economic outturn;
- agreeing or reconciling the financial statements with the underlying accounting records;
- examining material journal entries and other adjustments made while the financial statements were being prepared;
- physical examinations;
- check that selected transactions have been correctly entered in the accounts;
- substantive test of commitments, payments and certain balance sheet items, including accruals, bank and cash, debtors, deferred charges, cut-off, pre-financing, guarantees, bank confirmations, debtors' circularisations, etc.;
- check of off-balance sheet commitments.

### 2.5.5 Audit sampling

The auditor may need to validate an account which is a component of the financial statements (balance sheet, economic outturn account, etc.) or of the budgetary accounts from the reports on implementation. Sampling is the most appropriate audit technique when such accounts comprise a large number of entries or individual balances (e.g. pre-financing and related

guarantees, invoices payable).

For financial audits, Monetary Unit Sampling (MUS) is used. The sample size for MUS is determined by the following factors:

- combined risk assessment: high, medium or low (higher risk = larger sample);
- tolerable error (e.g. 2% of the total amount of liabilities);
- confidence level (e.g. 95% for the EU consolidated balance sheet).

Having established the audit objectives (completeness, reality, rights and obligations, measurement and valuation, presentation) to be achieved by substantive tests on the sample, the auditor **should** perform the following steps:

**(1) Define what constitutes an error**

Auditors establish criteria as to what constitutes an error for the sample on the reliability of accounts, depending on the type of audit objective for the specific balance sheet item under audit. Examples of potential misstatements for major balance sheet items are as follows:

**Examples of potential misstatements on pre-financing, per audit assertion:**

- *Existence*
  - the amount disclosed as pre-financing has never been paid to the beneficiary (absence of event giving rise)
  - the beneficiary has already presented all necessary justification of the pre-financing, but the Commission omitted to clear it in its accounts
- *Completeness*
  - the payment of the advance has erroneously been accounted for as an expense (recorded in the Economic outturn) instead of as pre-financing (recorded in the balance sheet)
- *Valuation expressed in terms of understatement or overstatement*
  - the amount booked in the accounts differs from the amount of pre-financing actually paid to the beneficiary
  - the pre-financing's corresponding amount of accrued charges is incorrectly calculated, leading to an incorrect amount of net pre-financing
  - omission of a clearing
  - reimbursement of the costs already incurred by the beneficiary is booked as expenses and charged to the economic outturn; they **should** not be booked as pre-financing as this would lead to an overstatement of assets
- *Presentation*

- the amount of the total pre-financing is correct, but it has been inappropriately split between long-term pre-financing (non-current assets in the balance sheet) and short-term pre-financing (current assets in the balance sheet). The criterion for the term is usually that pre-financing to cover the costs of the first X months of operation of the projects are short-term, and long-term for the costs beyond that period.

**Examples of potential misstatements of accounts payable, per audit assertion:**

- *Existence*
  - an amount is disclosed whereas no goods or service has ever been received (absence of event giving rise)
- *Completeness*
  - at year-end, some invoices/payments may be left unrecorded outside the accounting system because the auditee does not have proper procedures and controls to collect them
- *Valuation, expressed in terms of understatement or overstatement*
  - the amount booked in the accounts is not linked to the invoice received, whether it is before analysis of eligibility (Step 1) or after (Step 2).
  - the amount booked in the accounts does not reflect the real liability (e.g. when the beneficiary claims more than the amount committed, the maximum liability recorded as an invoice must be limited to the amount of the commitment, or when the Union erroneously endorses the total amount of an overall invoice in co-financed project
  - s, the liability must be limited to the rate of co-financing)
- *Presentation*
  - the invoice may be erroneously in an account which is reported under a balance-sheet heading other than "Accounts payable"

**Examples of potential misstatements of accrued charges, per audit assertion:**

- *Rights and obligations*
  - accrued charges may be erroneously charged to a project for which there are no further costs expected, because the final payment had already been made or because the project is already closed
- *Completeness*
  - the contract or the commitment has been omitted in the total

calculation

- *Valuation, often resulting from an incorrect parameter used in the estimation*
  - wrong average rate of decommitment
  - wrong average rate of consumption
  - omission of invoices already accepted and/or paid
  - omission of pre-financing
  - contract implementation dates not updated (after riders and addenda)
  - contract amount not updated (after riders and addenda)
- *Presentation*
  - the total accrued charges calculated for the commitment may be wrongly split between "Accrued charges on pre-financing" which are booked on the assets side of the balance sheet (as a deduction to pre-financings) and "Accrued charges" which are booked on the liabilities side of the balance sheet (in Accounts payable)

***Examples of potential misstatements of guarantees, per audit assertion:***

- *Existence*
  - a guarantee may be maintained in the accounts when it has already been released
  - the amount of a guarantee may be recorded in the accounts in the absence of a paper guarantee issued by a financial institution
- *Completeness*
  - the auditee has no proper system to record in a timely manner the guarantees given or received in the accounting system, leading to an incomplete amount at year-end
- *Valuation, expressed in terms of understatement or overstatement*
  - the amount booked in the accounts is higher than the value of the guarantee, because some partial releases were not recorded in the accounts
  - the amount booked in the accounts is lower than the guarantees actually received, e.g. when the beneficiary delivers an additional pre-financing guarantee after the amount of the pre-financing had been increased in the provisions of the contract, or an additional performance guarantee after the amount of the contract had been increased by an addendum
- *Presentation*

- the guarantees may be erroneously booked as "given" instead of "received" (guarantees are disclosed in the notes to the annual accounts as "Contingent assets" for guarantees received, and "Contingent liabilities" for guarantees given).

### ***(2) Determine the population from which items will be selected***

The populations to be tested include the following accounts or groups of accounts:

1. from the financial statements: pre-financing, cut-off of accrued charges, invoices to be paid, guarantees, etc.;
2. from the reports on budgetary implementation: the appropriations, commitments, payments, recoveries, RAL (*reste à liquider*), etc.

The population is the entire data set from which the sample will be drawn and about which the auditor wishes to draw conclusions, e.g. the population of recoveries, decommitments, pre-financings or any heading in the annual accounts. Any heading in the balance sheet in particular (e.g. "short-term pre-financings"), and the annual accounts in general, often comprises not just one single general ledger account, but several. For example, there are more than 20 general ledger accounts constituting the balance-sheet heading "Short-term pre-financing". The population from which the sample will be drawn therefore often constitutes a number of accounts. The population can be the number of final individual amounts which constitute the year-end balance of those several accounts at 31/12/N (e.g. final balance of individual pre-financings per contract), or some specific movements (e.g. debit movements or credit movements of individual pre-financings during the year).

### ***(3) Explore the nature of the population which serves as a basis for the sampling***

Auditors must gain as much information as possible about the population in order to ascertain its appropriateness for sampling, for instance:

- all items pertain to the financial year under audit;
- there is no exceptional amount which should be withdrawn, such as individual items exceeding the materiality threshold which are to be tested outside the sample;
- all items pertain to the entity under audit.

## 2.6 CONSIDERING FRAUD

**ISSAI 1240**  
**[ISA 240]**

*A discussion should take place among the engagement team members which shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud including how fraud might occur.*

### 2.6.1 Considering Fraud

#### 2.6.1 Considering Fraud

During this discussion, the engagement team should set aside assumptions that management and those charged with governance are honest and have integrity. The risks of material misstatements due to fraud should be further discussed and documented.

## 2.7 DRAWING UP THE AUDIT PLANNING MEMORANDUM AND AUDIT PROGRAMME

**ISSAI 1300**  
**[ISA 300]**

*The objective of the auditor is to establish the Audit Planning Memorandum and develop an audit programme in order to reduce audit risk to an acceptably low level.*

### 2.7.1 Audit Planning Memorandum

#### 2.6.1 Audit Planning Memorandum

Guidance on the content of the APM is given in [Chapter 2.6 of the general part of the manual](#).

## PART 2. RELIABILITY

### 2. RELIABILITY

[Section 1 - Framework](#)  
[Section 2 - Planning](#)  
[Section 3 - Examination](#)  
[Section 4 - Reporting](#)  
[Appendices](#)

# SECTION 3 – EXAMINATION

## TABLE OF CONTENTS

[3.1 Examination - Overview](#)

[3.2 Performing audit procedures – tests of controls and tests of details](#)

[3.3 Evaluating the results of audit procedures](#)

[3.4 Performing substantive analytical procedures](#)

[3.5 Written representations](#)

[3.6 Using the work of others](#)

[3.7 Other audit procedures](#)

[3.8 Clearing audit findings](#)

## 3.1 EXAMINATION – OVERVIEW

Guidance on the examination of audits is provided in [Chapter 3.1 of the general part of the manual](#).

## 3.2 PERFORMING AUDIT PROCEDURES – TESTS OF CONTROLS AND TESTS OF DETAILS

**ISSAI 1530**  
**[ISA 530]**

*The objective of the auditor is perform audit procedures appropriate to the particular audit objective on each item selected.*

[3.2.1 Performing tests of controls](#)

[3.2.2 Performing tests of details](#)

### 3.2.1 Performing tests of controls

When performing tests of controls, the auditor **should** follow the requirements in [Chapter 3.2.2 of the general part of the manual](#).

### 3.2.2 Performing tests of details

When performing tests of details, the auditor **should** follow the requirements in [Chapter 3.2.3 of the general part of the manual](#).

## 3.3 EVALUATING THE RESULTS OF AUDIT PROCEDURES

**ISSAI 1450**  
**[ISA 450]**

*The objective of the auditor is to evaluate the results from the sample in a manner that will provide an appropriate basis for the auditor to draw conclusions about the population.*

**ISSAI 1530**  
**[ISA 530]**

[3.3.1 Defining misstatements and their possible causes](#)

[3.3.2 Types of misstatements](#)

[3.3.3 The impact of misstatements on the audit approach](#)

[3.3.4 Communication and correction of misstatements](#)

[3.3.5 Evaluating the effect of uncorrected misstatements](#)

[3.3.6 Evaluating the financial statements as a whole](#)

### 3.3.1 Defining misstatements and their possible causes

**Definition**

A misstatement is the difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

When the auditor expresses an opinion on whether the accounts are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the accounts to be presented fairly, in all material respects.

**Error or fraud**

Misstatements may be *errors or fraud*. The term "error" refers to an unintentional misstatement in the financial statements. The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Two types of intentional misstatements are relevant to the auditor: misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

Misstatements may result from:

**Source of misstatements**

- (a) an *inaccuracy* in gathering or processing data from which the accounts are prepared;
- (b) an *omission* of an amount or disclosure;
- (c) an *incorrect accounting estimate* arising from overlooking or clear misinterpretation of facts; or
- (d) *management's judgments* concerning accounting estimates that the auditor considers unreasonable, or the selection and application of accounting policies that the auditor considers inappropriate.

### 3.3.2 Types of misstatements

The auditor **should** accumulate misstatements identified during the audit, other than those that are clearly trivial. To assist the auditor in considering the effects of misstatements accumulated during the audit and in communicating them to management, it is useful to distinguish between:

*factual* misstatements: misstatements about which there is no doubt;

*judgmental* misstatements: differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate;

*projected* misstatements: the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

### 3.3.3 The impact of misstatements on the audit approach

The auditor **should** consider whether the APM and audit programme need to be revised if the nature of identified misstatements and the circumstances of their occurrence are indicative of the existence of other misstatements that, when aggregated with misstatements accumulated during the audit, could be material.

The auditor cannot simply assume that a misstatement is an isolated occurrence. Evidence that other misstatements may exist include cases where the auditor establishes that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

The auditor **should** also determine whether the APM and audit programme need to be revised if the aggregate of misstatements accumulated during the audit approaches the materiality level(s). In such circumstances, there may be a greater than acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality level.

Undetected misstatements could possibly exist because of the presence of sampling risk or non-sampling risk.

It may be necessary for management to examine a class of transactions, account balance or disclosure to identify and correct misstatements therein. After management has examined a class of transactions, account balance or disclosure and corrected misstatements that were found, the auditor performs further audit procedures to re-evaluate the amount of misstatements.

### 3.3.4 Communication and correction of misstatements

The auditor **should** communicate all misstatements accumulated during the audit to the appropriate level of management on a timely basis and ask management to correct them.

Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if they disagree, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and take the necessary action.

If management refuses to correct some or all of the misstatements

communicated to it by the auditor, the auditor obtains an understanding of management's reasons for not making the corrections and takes this into account when evaluating whether the accounts as a whole are free from material misstatement.

### 3.3.5 Evaluating the effect of uncorrected misstatements

Before evaluating the effect of uncorrected misstatements, the auditor **should** reassess the materiality level(s) used in planning and performing the audit to confirm whether it/they remain appropriate.

The auditor **should** evaluate whether uncorrected misstatements are material, individually or in aggregate. In making this evaluation, the auditor considers the size and nature of the misstatements, both in relation to particular classes of transactions, account balances and disclosures and the annual accounts as a whole, and the particular circumstances of their occurrence.

Before considering the aggregate effect of uncorrected misstatements, the auditor considers each misstatement separately to:

**Materiality** (a) evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions account balance or disclosure, if any, has been exceeded;

**Offset** (b) evaluate whether it is appropriate to offset misstatements. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements;

**Classification** (c) evaluate the financial statement effect of classification misstatements. Determining whether a classification misstatement is material requires the use of *professional judgment* and the evaluation of qualitative considerations, e.g. the effect of the classification misstatement on (i) individual line items or sub-totals or (ii) key ratios.

#### *Special considerations*

The circumstances of some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are below the materiality level for the accounts as a whole (or for a particular class of transactions, account balance or disclosure, if any).

#### **Examples of special considerations**

Examples of circumstances that may affect the evaluation include the extent to which the misstatement:

- affects compliance with regulatory requirements;
- relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- affects segment information presented in the financial statements;
- is significant in view of the auditor's understanding of instances of known previous communications to users;
- concerns items involving related parties;
- is an omission of information not required by the applicable financial reporting framework but which, in the auditor's judgment, is important to the users' understanding of the financial position, financial result or cash flows of the entity.

If the auditor believes that a misstatement is, or may be, the result of fraud, the auditor **should** consider the implications in relation to other aspects of the audit.

### 3.3.6 Evaluating the financial statements as a whole

The auditor **should** evaluate whether the financial statements as a whole are free of material misstatement. When making this evaluation, the auditor **should** consider both the results of the evaluation of the uncorrected misstatements and the qualitative aspects of the entity's accounting practices.

#### Qualitative aspects

When considering the qualitative aspects of the entity's accounting practices, the auditor recognises that management makes a number of judgments about the amounts and disclosures in the financial statements. During the audit, the auditor **should** be alert for possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, cause the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that the auditor takes into account when evaluating whether the financial statements as a whole are materially misstated include the following:

- the selective correction of misstatements brought to management's attention during the audit;
- possible management bias in the making of accounting estimates.

If the auditor concludes that, or is unable to conclude whether, the financial

statements as a whole are materially misstated; the auditor **should** consider the effect thereof on the auditor's report.

## 3.4 PERFORMING SUBSTANTIVE ANALYTICAL PROCEDURES

**ISSAI 1520**  
**[ISA 520]**

*The objective of the auditor is to apply analytical procedures where appropriate to help in assessing risk, providing audit evidence and arriving at an overall audit conclusion.*

Audit evidence regarding the reliability of the accounts is mostly secured through tests of details, with substantive analytical procedures also undertaken when appropriate.

The main areas in which substantive analytical procedures are employed are in the analytical review of:

- the main accounting data for consistency and reasonableness;
- the accounts regarding off-balance sheet commitments;
- the economic outturn account and segment reporting;
- small bank balances (those opened in connection with imprests);
- so-called "small" accounts.

Substantive analytical procedures are carried out in the manner described in [Chapter 3.4 of the general part of the manual](#).

## 3.5 WRITTEN REPRESENTATIONS

*The objective of the auditor is to corroborate, by means of written representations:*

*(a) that management or where appropriate those charged with governance believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;*

*(b) other audit evidence relevant to the financial statements or specific assertions.*

*Further, the objective is (c) to respond appropriately to written representations provided or not provided.*

**ISSAI 1580**

**[ISA 580]**

[3.5.1 Acknowledgement by management of its responsibilities](#)

[3.5.2 Specific written representations on material matters](#)

[3.5.3 Evaluating the reliability of written representations](#)

### 3.5.1 Acknowledgement by management of its responsibilities

Auditors **should** obtain audit evidence that management:

Fair presentation

(i) acknowledges its responsibility for the *fair presentation of the accounts* in accordance with the applicable reporting framework, including whether

- the selection and application of accounting policies are appropriate;
- all transactions have been recorded;
- the following matters, where relevant, have been recognised, measured or disclosed per the financial reporting framework:
  - plans or intentions that may affect the carrying value or classification of assets and liabilities;
  - liabilities, both actual and contingent;
  - title to or control over assets, and the liens or encumbrances on assets, and assets pledged as collateral;
  - aspects of contractual agreements that may affect the financial statements, including non-compliance; and
  - events subsequent to period-end.

Internal control

(ii) acknowledges and understands its responsibility for *designing, implementing and maintaining internal control* relevant to financial statements that are free from material misstatement, and whether it believes the internal control is adequate for that purpose.

Information made available

(iii) believes that all *records, documents, unusual matters of which management is aware, and other information* relevant to the audit has been made available to the auditor.

By way of example, in the case of the European Union final annual accounts, the acknowledgement of the above-mentioned responsibilities is included in the management representation letter signed by the Commission's Accounting Officer. An example of a standard representation letter regarding the reliability of financial statements is included in [Appendix II](#).

### 3.5.2 Specific written representations on material matters

The auditor **should** obtain written representations regarding matters that are material, either individually or collectively, in order to corroborate audit evidence obtained from other sources. For example, for the audit of the consolidated annual accounts of the European Union final annual accounts, the AARs and declarations by the Directors-General of DG BUDG and the Internal Audit Service are examined for the evidence which they provide on accounting and internal control issues related to the reliability of the accounts (e.g. changes to the accounting system, audits performed, etc.).

### 3.5.3 Evaluating the reliability of written representations

The auditor **should**:

- *evaluate* whether the written representations appear reasonable and are consistent with other representations; and
- *consider* whether the individual(s) making the representations can be expected to be well informed on the particular matters (e.g. Accounting Officer).

## 3.6 USING THE WORK OF OTHERS

### [3.6.1 Using the work of another auditor](#)

### [3.6.2 Considering the internal audit function](#)

### [3.6.3 Using the work of an auditor's expert](#)

When using the work of others, the principles set out in [Chapter 3.6 of the general part of the manual](#) **should** be followed.

#### 3.6.1 Using the work of another auditor

**ISSAI 1600**    *The objective of the auditor is to determine, when the work of another auditor is used, how the work of the other auditor will affect the audit.*  
*[ISA 600]*

In certain instances, the work of other auditors is used when auditing the reliability of the accounts

When using the work of other auditors, the auditor **should** follow the requirements in [Chapter 3.6.2 of the general part of the manual](#).

#### 3.6.2 Considering the internal audit function

**ISSAI 1610**    *The objective of the external auditor is to obtain an understanding of the internal audit function and determine whether its activities are relevant to planning and performing the audit and, if relevant, the effect on the procedures performed by the external auditor.*  
*[ISA 610]*

The auditor examines the extent to which (s)he can rely on work carried out by the internal audit function (e.g. Internal Audit Capability of a Directorate-General or the Internal Audit Service).

When using the work of the internal audit function, the auditor **should** follow the requirements in [Chapter 3.6.3 of the general part of the manual](#).

#### 3.6.3 Using the work of an auditor's expert

**ISSAI 1620**    *The objectives of the auditor are:*  
*[ISA 620]*  
*(i) to determine whether to use the work of an auditor's expert, and, if so*  
*(ii) to determine whether that work is adequate for the purposes of the audit.*

External experts may be engaged in order to make available to the audit team such technical knowledge or skills that are essential to the achievement of the audit objectives and that would not otherwise be available. The audit team may engage an expert to carry out an in-depth

analysis of specific areas, e.g. employee benefits such as pensions and contributions to the sickness insurance scheme.

In such cases, all the requirements set out in the general part of the manual on using the work of experts ([Chapter 3.6.4](#)) **should** be complied with.

## 3.7 OTHER AUDIT PROCEDURES

This chapter deals with a number of other audit procedures to be performed by the auditor during the examination phase. In particular, these audit procedures concern:

[3.7.1 Accounting estimates](#)

[3.7.2 Subsequent events](#)

[3.7.3 External confirmations](#)

[3.7.4 Related parties](#)

### 3.7.1 Accounting estimates

**ISSAI 1540**

*[ISA 540]*

*The objective of the auditor is to obtain sufficient, relevant and reliable audit evidence about whether the accounting estimates and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework.*

Definition

“Accounting estimate” means an approximation of the amount of an item in the absence of a precise means of measurement. Significant estimates include, but are not limited to, amounts for pensions, accrued charges, provisions, contingent liabilities, and forecasts of revenues (recoveries).

Management is responsible for making accounting estimates included in financial statements. These estimates may be simple (e.g. accruing a charge for rent) or complex (estimating a provision for slow-moving or surplus inventory). They are often made in conditions of uncertainty regarding the outcome of events and involve the use of managerial judgment. As a result, there may be a risk of material misstatement, which the auditor may determine to be a significant risk that requires special audit consideration.

Approach to the audit of accounting estimates

The auditor **should** design and perform audit procedures to obtain sufficient appropriate audit evidence as to whether the entity’s accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed. Such audit evidence will often be difficult to obtain and less persuasive than in other areas; the auditor therefore needs to exercise judgment in assessing the sufficiency and appropriateness of the available audit evidence.

Considering accounting estimates during the planning phase

When performing risk assessment procedures, the auditor **should** obtain an understanding of the requirements regarding accounting estimates, how

management identifies events giving rise to such estimates, and management's process for making the estimates, as well as reviewing the outcome of the prior year's estimates.

When identifying and assessing the risks of material misstatement, the auditor **should** evaluate the degree of uncertainty and potential bias regarding estimates, and thus determine whether there are significant associated risks.

**Audit procedures concerning  
accounting estimates**

The auditor **should**:

- *determine* if the methods for determining accounting estimates have been applied consistently;
- *consider* whether an auditor's expert is required;
- *test* the operating effectiveness of the relevant controls; and
- *develop* a range to test management's estimate.

Furthermore, for estimates giving rise to significant risks, the auditor **should** evaluate alternative assumptions considered by management, consider whether the assumptions used are reasonable and, where relevant, assess management's intent to implement specific courses of action.

Where the auditor judges that management has not adequately addressed uncertainty for estimates giving rise to significant risks, (s)he **should** develop a range so as to evaluate the estimate's reasonableness.

The auditor **should** obtain written representations from management regarding the reasonableness of significant assumptions it has used to develop accounting estimates.

**Evaluation of  
accounting estimates and  
disclosures**

The auditor **should** evaluate whether the estimates and related disclosures are reasonable or misstated.

### 3.7.2 Subsequent events

**ISSAI 1560**  
**[ISA 560]**

***The objectives of the auditor are to:***

***(a) obtain sufficient, relevant and reliable audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that materially affect the financial statements are appropriately reflected in those financial statements; and***

***(b) respond appropriately to facts that become known to the auditor after the date of the auditor's report that materially affect the financial statements.***

**Definition of subsequent events**

Subsequent events are events, both favourable and unfavourable, that:  
(a) occur between the balance sheet date and the date of the auditor's

report; or

(b) are discovered after the date of the auditor's report but before the financial statements are issued; or

(c) are discovered after the financial statements have been issued.

Events in any of these categories may provide evidence of conditions existing at the balance sheet date (which, if material, require adjustments to the accounts) or indicate conditions that arose after that date (which, if material, require disclosure in the accounts).

The actions to be taken by the auditor will depend on which of the above time periods is involved; in the first instance, the auditor is obliged to perform audit procedures to identify such events, whereas in the two latter cases the auditor only needs to take action if (s)he becomes aware of subsequent events. Each scenario is explained below:

**Events occurring between the balance sheet date and the date of the auditor's report**

For events occurring between the balance sheet date and the date of the auditor's report, the auditor **should** perform audit procedures designed to obtain sufficient appropriate audit evidence that any such events that may require adjustment of, or disclosure in, the financial statements have been identified. However, the auditor is not expected to conduct a continuing review of all matters where audit procedures have already provided satisfactory conclusions.

The audit procedures are to be performed as near as practicable to the date of the auditor's report, and take into account the auditor's risk assessment. While dependent on the time that has elapsed since the last audit mission, such audit procedures typically include:

- reviewing management procedures to ensure that subsequent events are identified;
- reading minutes of meetings of those charged with governance held after the balance sheet date;
- reading the entity's latest available interim financial statements, budgets, cash-flow forecasts and other related management reports□;
- □enquiring of management as to whether any subsequent events have occurred which might affect the financial statements.

When the auditor identifies events which materially affect the financial statements, (s)he **should** determine whether such events are properly accounted for and adequately disclosed in the financial statements.

**Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued**

Concerning facts which become known to the auditor after the date of the auditor's report but before the financial statements are issued, the auditor has no responsibility to perform audit procedures or make any enquiry regarding the financial statements after the date of the auditor's report.

During the period from the date of the auditor's report to the date the financial statements are issued, responsibility for informing the auditor of facts which may affect the financial statements lies with management.

When, after the date of the auditor's report but before the date the financial statements are issued, the auditor becomes aware of a fact which may materially affect the financial statements, (s)he **should** discuss the matter with management, consider whether the financial statements need amendment, and determine whether management will amend the financial statements.

When management amends the financial statements, the auditor performs the audit procedures necessary and issues a new report on the amended financial statements. The new report is dated not earlier than the date of approval of the amended financial statements and, accordingly, the audit procedures referred to above would be extended to the date of the new auditor's report.

When management does not amend the financial statements and the auditor believes they need to be amended, and the auditor's report has not been released to the entity, the auditor **should** express a qualified opinion or an adverse opinion. When the auditor's report has been released to the entity, the auditor notifies management or those charged with governance, as appropriate, not to issue the financial statements and the auditor's report thereon to third parties. If the financial statements are subsequently released, the auditor needs to take action to prevent reliance on the auditor's report, subject to advice from the ECA's Legal Service.

**Facts discovered after the financial statements have been issued**

After the financial statements have been issued, the auditor has no obligation to make any enquiry regarding such financial statements. However, if after the financial statements have been issued, the auditor *becomes aware* of a fact which existed on the date of the auditor's report and which, if known on that date, may have caused the auditor to modify his/her report, (s)he **should** consider if the matter needs to be brought to the attention of stakeholders, e.g. through a report to the discharge authority.

### 3.7.3 External confirmations

**ISSAI 1505**  
**[ISA 505]**

***The objective of an auditor when using external confirmation procedures in response to an assessed risk of material misstatement is to design and perform such procedures to obtain relevant and reliable audit evidence.***

**Definition**

The higher the auditor's assessment of the risk of material misstatement, the more reliable and relevant is the audit evidence which (s)he seeks from substantive procedures, which may include external confirmation. External confirmation is the process of obtaining and evaluating audit evidence through a representation directly from a third party, in response to a request from the auditor for information about a particular item. Such audit evidence may, together with audit evidence from other audit procedures, assist in reducing the assessed risk to an acceptably low level.

**Examples**

External confirmations are frequently used to confirm the following:

- bank balances, loans, guarantees and other information from bankers;
- bank accounts opened in connection with imprests (e.g. delegations);
- amounts held at year-end at financial intermediaries;
- accounts receivable or accounts payable balances.

Such confirmations may provide audit evidence regarding some assertions, but not others. The auditor **should** consider the objective of the confirmation, i.e. the particular assertion(s) to be tested.

Having decided whether to use positive or negative external confirmation requests, the auditor **should** apply appropriate audit procedures when (i) performing the external confirmation procedures; (ii) considering the results; and (iii) evaluating the evidence.

**Positive or negative external confirmation requests**

The auditor may use positive or negative confirmation requests or a combination thereof. A *positive* external confirmation request asks the respondent to reply to the auditor in *all* cases; a response to a positive confirmation request generally provides reliable audit evidence. A *negative* external confirmation request asks the respondent to reply *only* in the event of *disagreement* with the information provided; it provides less reliable audit evidence than a positive confirmation request, but may be used when the assessed risk and expected error are low, there is a large number of small balances, and the auditor believes that respondents will reply.

**Performing the external confirmation procedures**

(a) Auditor controls the external confirmation requests and responses

The auditor **should**:

- *determine the information to be confirmed* and tailor external

confirmation requests to the specific assertions being addressed;

- *select the third party* - the auditor ensures, where practicable, that the confirmation request is directed to an individual with the knowledge and authority to provide the information, and assesses whether certain parties may not provide an objective response to a confirmation request;
- *design the confirmation requests*. When designing the request, the auditor considers the factors that are likely to affect the reliability of the confirmations, e.g. the form of the request, the nature of the information being confirmed, and the type of information respondents will be able to confirm readily (e.g. single transactions rather than entire account balances);
- *communicate with the third party*, i.e. send out the confirmation requests and ensure that the requests are properly addressed and include a statement that all replies are to be sent directly to the auditor, in order to minimise the possibility of interception and alteration of confirmation requests or responses and thus increase the reliability of the audit evidence obtained;
- *evaluate the evidence obtained*, considering responses, non-responses and exceptions.

(b) Auditor's response if management refuses to allow the auditor to send a confirmation request

Confirmation requests typically include management's authorisation to the respondent to disclose the information to the auditor. When the auditor seeks to confirm certain balances or information, and management requests him/her not to, the auditor **should** evaluate the reasonableness of such a refusal; evaluate the implications for the auditor's assessment of risk and the nature, timing and extent of audit procedures; and apply alternative audit procedures to obtain sufficient relevant and reliable audit evidence.

If the auditor concludes that management's refusal is unreasonable, or is unable to obtain audit evidence from alternative audit procedures, the auditor **should** communicate with those charged with governance and consider the possible impact on his/her conclusions and opinion.

**Considering the results**

(a) Reliability of responses received

The auditor **should** consider the response's authenticity and perform audit procedures to dispel any concern that external confirmations received may not be reliable. If (s)he determines the response is not reliable, the auditor **should** evaluate the implications for risk assessment and for the nature, timing and extent of audit procedures.

(b) No response to a positive confirmation request

If no response is received to a positive external confirmation request, the auditor **should** perform alternative audit procedures to provide audit evidence for the assertions concerned. If the auditor considers that a positive confirmation is required to provide sufficient, relevant and reliable audit evidence, and does not receive it, (s)he **should** determine the implications for the audit.

(c) Exceptions

The auditor **should** investigate exceptions to determine if they represent misstatements. If an exception indicates a misstatement or irregularity in the entity's records, the auditor determines the reasons, assesses whether it has a material effect, and reconsiders the nature, timing and extent of the audit procedures needed.

Evaluating the evidence

The auditor **should** evaluate whether the results of the external confirmation process, together with the results from any other audit procedures performed, provide sufficient, relevant and reliable audit evidence regarding the assertion being audited, or whether performing further audit procedures is necessary.

### 3.7.4 Related parties

The audit requirements regarding related parties and related party relationships and transactions are set out in [Chapter 3.7 of the general part of this manual](#).

## 3.8 CLEARING AUDIT FINDINGS

**ISSAI 1260**    *The objectives of the auditor are to:*  
     *[ISA 260] provide those charged with governance with timely observations arising from the audit that are relevant to their responsibility;*  
     *communicate appropriately to management or those charged with governance*  
**ISSAI 1265**    *deficiencies in internal control relevant to the audit that the auditor has identified*  
     *[ISA 265] during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.*

Audit findings **should** be cleared through the SPF process, as outlined in [Chapter 3.8 of the general part of this manual](#).



FINANCIAL AND  
COMPLIANCE AUDIT MANUAL

## PART 2. RELIABILITY

### 2. RELIABILITY

[Section 1 - Framework](#)

[Section 2 - Planning](#)

[Section 3 - Examination](#)

[Section 4 - Reporting](#)

[Appendices](#)

## SECTION 4 – REPORTING

### TABLE OF CONTENTS

[4.1 Reporting - Overview](#)

[4.2 Statement of Assurance – Forming an audit opinion](#)

[4.3 Modified Opinions](#)

[4.4 Emphasis of Matter and Other Matters Paragraphs](#)

[4.5 Comparative Information](#)

## 4.1 REPORTING – OVERVIEW

### Statement of Assurance

The results of all recurrent reliability audits **should** be reported in a Statement of Assurance. The requirement to produce a Statement of Assurance is therefore applicable to audits of the annual accounts of the European Union and EDFs as well as audits of the annual accounts of other EU agencies, bodies and offices.

### Opinion on the reliability of the annual accounts

The Statement of Assurance contains an opinion on the reliability of the annual accounts of the auditee. The Statement of Assurance is a core part of each Annual and Specific Annual Report and may also be published as a stand-alone document together with the annual accounts of the auditee.

More details about the structure and content of the Statement of Assurance, as well as the Annual and Specific Annual Report, are provided in [Section 4 of the general part](#) of this manual.

## 4.2 STATEMENT OF ASSURANCE – FORMING AN AUDIT OPINION

*The objectives of the auditor are to:*  
*(a) form an opinion on the reliability of the consolidated annual accounts and the underlying transactions based on an evaluation of the conclusions drawn from the audit evidence obtained; and*  
*(b) express clearly that opinion through a written report that explains the basis of the opinion.*

[ISSAI 1700](#)  
[\[ISA 700\]](#)

[ISSAI 1720](#)  
[\[ISA 720\]](#)

### [4.2.1 Introduction](#)

### [4.2.2 Contents of a Statement of Assurance for reliability](#)

### [4.2.3 Types of opinions](#)

### [4.2.4 Considerations in forming an opinion on the annual accounts](#)

### [4.2.5 Qualitative aspects of the entity's accounting policies](#)

### [4.2.6 Description of the applicable financial reporting framework](#)

### [4.2.7 Fair presentation](#)

### [4.2.8 Illustrations](#)

### [4.2.9 Supplementary and other information](#)

### 4.2.1 Introduction

The main output of audits of the consolidated annual accounts is a *Statement of Assurance*.

However, the audit of the consolidated accounts and the legality and regularity of the underlying transactions are two interconnected objectives (see [Chapter 1.5.2 of the Compliance part of this manual](#)). The auditor **should** consider the relationships between these two objectives when reporting the audit.

Consider relationship between reliability and legality/regularity

## 4.2.2 Contents of a Statement of Assurance for reliability

The main guidance on the content of the Statement of Assurance is given in [Section 4 of the general part](#) of this manual.

## 4.2.3 Types of opinions

The types of opinions are described in [Section 4 of the general part](#) of this manual.

## 4.2.4 Considerations in forming an opinion on the annual accounts

The auditor's conclusion on whether reasonable assurance has been obtained as to whether the consolidated annual accounts taken as a whole are free from material misstatement **should** take into account his/her conclusion whether:

- (a) sufficient appropriate audit evidence has been obtained;
- (b) uncorrected misstatements are material, individually or in aggregate;
- (c) the consolidated annual accounts are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. In particular, the auditor evaluates whether, in view of the specific requirements of the applicable financial reporting framework:
  - the consolidated annual accounts adequately disclose the significant accounting policies selected and applied;
  - the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
  - the accounting estimates made by management are reasonable;
  - the information presented in the consolidated annual accounts is relevant, reliable, comparable and understandable;
  - the consolidated annual accounts provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in these accounts;
  - the terminology used in the consolidated annual accounts, including their titles, is appropriate;
- (d) the consolidated annual accounts achieve fair presentation, including consideration of:

- the overall presentation, structure and content of the consolidated annual accounts; and
  - whether the consolidated annual accounts, including the related explanatory notes, represent the underlying transactions and events in a manner that achieves fair presentation;
- (e) the consolidated annual accounts adequately refer to or describe the applicable financial reporting framework.

#### 4.2.5 Qualitative aspects of the entity's accounting policies

Management makes a number of judgments about the amounts and disclosures in the consolidated annual accounts. When considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, cause the consolidated annual accounts as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor's evaluation whether the consolidated annual accounts as a whole are materially misstated include the following:

- selective correction of misstatements brought to management's attention during the audit;
- possible management bias in the making of accounting estimates.

#### 4.2.6 Description of the applicable financial reporting framework

Management is responsible for preparing and presenting the consolidated annual accounts in accordance with the applicable financial reporting framework and adequately describing that framework in the consolidated annual accounts. That description is important because it advises users of the consolidated annual accounts of the framework on which the consolidated annual accounts are based.

A description that the consolidated annual accounts are prepared and presented in accordance with a particular applicable financial reporting framework is appropriate only if the consolidated annual accounts comply with all the requirements of that framework effective on the date of the consolidated annual accounts.

The applicable financial reporting framework for the EU institutions, agencies and similar bodies are the accounting rules drawn up and approved by the Commission's accounting officer, as required by the

Financial Regulation<sup>37</sup>. Such accounting rules shall be based on the internationally accepted accounting standards for the public sector but the accounting officer may depart from them in order to give a true and fair view.

A description of the applicable financial reporting framework that contains imprecise qualifying or limiting language (e.g. “the consolidated annual accounts are in substantial compliance with the accounting rules”) is not an adequate description of that framework as it may mislead users of the consolidated annual accounts.

#### 4.2.7 Fair presentation

There may be cases where the consolidated annual accounts, although prepared and presented in accordance with the specific requirements of a fair presentation framework, do not achieve fair presentation. Where this is the case, management has a responsibility to provide disclosures beyond the specific requirements of the framework or, in extremely rare circumstances, to depart from a specific requirement in the framework to achieve fair presentation of the annual accounts.

#### 4.2.8 Illustrations

As illustration the Statement of Assurance 2016 for reliability of the accounts is included in [Appendix III](#) of the general part of this manual.

#### 4.2.9 Supplementary and other information

This topic is covered in [Chapter 4.2.3 of the general part of this manual](#).

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<sup>37</sup> Financial Regulation, Article 133.

## 4.3 COMMUNICATING KEY AUDIT MATTERS

*The objective of the auditor are to determine key audit matters and communicate them in the auditor's report.*

ISSAI 1701  
[ISA 701]

*Key audit matters are those which, in the auditor's professional judgement, were of most significance in the audit of the financial statements.*

[4.3.1 Determining key audit matters](#)

[4.3.2 Communicating key audit matters](#)

### 4.3.1 Determining key audit matters

The auditor shall determine, from the matters communicated to those charged with governance, those matters that required significant audit attention in performing the audit of the consolidated annual accounts. Auditors should take into account areas of higher assessed risk of material misstatement, significant auditor judgements or the effect of significant events or transactions during the period audited.

### 4.3.1 Communicating key audit matters

The auditor shall describe each key audit matter in a separate section of the auditor's report, noting that the auditors do not provide a separate opinion on those matters. The auditor shall not communicate a matter in the key audit Matters section of the opinion if the auditor would be required to modify the opinion as a result of that matter.

## 4.4 MODIFIED OPINIONS

***The objective of the auditor is to express clearly an appropriate modified opinion on the consolidated accounts or the underlying transactions that is necessary:***

***(a) when the auditor concludes that the consolidated accounts are not free from material misstatement; or***

***(b) when the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the consolidated accounts are free from material misstatement.***

**ISSAI 1705**  
**[ISA 705]**

[4.4.1 Nature of material misstatements](#)

[4.4.2 Pervasiveness of the matter\(s\) giving rise to a modification](#)

[4.4.3 Prohibition on issuing a piecemeal opinion](#)

[4.4.4 Form and content of the auditor's report when the opinion is modified](#)

### 4.4.1 Nature of material misstatements

A material misstatement of the consolidated annual accounts may arise in relation to the:

(a) *appropriateness of the selected accounting policies*, i.e. they (i) are inconsistent with the applicable financial reporting framework; (ii) are inappropriate in the circumstances; or (iii) result in the annual accounts not representing the underlying transactions and events in a manner that achieves fair presentation. Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a material misstatement of the financial statements may arise when the entity has not complied with these requirements;

(b) *application of the selected accounting policies*, i.e. (i) inconsistent application; (ii) unintentional misstatements in application;

(c) *appropriateness or adequacy of disclosures in the consolidated annual accounts*, i.e. (i) all required disclosures are not included; (ii) disclosures in the consolidated annual accounts are not presented in accordance with the applicable financial reporting framework; or (iii) the consolidated annual accounts do not provide the disclosures necessary to achieve fair presentation.

#### 4.4.2 Pervasiveness of the matter(s) giving rise to a modification

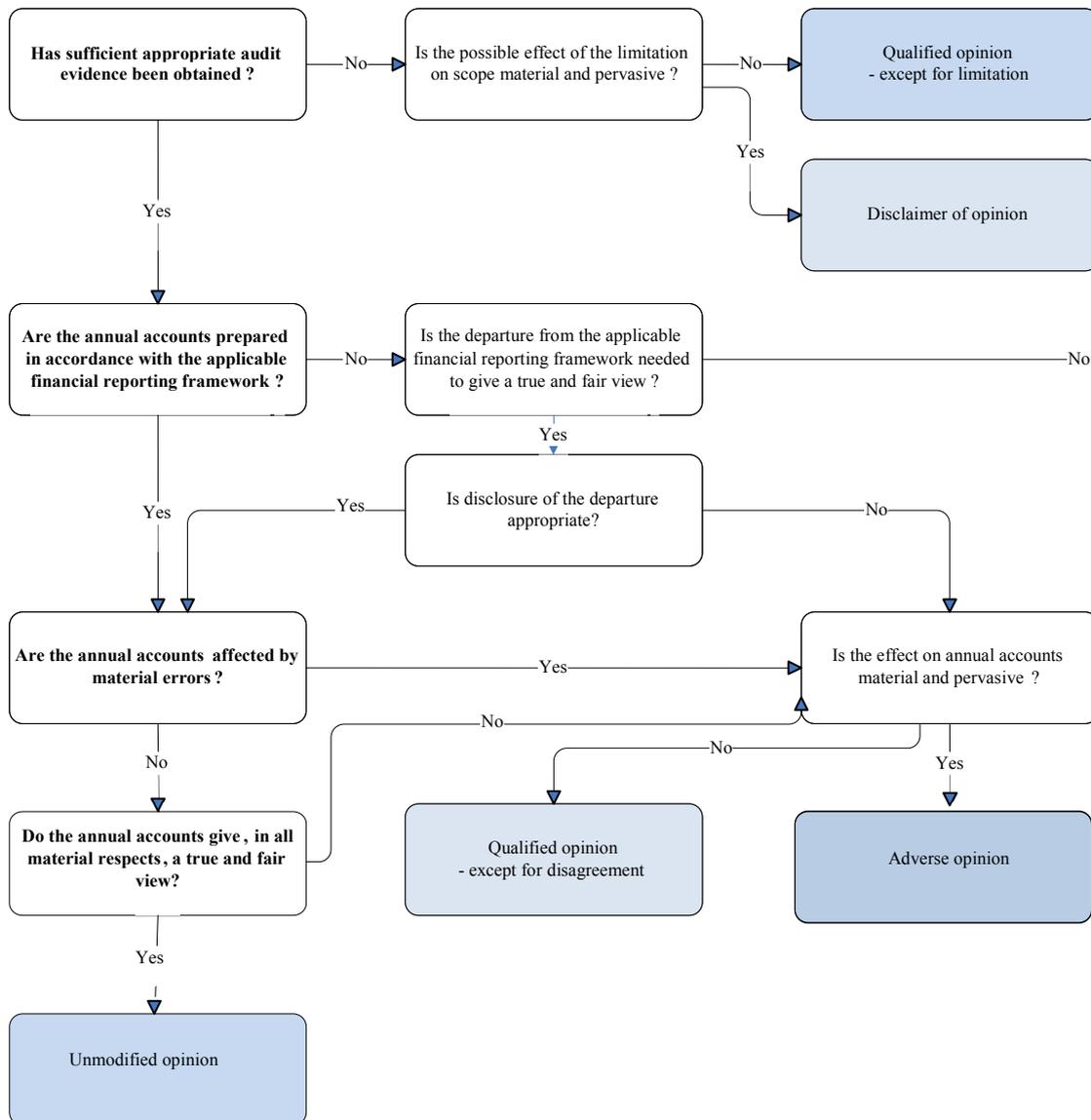
**Consolidated annual accounts are materially misstated**

The auditor may judge *misstatements that are material individually or in the aggregate to be pervasive to the annual accounts* when (i) such misstatements are not confined to specific elements, accounts or items of the consolidated annual accounts, or if confined, the misstatements represent or could represent a substantial proportion of the consolidated annual accounts; or (ii) in relation to disclosures, when the misstated disclosures are fundamental to users' understanding of the consolidated annual accounts.

**Inability to Obtain Sufficient Appropriate Audit Evidence**

The auditor may judge an *inability to obtain sufficient appropriate audit evidence* about one or more matters pertaining to the consolidated annual accounts to be both material and pervasive when the possible effects of the inability cannot be confined to specific elements, accounts or items of the annual accounts or, if confined, those possible effects could represent a substantial proportion of the consolidated annual accounts.

**Figure 3: Detailed flowchart for forming an opinion on reliability**



### 4.4.3 Prohibition on issuing a piecemeal opinion

Details on a piecemeal opinion are provided in Chapter [4.4.10 of the general part of this manual](#).

### 4.4.4 Form and content of the auditor’s report when the opinion is modified

Basis for Modification paragraph

Details on the modification of the opinion are provided in [Chapter 4.4 of the](#)

[general part of this manual.](#)

## 4.5 EMPHASIS OF MATTER AND OTHER MATTERS PARAGRAPHS

**ISSAI 1706**  
**[ISA 706]**

*The objective of the auditor is to include clear additional communication in the auditor's report when, in the auditor's judgment, such communication is necessary to draw users' attention to a matter presented or disclosed in the consolidated annual accounts, or to any other matter which may be relevant to his/her understanding of the consolidated annual accounts or the audit.*

[4.5.1 Nature of an Emphasis of Matter paragraph](#)

[4.5.2 Form and placement of an Emphasis of Matter paragraph](#)

### 4.5.1 Nature of an Emphasis of Matter paragraph

The auditor may consider it appropriate or necessary to emphasise in the Statement of Assurance that a matter presented or disclosed in the annual accounts is of such importance that it is fundamental to users' understanding of the financial statements.

### 4.5.2 Form and placement of an Emphasis of Matter paragraph

Further information is provided in Chapter [4.5.1 of the general part of this manual](#).

## 4.6 COMPARATIVE INFORMATION

**ISSAI 1710**  
**[ISA 710]**

*The objective of the auditor is to obtain sufficient appropriate audit evidence about whether the comparative information included in the consolidated annual accounts complies, in all material respects, with the applicable financial reporting framework.*

[4.6.1 Introduction](#)

[4.6.2 Audit Procedures](#)

[4.6.3 Audit Reporting](#)

### 4.6.1 Introduction

Corresponding figures

Comparative information represents the amounts and disclosures included in the consolidated annual accounts for one or more previous periods, and provides the users with information necessary to identify trends and changes affecting an entity over a period of time.

In the EU context, comparative information comprises *corresponding*

*figures*, where amounts and other disclosures for the prior period are included as an integral part of the current period consolidated annual accounts, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

## 4.6.2 Audit Procedures

The auditor **should** determine whether the annual accounts correctly include the corresponding figures and whether such information is appropriately classified. For this purpose, the auditor **should** evaluate whether:

Continuity of information

(a) the comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated; and

and accounting policies

(b) the accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, s(he) **should** perform such additional audit procedures as are appropriate in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists.

## 4.6.3 Audit Reporting

The Statement of Assurance **should not** specifically identify the corresponding figures except in the following circumstances:

*(i) if the Statement of Assurance on the prior period, as previously issued, included a modified opinion and the matter which gave rise to the modification is unresolved:*

(a) If the effects or possible effects of the matter on the current period’s figures are material and require a modification to the auditor’s opinion regarding the current period figures, the auditor **should** refer to both the current period’s figures and the corresponding figures in the description of the matter giving rise to the modification in the Basis for Modification

paragraph;

Example of Basis for Qualified Opinion paragraph:

“As discussed in Note X to the annual accounts, no depreciation has been provided in the annual accounts, which practice, in our opinion, is not in accordance with applicable standards. This is the result of a decision taken by management at the start of the preceding financial year and caused us to qualify our audit opinion on the annual accounts relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the economic result for the year should be impacted by xxx in 20X1 and xxx in 20X0, the fixed assets should be reduced by accumulated depreciation of xxx in 20X1 and xxx in 20X0, and the net assets should be decreased by xxx in 20X1 and xxx in 20X0.”

(b) If the effects or possible effects of the matter are either not relevant or material to the current period figures, the auditor **should** nevertheless modify the opinion in the Statement of Assurance on the current period’s annual accounts because of the effect or possible effects of the matter on the corresponding figures.

Example of Basis for Qualified Opinion paragraph:

“We were not able to observe the counting of the physical inventories at the beginning of the previous period starting 1.1.20X0 or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories enter into the determination of the results of operations, we were unable to determine whether adjustments to the results of operations and opening net assets might be necessary for 20X0. Our auditor’s report on the annual accounts for the period ended 31.12. 20X0 was modified accordingly.”

However, when the Statement of Assurance on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly dealt with in the consolidated annual accounts in accordance with the applicable financial reporting framework, the current Statement of Assurance need not refer to the previous modification.

*(ii) If the auditor becomes aware of a material misstatement that affects the prior period consolidated annual accounts on which an unmodified Statement of Assurance has been previously issued, the auditor **should** follow the relevant instructions for subsequent events:*

If the prior period consolidated annual accounts have not been amended and reissued, and the corresponding figures have not been properly restated or appropriate disclosures have not been made, the auditor **should** express a qualified opinion or an adverse opinion in the Statement of Assurance on the current period consolidated annual accounts, modified with respect to the corresponding figures included therein.

When the prior period consolidated annual accounts that are misstated have not been amended and a Statement of Assurance has not been reissued, but the corresponding figures have been properly restated or

appropriate disclosures have been made in the current period annual accounts, the Statement of Assurance may include an Emphasis of Matter paragraph describing the circumstances and stating where relevant disclosures that fully describe the matter can be found in the annual accounts.

## APPENDIX I – AUDITS OF RELIABILITY CONDUCTED BY THE ECA

Entities have their own legislative framework and accounting provisions that prescribe the form and content of the annual accounts. The financial reporting requirements for each type of European Union entity are summarised below:

Audit scope	Format of audit report	Legal base for the audit
Consolidated financial statements and the reports on implementation of the general budget, which present in aggregated form the financial information relating to the institutions and bodies (Financial Regulation Article 159)	Statement of Assurance (SoA) opinion + supporting observations	Art 287 of the Treaty on the Functioning of the European Union
Financial statements and report on financial implementation of the European Development Funds (EDF FR Article 49)	SoA opinion + supporting observations	Art 287 (by analogy) and EDF Financial Regulation
Accounts of the European Schools	Report on the accounts	Financial Regulation of the Schools, Art 90
Accounts of agencies, offices and other bodies	SoA-type opinion	Relevant Council Regulation for each agency and satellite body

## APPENDIX II

**Example of a representation letter regarding the reliability of the financial statements  
(provisional annual accounts 2016)**

(Entity Letterhead)

To the President of the European Court of Auditors

Subject: Representation letter: provisional annual accounts for 2016

This representation letter is provided in connection with your audit of the "Provisional annual accounts of the European Union" consisting of the "Consolidated financial statements and the consolidated reports on implementation of the budget" for the financial year ended 31 December 2016 for the purpose of expressing an opinion as to whether these present fairly, in all material respects, the financial position of the European Union as of 31 December 2016 and of the results of its operations and its cash flows for the year then ended.

In accordance with the Financial Regulation (EC, Euratom) No 1605/2002 of the Council of 25 June 2002, as last amended by Council Regulation (EC) No 1525/2007 of 17 December 2007, the "Consolidated financial statements" for the financial year 2016 are prepared on the basis of accounting rules adopted by myself which adapt accruals-based accounting principles to the specific environment of the European Union, while the "Consolidated reports on implementation of the budget" continue to be primarily based on movements of cash.

In line with Article 61 of the Financial Regulation, the accounting systems laid down by myself and, where appropriate, systems laid down by the authorising officers to supply and justify accounting information have been validated.

All the information necessary for the production of the accounts of the European Union which give a true and fair view of the assets and liabilities and of the budgetary implementation has been obtained from the authorising officers by delegation of the Commission, and from the accounting officers of the other institutions and the bodies referred to in Article 185 of the Financial Regulation in conformity with Article 128 of the Financial Regulation, who guaranteed its reliability.

I confirm, to the best of my knowledge and belief, having made such inquiries as I considered necessary for the purpose of appropriately informing myself, the following representations:

### **Financial Statements**

1. The "Provisional annual accounts of the European Union" for the financial year ended 31 December 2016 referred to above are presented in accordance with the Financial Regulation (EC, Euratom) No 1605/2002 of the Council of 25 June 2002, as last amended by Council Regulation (EC) No 1525/2007 of 17 December 2007, its implementing rules and the accounting rules and methods established under my responsibility.
2. Apart from the following reservations ....., no other issues requiring a reservation have been brought to

my attention.

3. Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.

4. Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of the accounting rules.

5. All events subsequent to the date of the financial statements and for which the accounting rules require adjustment or disclosure have been adjusted or disclosed.

(For final MRL only:)

6. The effects of uncorrected misstatements as communicated by the Court on 15 June are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the misstatements that the auditors have accumulated during the audit and that have not been corrected is attached to the representation letter.

7. There are no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements. The carrying value of receivables which are potentially irrecoverable has been corrected, where necessary.

8. The European Commission and the other consolidated bodies have satisfactory title to all assets and there are no liens or encumbrances on the assets. The accounting information related to the assets of the other consolidated bodies has been supplied by the accounting officers in conformity with Title VII of part one of the Financial Regulation.

9. All liabilities, both actual and contingent, have been recorded or disclosed, as appropriate, and all guarantees that have been given to third parties have been disclosed in the notes to the financial statements.

10. All claims against the European Commission and the other consolidated bodies are reflected in the accounts as a provision or, where relevant, as a contingent liability.

11. There are no formal or informal compensating balance arrangements with any of our cash and investment accounts. There are no lines of credit arrangements.

### **Information Provided**

With regard to the information provided and the representations 12-18 below, I highlight that I have provided you with such information for the Commission's accounts, whereas the accounting officers of the consolidated bodies included in the EU annual accounts are required to do the same for their accounts.

12. I have provided you with:

- access to all information of which I am aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
- additional information that you have requested for the purpose of the audit; and
- unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

13. All transactions have been recorded in the accounting records and are reflected in the financial statements.

14. I have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. I have relied on the representations of the accounting officers of the other consolidated bodies, as transmitted to the Court, with regard to the risk assessments made concerning their entities [note exceptions].

15. I have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements that I have been informed of by the relevant services.

16. I have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which I am aware, in accordance with the EU accounting rule 15.

17. I have disclosed to you all instances of non-compliance and of suspected non-compliance with laws and regulations that I am aware of and whose effects should be considered when preparing financial statements.

18. Apart from the above, I confirm that:

- the financial statements disclose adequately the provisional nature of those operations which are subject to future clearance of accounts or closure procedures;
- for all "probable" but not yet definitive receivables an adequate disclosure, including when possible an estimate of the amounts involved, is given in the notes to the financial statements;
- the accounts explain the heterogeneous nature of recovery activity (e.g. financial corrections, clearance of account decisions, or decisions to reimburse Union interventions following closure of programmes, audits or other eligibility checks);
- the accounts include all the recovery orders issued by the Authorising Officers concerning the operations giving rise to reimbursement to the Commission by the final beneficiary, third country or Member State recovery. Authorising Officers have not informed me of delays or other problems in the establishment of recovery orders;
- information regarding amounts recovered and financial corrections made by the European Commission or Member States in response to errors and irregularities detected following EU controls are disclosed in note 6 to the financial statements.....

**THE ACCOUNTING OFFICER OF THE EUROPEAN COMMISSION**

**(DATE)**

Introduction  
1 - General  
2 - Reliability of Accounts  
**3 - Compliance with Applicable  
Laws and Regulations**  
Glossary and Acronyms

# 3. COMPLIANCE WITH APPLICABLE LAWS AND REGULATIONS

## TABLE OF CONTENTS

Section 1 - Framework

Section 2 - Planning

Section 3 - Examination

Section 4 - Reporting

Appendix I - Assessment of how the supervisory and control systems work

### 3. COMPLIANCE

Section 1 - Framework  
Section 2 - Planning  
Section 3 - Examination  
Section 4 - Reporting  
Appendix

## PART 3. COMPLIANCE

# SECTION 1 - FRAMEWORK

## TABLE OF CONTENTS

1.1 Definition and objectives of compliance audit

1.2 Legal requirements for ECA to conduct compliance audits

1.3 Applicability of International Standards on Auditing (ISAs) to compliance audits

1.4 Aims and objectives of compliance audits

1.5 Legality and regularity audits

## 1.1 DEFINITION AND OBJECTIVES OF COMPLIANCE AUDIT

### Definition of compliance audit

Compliance audit comprises the assessment of whether activities, financial transactions and information are in accordance with the authorities which govern them. Such authorities may include budgetary laws or resolutions, other relevant laws, regulations and agreements, or specific rules.

ISSAI 1250  
[ISA 250]

***The objectives of the auditor in performing audit of the reliability of financial statements are:***

- a) to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have direct effect on the determination of material amounts and disclosures in the financial statements;***
- b) to perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements;***
- c) to respond appropriately to non-compliance or suspected non-compliance with laws and regulations during the audit.***

ISSAI 4200

***The objectives of the auditor in performing compliance audit in connection with the audit of financial statements are to:***

- a) obtain reasonable assurance about whether the activities, financial transactions, and information reflected in the financial statements are, in all material respects, in compliance with authorities which govern them; and***
- b) report the findings and judgments to the legislature or other bodies, as appropriate.***

ISSAI 414000<sup>38</sup>

***The objective of the auditor in performing separate compliance audits are to:***

- a) obtain reasonable assurance about whether the information gathered in relation to a particular subject matter is in compliance, in all material aspects, with a particular set of criteria;***
- b) report the findings and judgments to the legislature or other bodies, as appropriate.***

***Compliance audits are carried out by assessing whether activities, financial transactions and information comply, in all material respects, with the authorities that govern the audited entity.***

## 1.2 LEGAL REQUIREMENTS FOR ECA TO CONDUCT COMPLIANCE AUDITS

The ECA has the authority to conduct two different types of compliance audit:

<sup>38</sup> Paragraph. 26

**(i) Legality and regularity audits**

Article 287

Article 287 of the TFEU requires ECA to provide the European Parliament and the Council with a Statement of Assurance as to the legality and regularity of the underlying transactions for the European Union, as well as for all bodies set up by the Union insofar as the relevant constituent instrument does not preclude such examination. In this context, Article 287 also requires ECA to examine whether all revenue has been received and all expenditure incurred in a lawful and regular manner. This is the main type of compliance audit carried out by ECA, the results of which are included in an Annual Report (EU budget, European Development Funds) or Specific Annual Report (agencies, offices and other bodies).

**(ii) Other compliance audits**

The same Article goes on to state that "The Court of Auditors may also, at any time, submit observations, particularly in the form of special reports, on specific questions". This allows ECA to carry out selected compliance audits. Such compliance audits are undertaken on the basis of their priority, as determined by ECA, on management topics or budgetary areas, e.g. audits of procurement or funding arrangements.

## 1.3 APPLICABILITY OF INTERNATIONAL STANDARDS ON AUDITING (ISAS) TO COMPLIANCE AUDITS

The requirements of ISAs are, for the most part, also relevant to the various phases of compliance audit, however in this compliance part of the manual references to ISSAIs are preferred.

ISSAI 4000

However, concerning the reporting of one type of compliance audit - the Court's opinion on the legality and regularity of the underlying transactions as regards the European Union's ~~(EU)~~ general budget - the ISA prohibition on piecemeal opinions is not considered by ECA to be applicable, as providing opinions by MFF area or cluster provides better decision-making information for the discharge authority.

## 1.4 AIMS AND OBJECTIVES OF COMPLIANCE AUDITS

The aim of a compliance audit is to report to the discharge authority and other stakeholders on whether the activities, financial transactions and information are, *in all material respects*, in compliance with the authorities (i.e. the legal and regulatory frameworks) which govern them. The legal and regulatory framework consists of treaties, regulations, directives, decisions, budgets, contracts and other instruments which contain rules on how transactions should be managed and budgets implemented.

### Objectives of legality and regularity audits

The *objectives of an audit of the legality and regularity* of the underlying transactions are to ensure that, in all material respects:

- the transaction conforms to the relevant requirements of the TFEU, Financial Regulation, specific regulations, Implementing Rules or any rules internal to the institution required under these regulations;
- the transaction is eligible under the double legal basis (see 1.5 below);
- the budget line to which the transaction was charged has been approved; and
- the transaction has actually occurred and been properly recorded.

### Objectives of selected compliance audits

The objectives of selected compliance audits will vary, depending on the subject matter.

## 1.5 LEGALITY AND REGULARITY AUDITS

**ISSAI 400<sup>39</sup> Compliance auditing generally comprises the assessment of compliance with formal criteria, such as authorising legislation, regulations issued under framework legislation and other relevant laws, regulations and agreements, including budgetary laws (regularity).**

**1.5.1 Definition of underlying transactions**

**1.5.2 Concept of legality and regularity**

**1.5.3 Double legal basis and budgetary commitment**

**1.5.4 General and specific objectives of an audit of legality and regularity**

### 1.5.1 Definition of underlying transactions<sup>40</sup>

<p><b>Objective</b></p>	<p>The Court of Auditors is required to provide the European Parliament and the Council with a Statement of Assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions.</p> <p>The ECA shall use a definition for underlying transactions which allows it to arrive at a valid and robust judgment about whether a transaction has been legal and regular.</p>
<p><b>Underlying transactions for expenditure/expenses</b></p>	<p>The <i>transactions underlying the accounts</i> are transfers of funds from the Union's budget to final recipients of EU spending, and transfers of revenue from Member States to the Union's budget. These transfers may go through different stages of the expenditure cycle (budgetary and legal commitment, validation, authorisation and payment of expenditure) and give rise to several entries in the Commission's budgetary accounts or financial statements.</p> <p>The Commission's budgetary accounts capture the payment cycle of expenditure on a cash basis. A transfer of funds generally results in more than one payment, which may take different forms serving different objectives. Pre-financing payments (advances) are intended to provide the beneficiary with a float and are provided after the signature of the delegation agreement, the contract or grant agreement or after receipt of the grant decision. Interim payments are made as a counterpart of a partial execution of the action. Final payments are intended to pay the balance of the amounts due where the action is completely executed.</p> <p>The Commission's financial statements, in accordance with the principle of accrual-based accounting, reflect economic reality. Entries are booked in the accounts when they occur and not when cash is actually paid or recovered. Payments of funds may be booked as a pre-financing or other asset in the balance sheet or as an expense in the economic outturn account.</p> <p>The ECA is able to make a valid and robust judgment on the legality and</p>

<sup>39</sup> Paragraph 32

<sup>40</sup> [Text provisionally agreed by the CEAD Chamber on 5 April 2011 (see minutes and CH 122/11).]

regularity of a transaction when it has passed through the whole transfer cycle (committed, validated, authorised and paid) and there is sufficient evidence about the economic reality underlying the transaction, i.e. it is substantiated by expenditure incurred at the level of the final recipient.

The auditor will follow these transactions from the level of central management of the Union institutions to the level of the final recipients or those providing the Union with own resources. The auditor will assess the compliance of these transactions with every act, procedure, process or document, of a legal, administrative, financial or banking nature, as well as any physical events or factors which underlie them to the extent necessary to form a robust judgment.

Transactions **should** be part of the population only if:

- the related projects have reached a certain stage or are even finished, i.e. there is progress made and/or costs incurred at the level of the final recipient; and,
- the Commission has accepted the progress made and/or the related cost.

In practice, the population of underlying transactions for the legality~~and~~ regularity part of the SoA and the audit approach to be applied will be determined by the Audit Chambers together with the Chamber V when preparing the different SoA APMs.

**Practical implementation of the definition of underlying transactions**

*Underlying transactions* are, in this context, commitments and payments underlying the EU's budgetary accounts, as well as the related assets and liabilities registered in the EU's balance sheet, and expenses and income registered in the EU's economic outturn account.

The focus of the legality and ~~r~~egularity part of the SoA will take into consideration the *underlying progress*, i.e. the validation and *reimbursement of expenditure at the level of final recipients* of EU funds who implement activities which are directly related to the objectives of EU policies.

While *payments of the entire amount due*, and the related accruals-based elements of the EU's financial statements, will always be included in the population to be audited, the different forms of *multistage payments* (advances, interim payments and final payments) will be treated according to their underlying progress.

*Advances* paid by the Commission to public authorities managing EU funds (which represent pre-financing in the EU's balance sheet and therefore have the character of pure balance-sheet operations) are not included in the population to be audited.

*Advances* paid by the Commission to final recipients **should** not be part of

the audit population.

For *interim payments* two cases **should** be distinguished:

*Interim payments* by the Commission (partly) reimbursing expenditure incurred at the level of final recipients, as well as the related pre-financing registered in the EU's balance sheet or expenses registered in the EU's economic outturn account, are included in the population to be audited.

*Interim payments* by the Commission reimbursing advances establishing or contributing to funds, e.g. financial engineering instruments (which in substance represent pre-financing in the EU's balance sheet and therefore have the character of pure balance-sheet operations) or reimbursing advances paid to final recipients **should** not be included in the population to be audited.

In the context of closures leading to clearings or *final payments* by the Commission (which in extreme cases can take the form of "0-payments" or recoveries), the focus will be on expenses in the EU's economic outturn account which are based on the final validation of expenditure incurred at the level of final recipients (and clear pre-financing in the EU's balance sheet as well as previous interim payments and/or advances).

Due to the different management and payment cycles applied in the specific policy areas, Chamber V will provide further guidance on *sampling and extrapolation*.

#### Underlying transactions for revenue

The overriding objective is, as explained above, to define underlying transactions taking into account economic reality so as to include transactions for which:

- the underlying activity has reached a final stage and the revenue is due for collection, and
- the Commission has established the amount receivable and applied recovery procedures.

Most of revenue is represented by own resources which are generally cashed before the corresponding recovery orders are issued. Furthermore, where an action is brought before the Court of Justice<sup>41</sup> for fines and penalties (Title 7) the cashed recovery orders may remain open until the definitive amount to recover is finally set. Therefore, the more appropriate population of underlying transactions to be used will be the recovery orders issued in the audited financial year.

In respect of recovery orders which are directly linked to expenditure (i.e. Titles 4, 5, and 6), as they are issued in the context of programme or

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<sup>41</sup> After all legal remedies have been exhausted (see Article 85a of implementing rules of the Financial Regulation).

project closures when there is a final validation of the residual expenditure incurred at the level of final recipients (e.g., in the Cohesion and Competitiveness MFF headings, the audit of closures should cover at the same time the underlying expenditure and the recovery order (i.e. in the cases where the expenditure declared is insufficient for the recipient to keep advances received).

As a consequence, these recovery orders should be excluded from the revenue population and included in the population of the corresponding expenditure.

The population of underlying transactions obtained as explained above should be used as a basis for the selection of the central sample drawn by Chamber V for the work of substantive testing for legality and regularity of Revenue.

Any findings related to recovery orders linked to these programme or project closures **should** be reported in the specific assessments relating to the corresponding expenditure.

## 1.5.2 Concept of legality and regularity

<p>Criteria for the <i>legality</i> of acts are set out in Article 263 of the TFEU. This specifies that an act may be illegal on the grounds of lack of competence (of those adopting the act); infringement of an essential procedural requirement; infringement of the Treaties or of any rule of law relating to their application, or misuse of powers.</p>	<p><i>Irregularity</i> means any infringement of a provision of EU law resulting from an act or omission by an economic operator which has, or would have, the effect of reducing or losing revenue or including an unjustified item of expenditure (Council Regulation (EC, Euratom) No 2988/95 of 18 December 1995 (OJ L312, 23.12.1995)).</p>
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In view of the difficulty in the Union sphere of drawing a precise boundary between the concepts of legality and regularity, and given that the consequences of non-compliance with these rules are exactly the same for the Statement of Assurance, ECA does not make a distinction between the two concepts. Thus, ECA verifies that the transactions are both *legal and regular*. To be legal and regular, a transaction must comply *in all material respects* with the *relevant parts* of the legislation, which encompasses:

- (i) Union legislation, comprising the financial rules (TFEU, Financial Regulation, and Implementing Rules), the basic legislation establishing the policy, programme or activity concerned, any rules or regulations established in accordance with that basic legislation, and the contractual

framework.

(ii) Where Union legislation requires or empowers Member States to draw up national laws or rules for the management of Union programmes, then conformity with these laws or rules is examined in the context of legality and regularity.

(iii) Legislation of a purely national nature is relevant in the context of an audit of legality and regularity if this introduces compliance requirements on the EU funding. This is particularly relevant in shared management.

### 1.5.3 Double legal basis and budgetary commitment

Expenditures in the European Union context must have a *double legal basis* (a basic act and a legal commitment) and a budgetary commitment.

- The *basic act*, adopted by the legislative authority, provides the legal foundation necessary for the Union measure and the related expenditure. Basic acts are the regulations, directives and decisions of the Council and of the Parliament, of the Council or of the Commission referred to in Article 288 of the TFEU.
- The legal commitment is the act whereby the authorising officer enters into or establishes an obligation which results in a charge<sup>42</sup>. It may consist of a financing decision or contract.
  - Financing decisions, which are required for all operational expenditure, are taken by the Commission. These decisions specify the activities which will be undertaken to implement the budget for a given year. In order to be implemented, they must be followed by award decisions.
  - Award decisions (e.g. contracts) are separate implementation decisions generally taken by the responsible authorising officer, on the basis of a financing decision already adopted by the Commission. An award decision specifies to whom contracts or grants are awarded.

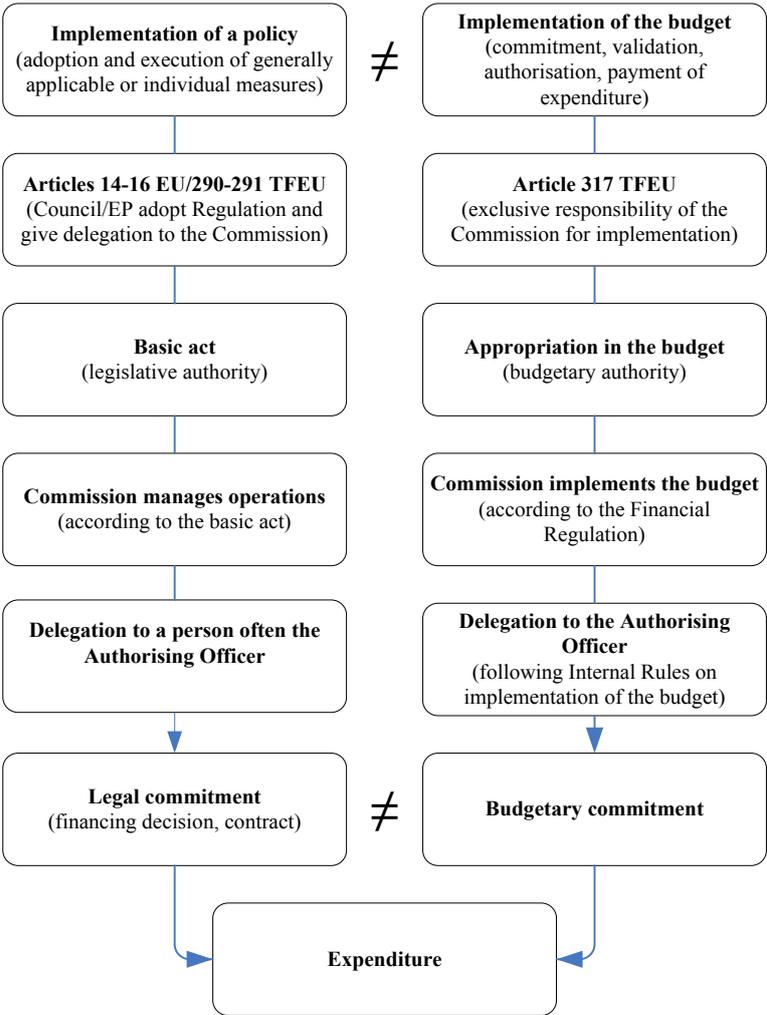
The *budgetary commitment* is the operation reserving the appropriation necessary to cover subsequent payments to honour a legal commitment<sup>42</sup>. It is based on an appropriation made available in the budget by the budgetary authority. Revenue and expenditure are shown in the budget in accordance with a binding nomenclature which reflects the nature and purpose of each item, as imposed by the budgetary authority.

The requirement for a double legal basis and budgetary commitment is highlighted in the following diagram.

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<sup>42</sup> Article 7685 of the Financial Regulation.

**Figure 1: Requirement for double legal basis and budgetary appropriations**



### 1.5.4 General and specific objectives of an audit of legality and regularity

<b>General objectives</b>	The general audit objective for an audit of the legality and regularity of underlying transactions is to determine whether, <i>in all material respects</i> , the underlying transactions are legal and regular.
<b>Assertions</b>	<p>The specific objectives, or assertions, for which the auditor <b>should</b> ultimately draw conclusions are:</p> <p><i>Reality and measurement</i> - underlying operations exist and are accurately determined</p> <p><i>Eligibility of underlying transactions</i> - eligibility criteria are met for the various transactions</p> <p><i>Compliance with other regulatory requirements</i> - other (non-eligibility) criteria are met</p> <p><i>Correctness of calculations</i> - all calculations are correctly undertaken</p> <p><i>Completeness and accuracy of accounting</i> - all transactions are accounted for, are not included more than once, and are recorded in the correct accounting period and at correct value.</p>

### 3. COMPLIANCE

Section 1 - Framework  
**Section 2 - Planning**  
Section 3 - Examination  
Section 4 - Reporting  
Appendix

## PART 3. COMPLIANCE

# SECTION 2 - PLANNING

## TABLE OF CONTENTS

2.1 Planning - Overview

2.2 Determining materiality

2.3 Identifying and assessing risks through understanding the auditee and its environment

2.4 Considering the sufficiency, relevance and reliability of audit evidence

2.5 Designing audit procedures

2.6 Drawing up the Audit Planning Memorandum and Audit Programme

## 2.1 PLANNING – OVERVIEW

<p>ISSAI 1300 [ISA 300]</p>	<p><b><i>The objective of the auditor is to plan the audit so that it is carried out in an effective manner.</i></b></p>
<p>ISSAI 4000<sup>43</sup></p>	<p><b><i>The auditor shall define the subject matter to be measured or evaluated against criteria.</i></b></p> <p><b><i>The auditor shall identify relevant audit criteria prior to the audit to provide a basis for an opinion/a conclusion on the subject matter.</i></b></p> <p><b><i>The auditor shall develop and document an audit strategy and the audit plan that together describe how the audit will be performed to issue reports that will be appropriate in the circumstances, the resources needed to do so and the time schedule for the audit work.</i></b></p>

2.1.1 Nature of European Union expenditure and its implications for the audit

2.1.2 The basis of the auditor's approach to the audit of compliance

2.1.3 Compliance audit criteria

2.1.4 Terms of compliance audit engagements

### 2.1.1 Nature of European Union expenditure and its implications for the audit

Compliance audits must be viewed within the context of the specific nature of European Union expenditure, which presents particular risks, including the following:

- |                           |   |
|---------------------------|---|
| <p>Structure</p>          | <ul style="list-style-type: none"> <li>• <i>complex structure</i>: shared management of expenditure between the Commission and the Member States represents around 80% of the budget. This involves delegation risk, with the Member State managing the control system and the Commission exercising supervision. This shared management arrangement also raises issues concerning the selection of transactions by the auditor;</li> </ul> |
| <p>Rules</p>              | <ul style="list-style-type: none"> <li>• <i>complex rules</i> apply in the implementation of many different expenditure programmes in the Member States, with numerous programmes having a number of different eligibility rules. This emphasises the need for the auditor to have an in-depth knowledge of the area prior to undertaking the audit;</li> </ul>   |
| <p>Many beneficiaries</p> | <ul style="list-style-type: none"> <li>• a high percentage of the payments made is based on claims submitted by <i>many and diverse final beneficiaries</i> in the Member States and some even in third countries. This further highlights the need for good planning in</li> </ul>   |

<sup>43</sup> Paragraphs 107, 110, 137

terms of logistics and timing, as well as regarding the selection of transactions.

## 2.1.2 The basis of the auditor's approach to the audit of compliance

In an audit of compliance, the auditor plans to perform the following steps in order to reach a conclusion as to whether management's assertions are satisfied:

**(i) identify and assess the risk of non-compliance**

The auditor identifies and assesses the risk of non-compliance by obtaining a sufficient understanding of the legal and regulatory framework applicable to the auditee, and how the auditee is complying with that framework. The auditor obtains a broad understanding that is sufficient to enable identification of transactions or events that may have a significant effect on compliance.

**(ii) form a preliminary assessment of internal control**

The auditor considers the systems and procedures in place to ensure compliance with laws and regulations, and obtains an understanding of internal control so as to enable a preliminary assessment of control risk in this regard.

**(iii) test for compliance**

To obtain sufficient appropriate evidence to substantiate assertions about compliance, the auditor will have to perform substantive procedures on transactions. The extent of these procedures will depend on the auditor's assessment of the effectiveness of the design of systems at translating laws and regulations into controls and the extent to which tests of those controls support an assessment of moderate or low control risk.

**(iv) report on compliance**

The auditor issues a report on compliance and an opinion (Statement of Assurance).

## 2.1.3 Compliance audit criteria

Audit criteria are the standards against which the actual performance of the entity in relation to compliance can be assessed. Audit criteria **should** be relevant and free from bias on the part of the auditor or audited entity (e.g. the applicable law, regulation or contract).

## 2.1.4 Terms of compliance audit engagements

The terms of engagement for ECA's compliance audits may be:

- defined by the legal framework;
- determined by ECA for selected compliance audits. The auditee **should** be informed, in keeping with ECA's "no surprises" approach.

## 2.2 DETERMINING MATERIALITY

[ISA 320]	<i>The objective of the auditor is to determine, and reconsider as the audit progresses, an appropriate materiality level or levels to enable the auditor to plan and perform the audit.</i>
ISSAI 4000 <sup>44</sup>	<i>The auditor shall determine materiality to form a basis for the design of the audit, and re-assess it throughout the audit process.</i>

2.2.1 Materiality regarding compliance with applicable laws and regulations

2.2.2 Quantitative materiality

2.2.3 Qualitative materiality

2.2.4 Materiality in the context of systems failures

### 2.2.1 Materiality regarding compliance with applicable laws and regulations

#### Focus on users

The auditor plans and performs the audit to determine whether, in all *material* respects, the activity, transactions and information comply with the relevant authorities. In theory, deviations, or errors, are material if they, individually or aggregated with other errors, would reasonably affect the underlying audit conclusions or the decisions of the addressees of the audit report. In practice, ECA applies extrapolation.

### 2.2.2 Quantitative materiality

#### 0.5 - 2%

Determining quantitative materiality involves a judgment as to the maximum level of non-compliance that is acceptable. It is ECA's policy that the materiality-by-value threshold **should** be set at between 0.5% and 2% of the value that most reasonably reflects the level of financial activity or subject of the audit. The latter is typically total expenditure (i.e. utilisation of commitment appropriations for the audit of commitments and the utilisation of payment appropriations for the audit of payments) or total revenue. For example:

- for the general budget, the materiality threshold is fixed at 2% of total expenditure per MFF heading or total revenue of the EU budget;
- for the EDFs, the materiality threshold is set at 2% of the total expenditure or total revenue of the EDFs budget;
- for the Agencies, the materiality threshold is set at 2% of the budgeted appropriations available for payment.

For audits of legality and regularity, it should be noted that the actual

<sup>44</sup> Paragraph 125.

audited underlying transaction, having passed through various levels of implementation in the Member State concerned, may be a payment of a rather low amount (e.g. 1000 euros). Although this may not be considered to be material by the authorising officer, it will, if it affects the conditions for payment and exceeds 2% of the audited expenditure, be material when projected.

### 2.2.3 Qualitative materiality

#### Material by nature or context

Furthermore, certain types of non-compliance, while not quantitatively material, may - because of their *nature* or because of the *context* in which they arise - be qualitatively material and thus have an impact on the audit conclusion reached. An example would be a situation where, while the total value of irregularity errors by value is below the materiality threshold, the auditor is aware that the Budgetary Control Committee has expressed a special interest in irregularities, and thus considers that those found merit mention in ECA's report. Issues that are material by nature or context are to be disclosed; however, only in exceptional cases, to be decided by ECA, are they to be taken into consideration in the audit opinion.

### 2.2.4 Materiality in the context of systems failures

#### 2% threshold in certain cases

It would not be appropriate to use the materiality threshold of 2% as the only benchmark in the context of systems failures regarding non-compliance. In fact, systems weaknesses may be a management risk without in themselves resulting in actual errors of non-compliance, or may be a risk to compliance without materialising. The quality or effectiveness of the internal control systems can be determined solely on the basis of the materiality threshold of 2% if the audit provided a reasonable assurance (for instance, based on sufficient tests of controls and/or substantive tests):

- that a systems weakness did not lead to material errors. In this case the internal control system would be rated as “effective”;
- or, on the contrary, that due to the system weakness errors have not been prevented or detected and corrected that exceeded the materiality threshold that had been set. In this case, the internal control system would be rated as either “partially effective” or “not effective”.

The evaluation of the internal control system (ICS) in the Annual Report is divided into “effective”, “partially effective” or “not effective”.

The internal control system is considered “*effective*” if the most likely error

rate is below 2%, i.e. the controls mitigate the risk of error in transactions. operating effectiveness is affected by the system weaknesses. The ICS is "partially effective" if there are some weaknesses affecting operational effectiveness. The ICS is rated "not effective" if weaknesses are pervasive and thereby completely undermine operating effectiveness.

and quantitative and qualitative aspects in others

In order to assess the materiality of a systems weakness in other cases (i.e. without sufficient tests of controls and/or substantive tests), consideration **should** be given both to its *qualitative aspect* (specifically, the seriousness of the shortcoming found) and the *quantitative aspect* (i.e. its potential financial impact). If the impact of these two elements together is of an order judged to exceed defined limits, the systems weakness must be considered material. As an indication, this is the case when a fundamental part of the internal control system has not been implemented (absence of an obligatory external auditor's certificate, absence of independence in a certifying body, etc.) and if the total sum of the transactions concerned exceeds a magnitude of around 10% of the total financial volume of the activities in question<sup>45</sup>.

## 2.3 IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE AUDITEE AND ITS ENVIRONMENT

ISSAI 1315  
[ISA 315]

*The auditor shall perform procedures to reduce the risk of producing incorrect conclusions to an acceptable low level.*

ISSAI 4000<sup>46</sup>

*The auditor shall have an understanding of the audited entity and its environment, including the entity's internal control, to enable effective planning and execution of audit.*

2.3.1 Audit risk and risk assessment procedures concerning material non-compliance

2.3.2 Understanding the entity's laws and regulations so as to identify and assess inherent risk

2.3.3 The entity's internal control over compliance with applicable laws and regulations

<sup>45</sup> This materiality threshold is based on the following logic: Based on experience, if the volume of transactions exceeds 10% and the expected maximum error rate exceeds 20% the materiality threshold will be exceeded ( $0,2 * >10\% = >2\%$ ).

<sup>46</sup> Paragraphs 52 and 131

## 2.3.1 Audit risk and risk assessment procedures concerning material non-compliance

**Inherent risk** The *inherent risk* of a compliance deviation, or error, occurring can be assessed by the auditor using *judgment* to evaluate a range of factors, including:

- the complexity of the structure of shared management arrangements;
- the complexity of the framework of regulations;
- the complexity of the rules and regulations, e.g. regarding eligibility;
- the introduction of new legislation or changes in existing regulations;
- services and programmes delivered through third parties;
- payments and receipts made on the basis of claims or declarations;
- the number and diversity of final beneficiaries.

As part of the risk assessment, the auditor determines which of the inherent risks identified are, in his/her judgment, risks that require special audit consideration (significant risks), for which the auditor **should** evaluate the design of the related controls and determine through testing whether these controls have been implemented effectively and continuously throughout the period under review.

**Control risk** *Control risk* is the risk that a material deviation could occur that would not be prevented, or detected and corrected on a timely basis, by the internal control systems. Where the auditor expects to be able to rely on his/her assessment of control risk to reduce the extent of substantive procedures relating to compliance, (s)he makes a preliminary assessment of control risk and plans and performs tests of control to support that assessment.

**Detection risk** *Detection risk* is the risk that the auditor will not detect material deviations which have occurred and have not been prevented, or detected and corrected on a timely basis, by the internal control system.

**Risk assessment** The auditor's *risk assessment* **should** determine the reasonable expectation about the potential level of deviations as regards compliance with applicable laws and regulations.

**Information to consider** The following *important information* **should** be considered as part of the risk assessment for audits of compliance with applicable laws and regulations:

- the Directorate-General's annual Management Plan (MP) contains the critical risks identified for the Directorate-General (DG) concerned;
- the information in the Commission's AMPR and the AARs and declarations by the Directors-General for the preceding financial year(s), provided that these are confirmed by ECA's audit findings. Such representations contribute to determining whether the control risk level is

high, medium or low;

- the effective implementation of internal control standard n°6 on risk management processes;
- relevant reports by the various control bodies of the Commission (including the IAS - and Member States, or other auditors);
- the ECA's previous work, and the knowledge and experience of the Audit Chambers.

## 2.3.2 Understanding the entity's laws and regulations so as to identify and assess inherent risk

### The applicable legal and regulatory framework

The regulatory framework which the auditor considers when obtaining a knowledge of the auditee's activities and identifying relevant laws and regulations applicable to the auditee's activities will include the relevant parts of:

- the TFEU;
- the Financial Regulation and Implementing Rules;
- the basic legislation establishing the policy, programme or activity;
- rules or regulations established in accordance with that basic legislation.

### Reasons for understanding the entity's laws and regulations

Understanding the framework of laws and regulations and using this information appropriately will assist the auditor in identifying potential material deviations, e.g. from new and complex legislation or from a misinterpretation of legislation and its scope. This understanding then helps the auditor to determine whether the inherent risk is to be classified as high or not high, for use in the Assurance model (see [Chapter 2.3.8 of the general part of this manual](#)), and in deciding upon the nature, timing and extent of audit procedures to be performed.

The auditor's understanding includes knowledge of the reasons for the legislation and its objectives, as this will aid his/her understanding of any secondary legislation or subsidiary regulations.

### Extent of the auditor's work in understanding the applicable laws and regulations

The extent of the auditor's work on obtaining a sufficient understanding of the legal and regulatory framework will depend on the nature and complexity of the laws and regulations. However, the auditor only needs to understand the parts of the legislation that are *relevant* to the particular audit task. In all cases, the audited entity retains the responsibility for ensuring compliance with applicable laws and regulations; this includes ensuring that legislation and regulations are appropriately reflected at all stages through to operational guidance.

In complex regulatory environments, the auditor considers the translation of laws and regulations into relevant rules and procedures, and may seek written representations from management in this regard; however, such representations constitute weak audit evidence, and need to be reviewed critically. Ultimately, the auditor's conclusion **should** be based on evidence of compliance with the appropriate laws and regulations and the contractual framework, rather than on evidence of compliance with the entity's understanding of the framework.

Where the auditor is uncertain whether legislation has been properly interpreted and the effect could be material, it may be necessary to seek a legal opinion. If the laws and regulations do not change from year to year, the auditor may already have sufficient knowledge from previous audits.

### 2.3.3 The entity's internal control over compliance with applicable laws and regulations

#### Purpose of internal control over applicable laws and regulations

Internal control regarding compliance is designed to address risks and to provide reasonable assurance that, in pursuit of the entity's mission, the objectives relating to compliance with applicable laws and regulations are achieved.

Internal control requirements may be specifically set out in legislation. For example, the Financial Regulation (Article 65) requires that the authorising officer by delegation shall put in place, in compliance with the minimum standards adopted by each institution and having due regard to the risks associated with the management environment and the nature of the actions financed, *the organisational structure and the internal management and control procedures* suited to the performance of his/her duties.

#### Relevant key controls

The auditor **should** focus on controls that are relevant to the objective of compliance with applicable laws and regulations by the entity's financial transactions. This includes those that govern the entity's power to make payments or receive money, or set out the value of such payments or receipts. It is not concerned with administrative rules or regulations that are not directly linked to financial transactions. Furthermore, the auditor focuses on the *key controls* to ensure compliance in all material respects with the applicable laws and regulations.

The auditor's consideration of the controls over compliance will involve an assessment of the general control environment at entity level and control procedures relating to individual transaction streams. The auditor considers how the entity's management seeks to mitigate the risk of material deviations through controls. The aim of identifying and evaluating internal

control systems is to contribute to a reasonable assurance regarding compliance with applicable laws and regulations.

Management is responsible for establishing an effective system of internal controls to ensure compliance with laws and regulations. When designing steps and procedures to test or assess compliance, auditors **should** evaluate the entity's internal controls and assess the risk that the control system might not prevent or detect non-compliance.

**Control systems to be considered**

Controls and procedures which the auditee implements to ensure compliance with applicable laws and regulations may include:

- the process to ensure that regulations are appropriately translated into relevant rules and procedures (see below);
- the application of desk instructions for staff which translate statutory requirements into a set of operating procedures;
- the appointment of an officer responsible for ensuring that desk instructions are kept up-to-date and reflect any legislative changes;
- guidance set out in financial memoranda between the payee and the entity in receipt of grants, etc.;
- monitoring of compliance with financial memoranda;
- receipt of compliance reports from auditors of other entities, e.g. paying agencies;
- ex-ante and ex-post controls over payments;
- annual summaries of audits and declarations required by the Financial Regulation and sectoral regulations (such as on paying agencies within agriculture and issued by audit authorities in the case of Structural Funds).

**The auditor's consideration of how regulations are translated into subsidiary regulations**

The auditor considers how regulations are translated into subsidiary regulations and guidelines. This may involve reviewing the legislation to identify the provisions that authorise activities, and reviewing the process for their translation and interpretation in subsidiary regulations and guidelines. It may also extend to the process for the translation of those regulations into working manuals or other key documentation. When conducting this review, the auditor pays particular attention to the regulations which govern, for example,

- the controls to be implemented by the entity responsible for administering a scheme;
- the eligibility of beneficiaries to receive grants/financial support under a scheme;
- the calculation of grants or any other payments; and

- the setting of fees and charges and other revenues.

When considering relevant rules and procedures relating to schemes, the auditor also identifies those controls designed to prevent and detect material deviations.

Where the volume of laws or regulations is significant, entities may have systems for the design and monitoring of procedures and controls to ensure that they are appropriate and meet legislative requirements. Internal audit units may also have their own programme of work for reviewing controls to ensure compliance with regulations and authorities. The auditor may seek to place reliance on the entity's systems governing the translation of authorities and the design of rules and procedures by testing the controls over this process.

**Risks to compliance and potential related control procedures**

Some risk factors and potential mitigating controls that the auditor may consider are:

**Table 1: Risks to compliance and related controls**

<i>Risk</i>	<i>Description</i>	<i>Mitigating controls</i>
Complexity of regulations	The more complex the regulations, the greater the risk of error. This may occur either through a misunderstanding or misinterpretation of the regulation or through an error in application.	<ul style="list-style-type: none"> <li>• Agreed and documented procedures for the translation of statutory requirements into operating instructions.</li> </ul> Agreed and documented control plans prepared and monitored by scheme managers. Review of scheme control plans and operating manuals by internal audit.
New legislation	New legislation may require the introduction of new administrative and control procedures. This may result in errors in either the design or operation of controls required to ensure regularity.	Review of scheme control plans and operating manuals by internal audit. Agreed and documented control plans and the independent review of operating instructions for schemes introduced following new legislation.
Services and programmes delivered through third parties	Where programmes are administered by agents, Directorates-General loses a degree of direct control and may have to rely on agents to ensure compliance with applicable laws and regulations.	Documented agreement between the entity and the agent defining control procedures to be applied in the administration of services. Management control and monitoring of third party activities. Inspection visits by internal audit to third parties to review systems and procedures. Independent certification of payments and receipts by the third parties' auditor.
Payments and receipts made on the basis of claims or declarations	An entity's ability to confirm compliance with applicable laws and regulations may be restricted where, for example, criteria specified for receipt of grants are not subject to direct verification.	Established criteria for making claims clearly set out in instructions to claimants. Standard requirements for documentation and evidencing entitlement to be submitted in support of

		<p>claims.</p> <p>Physical inspection of claimants' records, etc. to confirm eligibility.</p> <p>Procedures for assessing the financial standing of claimants before awarding a grant and for monitoring continuing solvency.</p> <p>Independent certification of the application of grant by an external auditor.</p>
--	--	--

The auditor's preliminary assessment of control risks

Based on the auditor's understanding of internal control, (s)he determines the control risk as high, medium or low, to be used in determining the nature, timing and extent of audit procedures (see Assurance Model, [Chapter 2.3.8 of the general part of this manual](#)).

## 2.4 CONSIDERING THE SUFFICIENCY, RELEVANCE AND RELIABILITY OF AUDIT EVIDENCE

ISSAI 1500  
[ISA 500]

*The objective of the auditor is to design and perform audit procedures so as to be able to obtain sufficient, relevant and reliable audit evidence.*

ISSAI  
4000<sup>47</sup>

*The auditor shall plan and perform procedures to obtain sufficient and appropriate audit evidence to form a conclusion with the selected level of assurance.*

*The auditor shall select a combination of audit techniques to be able to form a conclusion with the selected level of assurance.*

2.4.1 Introduction

2.4.2 Sources of audit evidence

2.4.3 Audit procedures to obtain audit evidence

### 2.4.1 Introduction

The auditor aims to obtain sufficient, relevant and reliable audit evidence to be able to reach a conclusion with reasonable assurance. The audit **should** take place at the highest level where sufficient appropriate audit evidence is available to assess compliance.

<sup>47</sup> Paragraphs 144 and 158

#### All compliance audits

Audit evidence concerning compliance with applicable laws and regulations is gathered primarily from tests of controls and tests of details which provide in-depth evidence from a sample of transactions. This audit evidence makes it possible to:

- assess compliance down to final beneficiary level for the area as a whole;
- provide monitoring elements of the origin, nature, frequency and impact of the errors detected in spite of the internal control systems;
- identify areas where action needs to be taken to avoid further errors;
- facilitate communication with auditees by producing concrete examples of shortcomings observed.

This evidence is supplemented by analytical procedures where appropriate.

#### Legality and regularity of the underlying transactions

Furthermore, for audits of the legality and regularity of the underlying transactions, additional audit evidence may be available from two supporting sources:

- the AARs and statements by the Directors-General, which constitute written management representations. Because of the importance of compliance in the EU context, the auditor analyses representations provided annually by Directors-General on the discharge of their responsibility for the legality and regularity of transactions, particularly in areas where direct evidence is not available to the auditor.
- the work of other auditors. This refers to the external audits carried out by other auditors, such as the Supreme Audit Institution of the relevant Member State or the certifying bodies of the Member States.

Entities such as paying agencies will usually have established internal controls designed to ensure the legality and regularity of underlying transactions. Evidence will be required of such an entity's exercise of its responsibilities to satisfy itself about the transactions (e.g. eligibility of final beneficiaries to receive grants or other financial assistance). If such evidence of the proper functioning of control systems is not forthcoming, substantive procedures **should** be undertaken at the level of the final beneficiaries.

### 2.4.2 Sources of audit evidence

Audit evidence for compliance with applicable laws and regulations may emanate from the following sources:

- *internal* to the entity, e.g. grant agreements, invoices, etc.;

- *external* to the entity, e.g. the use of reports of other auditors (see also [Chapter 3.6.2 of the general part of this manual](#));
- *produced by the auditor*, e.g. analytical review of expenditure trends.

### 2.4.3 Audit procedures to obtain audit evidence

The audit procedures employed to obtain audit evidence regarding compliance with applicable laws and regulations include amongst others:

- |             |  |
|-------------|--|
| Computation | <ul style="list-style-type: none"> <li>• arithmetic checks of amounts, e.g. on an invoice;</li> </ul>  |
| Analysis    | <ul style="list-style-type: none"> <li>• analytical review of the consistency of expenditures compared to budget or prior years;</li> <li>• analysis of decisions to check compliance with rules and regulations;</li> </ul> |
| Inspection  | <ul style="list-style-type: none"> <li>• invoices, records and documents;</li> <li>• tangible items, e.g. livestock, bridges and roads.</li> </ul>   |

## 2.5 DESIGNING AUDIT PROCEDURES

ISSAI 1330  
[ISA 330]

***The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of non-compliance, through designing and implementing appropriate responses to those risks.***

ISSAI 4000<sup>48</sup>

***The auditor shall select a combination of audit techniques to be able to form a conclusion with selected level of assurance.***

***The auditor shall use audit sampling, where appropriate, to provide a sufficient amount of items to draw conclusions about the population from which the sample is selected. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.***

2.5.1 Considerations when designing audit procedures for compliance

2.5.2 Tests of controls

2.5.3 Substantive procedures

2.5.4 Audit sampling

### 2.5.1 Considerations when designing audit procedures for compliance

Dual purpose tests

Circumstance, e.g. time constraints, may dictate the audit procedures to be followed. For example, ECA's deadlines for issuing compliance audit

<sup>48</sup> Paragraphs 158 and 172.

opinions regarding the legality and regularity of the underlying transactions, as set out in the Financial Regulation, make it difficult to follow the traditional audit process. In this context, the *same transactions may be used for both tests of controls and tests of details* ("dual purpose tests"). In such cases, the auditor considers whether the audit results are consistent with the audit hypothesis and whether additional audit procedures need to be performed.

## 2.5.2 Tests of controls

### Relevant high-level controls

Tests of controls for compliance **should** focus on the key controls that are (i) relevant to achieving the entity's objective of complying with applicable laws and regulations; and (ii) at the highest level possible to satisfy the audit objectives.

### Examples

For example, key, high-level controls in place that may be tested in an audit of the legality and regularity of the underlying transactions include:

- ex-ante controls;
- audit certificates and reliability of the certification process (e.g. certifying bodies and audit authorities);
- ex-post controls, e.g. clearance of accounts procedures, conformity decisions; ex-post controls on projects for Transport, Research and Energy;
- information systems, such as the Integrated Administrative and Control System (IACS);
- monitoring performed by the Commission.

## 2.5.3 Substantive procedures

### Examples

The following table presents the main areas for which substantive audit procedures may be undertaken when testing for compliance with applicable laws and regulations.

**Table 2: Main areas for substantive audit procedures**

<b>Central level (e.g. Commission)</b>
<p><b>1. Legal Base</b></p> <p>For any "significant Union action", the existence of the required legal base (e.g. the TFEU; Financial Regulation; Interinstitutional Agreement; Decision; Regulation; Directive).</p>
<p><b>2(a). Selection Procedure – direct expenditure (where applicable)</b></p> <ul style="list-style-type: none"> <li>• Compliance with the regulations on calls for tender.</li> <li>• Respect of the principles of proportionality, transparency, equal treatment and non-discrimination as laid down in the Financial Regulation.</li> <li>• The coherence and consistency of the contracts and any amendments with the selection procedures (call for tender, evaluation report, recommendations for selection, etc.).</li> </ul>
<p><b>2(b). Selection Procedure – grants (where applicable)</b></p> <p>Call for proposals, eligibility criteria, evaluation committee recommendation and authorising officer decision.</p>
<p><b>3. Financing decision, budgetary and legal commitment</b></p> <ul style="list-style-type: none"> <li>• The adoption of the financing decision before any budgetary commitment.</li> <li>• The existence of the budgetary commitment prior to a legal commitment.</li> <li>• The grant agreement includes the elements required and is dated and signed by the duly authorised official.</li> </ul>
<p><b>4. Payment authorisation</b></p> <ul style="list-style-type: none"> <li>• Payment in accordance with the specifications of the related budgetary commitment (supporting documentation) and paid by the regulatory deadline.</li> <li>• The amount of the payment is correctly calculated and in line with the legal and contractual provisions (e.g. regarding co-financing rate, exchange rate, eligibility of costs declared, etc.).</li> <li>• The payment instruction refers to the correct recipient (name and bank account).</li> <li>• The payment was actually processed (bank statement).</li> </ul>
<b>Member State, intermediary and final beneficiary level (to the extent applicable)</b>
<ul style="list-style-type: none"> <li>• Claims exist and eligibility requirements are satisfied.</li> <li>• Project receipts (including interest on pre-financing) are correctly declared and calculated; cofinancing requests are correctly calculated.</li> <li>• Respect of contractual provisions (e.g. regarding subcontracting, payment delays, allocation funds within the consortium, etc.).</li> <li>• Contractually agreed deliverables.</li> </ul>

## 2.5.4 Audit sampling

### Defining errors

Errors or deviations consist of activities or transactions, or parts thereof, and/or actions linked to them which have not been carried out in accordance with the applicable legal and regulatory provisions. Such errors are material if, either individually or in aggregate, they would reasonably affect the decisions of the addressees of ECA's reports.

Errors detected and corrected on the initiative of the audited entity, independently of the checks carried out by ECA, are not taken into account, since they demonstrate that the internal control system works efficiently (for more details see chapter 3.3.2 of the compliance part of this manual). Furthermore, if the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by circumstances rather than by the audited entity, the auditor **should not** consider the effect as an error.

Concerning the legality and regularity of the underlying transactions, a distinction must be made between non-compliance errors affecting:

- the conditions for payment directly (e.g. failure to observe eligibility rules or obligations concerning recoveries); and
- other compliance issues which have no direct impact on the payment made but imply a financial risk and/or could lead to financial corrections to be borne by Member States or fines to be paid by final beneficiaries (e.g. non-observance of management and control procedures or best practices imposed by Union provisions).

For more information on audit sampling and on the assurance model see [Chapters 2.5.6](#), and [2.3.8 of the general part of the manual](#).

## 2.6 DRAWING UP THE AUDIT PLANNING MEMORANDUM AND AUDIT PROGRAMME

*[ISA 300]*  
ISSAI 4000<sup>49</sup>

***The auditor shall develop and document an audit strategy and the audit plan that together describe how the audit will be performed to issue reports that will be appropriate in the circumstances, the resources needed to do so and the time schedule for the audit work.***

Guidance on the content of the APM is given in [Chapter 2.6 of the general part of the manual](#).

<sup>49</sup> Paragraph 137

**3. COMPLIANCE**

Section 1 - Framework  
Section 2 - Planning  
**Section 3 - Examination**  
Section 4 - Reporting  
Appendix

**PART 3. COMPLIANCE**

**SECTION 3 - EXAMINATION**

**TABLE OF CONTENTS**

**3.1 Examination - Overview**

**3.2 Performing audit procedures - tests of control and tests of details**

**3.3 Audit examination - Evaluating the results of tests of controls and tests of details – Compliance with applicable laws and regulations**

**3.4 Analytical procedures**

**3.5 Written representations**

**3.6 Using the work of others**

**3.7 Other audit procedures**

**3.8 Clearing audit findings**

## 3.1 EXAMINATION – OVERVIEW

Guidance on the examination of audits is provided in [Chapter 3.1 of the general part of this manual](#).

## 3.2 PERFORMING AUDIT PROCEDURES - TESTS OF CONTROLS AND TESTS OF DETAILS

ISSAI 1530  
[ISA 530]

*The objective of the auditor is to perform audit procedures appropriate to the particular audit objective on each item selected.*

3.2.1 Performing tests of controls

3.2.2 Performing tests of details

### 3.2.1 Performing tests of controls

When performing tests of controls, the auditor should follow the requirements in [Chapter 3.2.2 of the general part of this manual](#).

### 3.2.2 Performing tests of details

When performing tests of details, the auditor **should** follow the requirements in [Chapter 3.2.3 of the general part of this manual](#).

## 3.3 AUDIT EXAMINATION - EVALUATING THE RESULTS OF TESTS OF CONTROLS AND TESTS OF DETAILS - COMPLIANCE WITH APPLICABLE LAWS AND REGULATIONS

ISSAI 1450  
[ISA 450]

ISSAI 1530  
[ISA 530]

*The objective of the auditor is to evaluate the results from the sample in a manner that will provide an appropriate basis for the auditor to draw conclusions about the population.*

3.3.1 Evaluating the results of tests of controls

3.3.2 Evaluating the results of tests of details

The auditor's assessment of what represents a material compliance deviation is a matter of *judgment* and includes considerations of context as well as both the quantitative (size) and qualitative (nature) aspects of the transactions or issues concerned. For example, the auditor considers the nature of the relevant laws and regulations and the extent or monetary value of the deviation.

### 3.3.1 Evaluating the results of tests of controls

Where the auditor has decided to rely on internal controls and has designed the audit approach accordingly, the objective of tests of controls is to confirm the extent of reliance on these controls.

The results of tests of controls may be as follows:

- i. if, when testing the controls, the auditor has ensured that they are *operating effectively and continuously* throughout the period, then (s)he will maintain the audit approach adopted at the planning stage;
- ii. if some weaknesses are noted, but the *overall system is not considered unreliable*, then the assessment of control risk is revised and the extent of substantive procedures is increased in accordance with the assurance model;
- iii. if the controls are *not operating as they should*, then no assurance can be obtained regarding compliance with applicable laws and regulations. The auditor **should** then obtain the audit evidence mainly or solely from substantive testing.

Another separate objective may be to report on the effectiveness of internal controls, in which case the assessment of controls may be effective, partially effective or not effective, respectively.

### 3.3.2 Evaluating the results of tests of details

#### General

The auditor **should** evaluate the sample results, by comparing the *projected* error rate/amount to the *tolerable* error rate/amount (amount of immaterial error), in order to determine whether his/her assessment of the relevant characteristic of the population is confirmed or needs to be revised (e.g. if the auditor has found an unexpectedly high error amount for tests of details). Based on the evaluation of the results, auditors may need to extend their audit procedures and/or carry out additional procedures, as explained in the general part of this manual.

#### Legality and regularity

##### (a) Calculating errors

The percentage error and the monetary value of the quantifiable error discovered **should** be calculated in relation to the recorded value of the transaction at the level concerned. The quantification of the error concerns the EU contribution; in cases of co-financing (mainly with the Member States), a distinction is made between the proportion financed by the EU and the proportion financed by third parties.

Quantification depends on a comparison between the actual value of the transaction and the value if it had been conducted in accordance with applicable provisions. The difference thus calculated is expressed as a percentage underestimation or overestimation of the value of the transaction recorded. For SoA audits the ECA's electronic support system automatically calculates the amount and percentage error based on the input of identified information.

*(b) Evaluating the nature and causes of errors*

The nature and causes of errors identified **should** be carefully evaluated and their possible effect on the particular audit objective and other areas of the audit assessed.

*(c) Classifying an error*

**should** be analysed in a step-by-step process in order to determine whether and to what extent they are relevant for inclusion in the audit conclusion or opinion, which involves an analysis of:

1. whether legal requirements (conditions for payment or other compliance issues) are affected;

2. whether errors are quantifiable and material (i.e. higher than the materiality threshold) and, if not, whether they are material by nature or context;

4. whether errors are systematic;

5. the overall impact of errors as a result of the extrapolation of quantifiable findings. The findings can only be extrapolated if the selection procedure resulted in a representative sample.

Errors that are detected and corrected on the initiative of the managing body before the closure of the accounts for the financial year and independently of the checks carried out by the ECA, are not taken into account in the SoA, since they demonstrate the efficient working of the EU system and no longer affect the accounts of the financial year.

If management refuses to or cannot make the necessary adjustments and the results of extended audit procedures do not enable the auditor to conclude that the aggregate effect is not material, the auditor **should** consider an appropriate modification to the auditor's report

The auditor may have to consider how to report deviations that have been identified and which may not be quantitatively material, as the discharge authority may have an interest in breaches of authority in certain sensitive areas.

## 3.4 ANALYTICAL PROCEDURES

**ISSAI 1520  
[ISA 520]** *The objective of the auditor is to apply analytical procedures where appropriate to help in assessing risk, providing audit evidence, and arriving at an overall audit conclusion.*

Analytical procedures may, in certain circumstances, assist the auditor in evaluating compliance. For example, where allowances under a grants scheme are subject to a maximum value and the number of recipients is known, the auditor may use analytical procedures to establish whether the permitted maximum has been breached.

## 3.5 WRITTEN REPRESENTATIONS

**ISSAI 1580  
[ISA 580]** *The objective of the auditor is to corroborate, by means of written representations:*

*(a) that management or where appropriate those charged with governance believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;*

*(b) other audit evidence relevant to the financial statements or specific assertions.*

*Further, the objective is (c) to respond appropriately to written representations provided or not provided.*

### 3.5.1 Introduction

### 3.5.2 Acknowledgement by management of its responsibilities

### 3.5.3 Specific written representations regarding particular assertions

### 3.5.1 Introduction

Given the importance in the EU context of compliance with applicable laws and regulations, the auditor typically obtains written representations regarding compliance, in particular:

- (i) written acknowledgement by management of its *responsibilities*;
- (ii) specific written representations, whether from management, those charged with governance, or employees with specialist knowledge regarding *particular assertions*.

### 3.5.2 Acknowledgement by management of its responsibilities

Auditors **should** seek representations from the responsible party/parties, who are expected to provide a formal statement on the discharge of their responsibility for compliance with applicable laws and regulations.

Such representations may cover, in particular, whether,

(i) to the best of the official's knowledge and belief, the activities and financial transactions (and for compliance audits related to transactions underlying the financial statements, information reflected in the financial statements of the entity) are in compliance with the authorities which govern them;

(ii) management has reasonable assurance that the internal controls put in place prevent and detect material instances of non-compliance;

(iii) all relevant information has been made available to the auditor.

#### AARs and declarations

SoA legality and regularity audits, such representations are made in the representation letter for the European Union's consolidated annual accounts, signed by the Accounting Officer in the Commission's AMPR, AARs and declarations by the Directors-General, to which the discharge authority (European Parliament and Council) attaches considerable importance. In the AAR, the Director-General reports on the achievement of assigned political objectives, and describes and expresses a conclusion about the effectiveness of the internal control system. In this respect, they attach to their report a statement of the accounts (budgetary execution), and disclose any constraints the DG encountered in the course of its activities.

**THE DECLARATION BY THE DIRECTOR-GENERAL STATES THAT: "*I have/have not reasonable assurance that the resources assigned to the activities described in this report have been used for their intended purpose and in accordance with the principles of sound financial management, and that the control procedures put in place give the necessary guarantees concerning the legality and regularity of the underlying transactions.*"**

If there are recurring weaknesses in the system of internal control, or particular difficulties that may have an impact on the legality and regularity of the operations for which (s)he is responsible, the Director-General may express reservations in order to highlight such weaknesses.

#### Auditor's objective

The auditor's objective when reviewing the letter of representation (and, where appropriate, other declarations on the legality and regularity of transactions) is to note whether assurance is not given, or is qualified. Where this is the case, the auditor will consider the impact on the audit opinion (see [Chapter 3.5.4 of the general part](#)). The auditor is not required

to report on whether the management representation is justified, but may report where (s)he has audit evidence that the information provided is significantly incorrect. Thus, the omission by the Director-General of material weaknesses, or a declaration which is incompatible with existing weaknesses, means that such written management representations are of no use as audit evidence.

It is emphasised that management representations such as those contained in the AARs and declarations by Directors-General can never be a substitute for substantive tests of the operating effectiveness of controls.

### 3.5.3 Specific written representations regarding particular assertions

The auditor obtains specific written representations where necessary to corroborate other audit evidence. However, such specific written representations do not constitute sufficient appropriate audit evidence by themselves.

## 3.6 USING THE WORK OF OTHERS

ISSAI 1600 [ISA 600]	<i>Using the work of another auditor</i>
ISSAI 1610 [ISA 610]	<i>Using the work of an internal auditor</i>
ISSAI 1620 [ISA 620]	<i>Using the work of an auditor's expert</i>

3.6.1 Using the work of another auditor

3.6.2 Considering the internal audit function

3.6.3 Using the work of an auditor's expert

### 3.6.1 Using the work of another auditor

ISSAI 1600 [ISA 600]	<i>The objective of the auditor is to determine, when the work of another auditor is used, how the work of the other auditor will affect the audit.</i>
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When using the work of other auditors, the auditor **should** follow the requirements in [Chapter 3.6.2 of the general part of the manual](#).

### 3.6.2 Considering the internal audit function

ISSAI 1610 [ISA 610]	<i>The objective of the external auditor is to obtain an understanding of the internal audit function and determine whether its activities are relevant to planning and performing the audit and, if relevant, the effect on the procedures performed by the external auditor.</i>
-------------------------	--

When using the work of the internal audit function, the auditor **should**

follow the requirements in [Chapter 3.6.3 of the general part of the manual](#).

### 3.6.3 Using the work of an auditor's expert

**ISSAI 1620  
[ISA 620]**      ***The objectives of the auditor are:***  
                   ***(i) to determine whether to use the work of an auditor's expert; and***  
                   ***(ii) if the answer is yes, to determine whether that work is adequate for the***  
                   ***purposes of the audit.***

Only experts contracted by ECA

Experts may be used to provide technical expertise in areas such as construction of roads, bridges, etc. However, this section applies only to experts contracted by ECA, and not to those experts contracted by the Member State or local authorities. Work performed by the latter *may* be taken into consideration by the auditor as *corroborative* audit evidence if suitable for the purposes of the audit.

The auditor **should** comply with the requirements set out in the general part of the manual ([Chapter 3.6.4](#)) regarding the use of the work of an auditor's expert, in particular:

- determining whether to engage an auditor's expert;
- evaluating the adequacy of the expert's work;
- referring to the auditor's expert in the auditor's report; and
- becoming familiar with ECA's requirements regarding the engagement of auditor's experts.

## 3.7 OTHER AUDIT PROCEDURES

[3.7.1 Subsequent Events](#)

[3.7.2 Related Parties](#)

### 3.7.1 Subsequent Events

**ISSAI 1560  
[ISA 560]**      ***The objective of the auditor is to obtain sufficient, relevant and reliable audit***  
                   ***evidence about whether events occurring after the end of the reporting period***  
                   ***and up until the date of the auditor's report are appropriately disclosed.***

**Definition**

Subsequent events in relation to compliance audits are events, both favourable and unfavourable, that occur between the end of the reporting period and the date of the auditor's report. As such, subsequent events may occur in relation to compliance audits concerning the legality and regularity of the underlying transactions.

The auditor **should** perform audit procedures to determine if any events have occurred between the end of the reporting period and up until the

date of the auditor's report that may result in material deviations and therefore require disclosure. However, the auditor is not expected to conduct a continuing review of all matters where audit procedures have already provided satisfactory conclusions.

**Audit procedures**

The audit procedures are performed as near as practicable to the date of the auditor's report, and take into account the auditor's risk assessment. While dependent on the time that has elapsed since the last audit mission, such audit procedures typically include:

- reviewing management procedures to ensure that subsequent events are identified;
- reading minutes of meetings of those charged with governance held after the end of the reporting period;
- enquiring of management as to whether any subsequent events have occurred which might result in material non-compliance.

When the auditor identifies events which may result in material deviations, (s)he **should** determine whether such events are adequately disclosed.

### 3.7.2 Related Parties

The audit requirements regarding related parties and related party relationships and transactions are set out in the [Chapter 3.7 of the general part of this manual](#). The auditor addresses the risks of non-compliance with the specific requirements in this regard established by the audited entity.

## 3.8 CLEARING AUDIT FINDINGS

*The objectives of the auditor are to:*

*provide those charged with governance with timely observations arising from the audit that are relevant to their responsibility;*

*[ISA 260]ISSAI  
1265  
[ISA 265]*

*communicate appropriately to management or those charged with governance deficiencies in internal control relevant to the audit that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.*

*[ISA 705]*

*ISSAI 400<sup>50</sup>*

*The auditor shall compare the obtained audit evidence with the stated audit criteria to form audit findings for the audit conclusion(s)*

*The auditor shall communicate the conclusion in the audit report. The conclusion can be expressed either as an opinion, conclusion, answer to specific audit questions or recommendations.*

<sup>50</sup> Paragraphs 179 and 191.

Audit findings **should** be cleared through the clearing letter process, as outlined in [Chapter 3.8 of the general part of this manual](#).

### 3. COMPLIANCE

Section 1 - Framework  
Section 2 - Planning  
Section 3 - Examination  
**Section 4 - Reporting**  
Appendix

## PART 3. COMPLIANCE

# SECTION 4 - REPORTING

## TABLE OF CONTENTS

4.1 Reporting - Overview

4.2 Statement of Assurance - forming an audit opinion

4.3 Modified opinions

4.4 Emphasis of Matter and Other Matters paragraphs

4.5 Information in support of the Statement of Assurance

4.6 Specific assessments in the context of the Statement of Assurance

4.7 Special compliance audit reports

## 4.1 REPORTING – OVERVIEW

### Statement of Assurance

The results of all recurrent compliance audits on the legality and regularity of transactions underlying the consolidated annual accounts **should** be reported in a Statement of Assurance. The requirement to produce a Statement of Assurance is applicable to compliance audits of transactions underlying the consolidated annual accounts of the European Union and EDFs as well as other EU bodies, offices and agencies.

The Statement of Assurance is a core part of each Annual and Specific Annual Report. In the case of the consolidated accounts of the European Union, it may also be published as a stand-alone document together with the annual accounts of the auditee.

### Opinion on legality and regularity of transactions as a whole

The Statement of Assurance contains an opinion on the legality and regularity of transactions underlying the consolidated annual accounts of the auditee.

### or by MFF heading

In the case of the ECA's Annual Report on the implementation of the EU general budget, the ECA may give *separate opinions on the legality and regularity of transactions underlying the annual accounts for each policy group (MFF heading)*. The Statement of Assurance containing these opinions *may* be supplemented with supporting information and specific assessments, which provide more details for the discharge authority.

More details about the structure and content of the Statement of Assurance, as well as the Annual and Specific Annual Reports, are provided in [Section 4 of the general part](#) of this manual.

## 4.2 STATEMENT OF ASSURANCE - FORMING AN AUDIT OPINION

ISSAI 1700  
[ISA 700]

***form an opinion on the legality and regularity of the transactions underlying the consolidated annual accounts based on an evaluation of the conclusions drawn from the audit evidence obtained;***

ISSAI 4000<sup>51</sup>

***express clearly that opinion through a written report that explains the basis of the opinion.***

***The auditor shall compare the obtained***

### 4.2.1 Introduction

### 4.2.2 Requirements

### 4.2.3 Types of opinions

### 4.2.4 Considerations when forming an opinion on legality and regularity

### 4.2.5 Qualitative aspects of the entity's compliance practices

### 4.2.6 The applicable legal and regulatory framework

### 4.2.7 Illustrations

<sup>51</sup> Paragraphs 179, 188, 191, 202.

*audit evidence with the stated audit criteria to form audit findings for the audit conclusions(s).*

*The auditor shall communicate the level of assurance provided in a transparent way.*

*The auditor shall communicate the conclusion in the audit report. The conclusion can be expressed either as an opinion, conclusion, answer to specific audit questions or recommendations.*

## 4.2.1 Introduction

Consider relationship between reliability and legality/regularity

Compliance audit concerns the legality and regularity of the underlying transactions, the main output of which is a Statement of Assurance.

The reliability of the annual accounts and the legality and regularity of the underlying transactions are two interconnected objectives, as described in [Chapter 1.5.2](#). The auditor **should** consider the relationships between these two objectives when reporting on the audit.

## 4.2.2 Requirements

The main guidance on the content of the Statement of Assurance is given in [Section 4 of the general part](#) of this manual.

## 4.2.3 Types of opinions

The types of opinions are described in [Section 4 of the general part](#) of this manual.

## 4.2.4 Considerations when forming an opinion on legality and regularity

Reasonable assurance

The auditor **should** conclude whether reasonable assurance has been obtained about whether the underlying transactions taken as a whole (or, in the case of the EU general budget, by MFF heading) are free from material errors and irregularities. This conclusion **should** take into account his/her evaluation as to whether:

Consider  
- evidence  
- materiality

- (a) sufficient appropriate audit evidence has been obtained;
- (b) identified errors or irregularities are material, individually or in aggregate;

- qualitative aspects

(c) the qualitative aspects of the entity's compliance practices are consistent with the applicable legal and regulatory framework and are appropriate, including consideration of the practices and processes of the entity and its management, and whether there are indicators of possible bias in management's judgments or actions.

## 4.2.5 Qualitative aspects of the entity's compliance practices

Potential management bias

Management makes a number of judgments when taking decisions within the legal and regulatory framework. When considering the qualitative aspects of the entity's compliance practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of errors and irregularities, cause the transactions underlying the annual ~~annual~~ accounts as a whole to be materially non-compliant with the applicable laws and regulations. Indicators of a lack of neutrality that may affect the auditor's evaluation whether the underlying transactions as a whole are materially non-compliant include the following:

Indicators of bias

- selective correction of errors and irregularities brought to management's attention during the audit or previous audits;
- possible management bias in the management representations.

In the case of the compliance audit of the EU general budget, this point may be relevant not only at the level of the European Commission, but also at the level of national Member States authorities.

## 4.2.6 The applicable legal and regulatory framework

Management is responsible for taking decisions on the transactions underlying the annual ~~annual~~ accounts in accordance with the applicable legal and regulatory framework. The definition of the legal and regulatory framework is important because it advises the discharge authority and interested public of the framework on which the decisions on the underlying transactions are based.

The auditor **should** ensure that the definition of the legal and regulatory framework exists and is appropriate. The auditor **should** make reference to the applicable legal and regulatory framework when forming the auditor's opinion and the basis for that opinion.

There may be cases where the underlying transactions, although compliant with one authority, do not comply with another authority. In the event of contradictory requirements within the legal and regulatory framework, the

auditor **should** seek the advice of the Legal Service.

## 4.2.7 Illustrations

As illustration the Statement of Assurance 2015<sup>9</sup> for the legality and regularity of the underlying transactions is included in [Appendix III, of the general part](#) of this manual.

## 4.3 MODIFIED OPINIONS

***The objective of the auditor is to express clearly an appropriate modified opinion on the underlying transactions that is necessary:***

***(a) when the auditor concludes that the underlying transactions do not comply in all material respects with the applicable legal and regulatory framework; or***

***(b) when the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the underlying transactions comply in all material respects with the applicable legal and regulatory framework***

ISSAI 1705  
[ISA 705]

4.3.1 Nature of material instances of non-compliance

4.3.2 Pervasiveness of the matter(s) giving rise to a modification

4.3.3 Form and content of the auditor's report when the opinion is modified

### 4.3.1 Nature of material instances of non-compliance

A material instance of non-compliance of the transactions underlying the annual accounts (an error or deviation) may arise in relation to:

Appropriateness of processes and policies

(a) *the appropriateness of the compliance processes and policies*, i.e. (i) they are not consistent with the applicable legal and regulatory framework; (ii) they are not appropriate in the circumstances; or (iii) they result in the transactions underlying the annual accounts not complying in all material aspects with the legal and regulatory framework.

Application of rules, regulations and policies

(b) *the application of rules, regulations and policies*, i.e. (i) inconsistent application whether in terms of required timeframe or similar transactions and events; (ii) incorrect method of application, or when there is disagreement with management about the underlying facts and circumstances to which the rules, etc., are applied; or (iii) when the entity has not complied with new requirements following a change in rules, etc.

### 4.3.2 Pervasiveness of the matter(s) giving rise to a modification

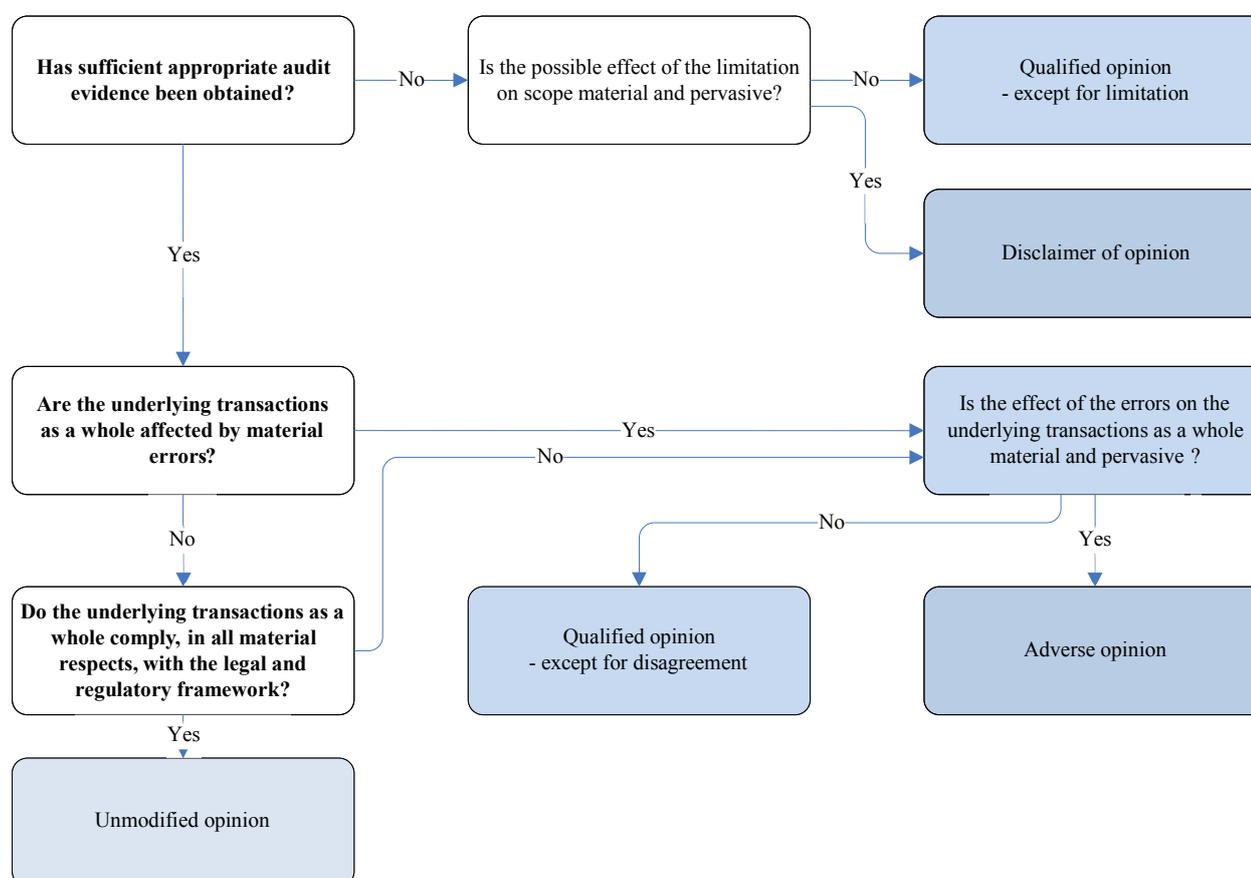
Transactions underlying the annual accounts do not comply with the legal and regulatory framework

Inability to Obtain Sufficient Appropriate Audit Evidence

The auditor may judge errors that are material individually or in aggregate to be pervasive when such errors are not confined to specific elements or types of transactions, or if confined thereto, the errors represent or could represent a substantial proportion of the transactions.

When the auditor has been unable to obtain sufficient appropriate audit evidence about one or more matters pertaining to the transactions underlying the annual accounts, (s)he may deem this inability to be both material and pervasive. This is the case when the possible effects of the inability cannot be confined to specific elements or types of transactions or, if confined, those possible effects could represent a substantial proportion of the transactions.

**Figure 2: Detailed flowchart for forming an opinion on legality and regularity**



When the opinion on the legality and regularity of underlying transactions is modified, the auditor **should** consider the wider implications for the annual consolidated accounts as a whole and for the Statement of Assurance and the other parts of the report thereon.

### 4.3.3 Form and content of the auditor’s report when the opinion is modified

Basis for Modification paragraph

Details on the modification of the opinion are provided in [Chapter 4.4 of the general part](#) of this manual.

## 4.4 EMPHASIS OF MATTER AND OTHER MATTERS PARAGRAPHS

ISSAI 1706  
[ISA 706]

*The objective of the auditor is to include clear additional communication in the Statement of Assurance when, in the auditor’s judgment, such communication is necessary to draw users’ attention to a matter stated in writing by the management, or to any other matter which may be relevant to his/her understanding of the annual accounts, the underlying transactions or the audit.*

Information regarding Emphasis of Matter or Other Matters paragraphs is provided in [Chapter 4.5 of the general part](#) of this manual.

## 4.5 INFORMATION IN SUPPORT OF THE STATEMENT OF ASSURANCE

Clarify approach and provide overview

The section on the legality and regularity of underlying transactions in the information in support of the Statement of Assurance **should** be used for providing additional information on ECA’s approach to preparing the Statement of Assurance and also for providing a brief overview of the audit results further described in the specific assessments.

In the case of other bodies, offices and agencies, the information in support of the Statement of Assurance may also include significant observations and recommendations for the auditee.

## 4.6 SPECIFIC ASSESSMENTS IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Provide detailed explanation

In addition to the opinion on legality and regularity included in the Statement of Assurance, ECA’s auditors may provide in the accompanying report further more detailed explanations. Such additional explanations

may be appropriate when the opinion is modified as a consequence of material non-compliance. The purpose of this is to provide the discharge authority, the audited entity, and/or other bodies as appropriate, with a detailed explanation beyond that given in the Statement of Assurance. The auditor **should** report such compliance issues in sufficient detail to enable the discharge authority or relevant committee to understand these matters properly.

In the case of the agencies, offices and other bodies, the information in support of the Statement of Assurance may also include significant observations and recommendations for the auditee.

**Focus on compliance and systems**

Specific assessments - which are not opinions - may complement the Statement of Assurance and describe the audit results of an entity's individual budgetary, activity or policy areas, including conclusion(s) for that area. The focus **should** be on an assessment of the legality and regularity of underlying transactions and systems aspects.

In the case of the legality and regularity of transactions underlying the consolidated annual accounts of the European Union, there is a specific assessment for most MFF headings, comprising:

- a description of the audit scope and characteristics of the audited area;
- an assessment of the legality and regularity of underlying transactions in the area, including significant findings and observations;
- an assessment of the effectiveness of internal control systems in the area, supported by a discussion thereon;
- conclusions and recommendations;

## 4.7 SPECIAL COMPLIANCE AUDIT REPORTS

ISSAI  
4000<sup>52</sup>

***The auditor shall compare the obtained audit evidence with the stated audit criteria to form audit findings for the audit conclusions(s).***

***The auditor shall communicate the level of assurance provided in a transparent way.***

***The auditor shall communicate the conclusion in the audit report. The conclusion can be expressed either as an opinion, conclusion, answer to specific audit questions or recommendations.***

***The auditor shall prepare an audit report based on the principles of***

[4.7.1. Introduction](#)

[4.7.2 Form and content of special audit reports](#)

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<sup>52</sup> Paragraphs 179, 188, 191, 202.

***completeness, objectivity, timeliness, accuracy and contradiction.***

### 4.7.1 Introduction

The form of special (non-SoA) compliance audit reports may vary depending on the circumstances. However, some consistency in the reports may help users of the report to understand the audit work done and conclusions reached, and to identify unusual circumstances when they arise. The criteria against which the subject matter is assessed should be identified in the special report. In performing compliance audits, the criteria may differ greatly from audit to audit. Clear identification of the criteria in the report is therefore important so that the users can understand the basis for the audit work and conclusions.

### 4.7.2 Form and content of special audit reports

In general, special compliance audit reports should be structured into the following sections:

- a) Title page
- b) Table of contents
- c) Glossary (if necessary)
- d) Executive summary
- e) Introduction
- f) Audit scope and approach
- g) Observations
- g) Conclusions and recommendations
- i) Responses from the audited entity
- j) Appendices (if necessary)

(i) Title page, table of contents and glossary

The *title page* clearly sets out the title of the report, the report date, to whom the report is addressed and the preparer of the report. Including a *table of contents*, especially if the report is voluminous, helps give the report structure and guide the reader to areas of particular interest. A glossary may also be helpful to readers if technical or unfamiliar terminology, acronyms, abbreviations or words with a particular contextual meaning are used repeatedly throughout the report.

(ii) Executive Summary

The *executive summary* is critical as it is often the part of the report most read by users. The executive summary should reflect fully and accurately, while at the same time in a concise and balanced fashion, the content of the report. To be effective, an executive summary should normally be one to two pages in length. The main focus of the executive summary should be on the identified criteria (significant questions to be answered) and summarise the main audit conclusions and recommendations in relation to such criteria.

**(iii) Introduction**                      The *introduction* sets out the context of the audit including identification or description of the subject matter or subject matter information, and the responsibilities of the various parties involved. The introduction is generally short without a lot of detail. If necessary, relevant detailed information may be included in appendices.

**(iv) Audit scope and approach**                      The *scope* and the objectives of the audit are set out in detail in this part of the special compliance audit report.

**(v) Observations**                      The *observations and findings* section comprises the main body of the special compliance audit report. This section describes the audit work performed and related findings. It is structured in a logical manner, normally around the identified criteria, and in a way that assists the reader in following the logical flow of a particular argument. When presenting audit observations and findings, the following four elements should be made apparent to users assisting them in gaining a better understanding of the audit work performed and the significance and consequences of the audit findings:

- a) *Standards (criteria)* – the benchmark or measure against which performance is compared or evaluated
- b) *Facts (conditions)* – the situation observed
- c) *Analysis (cause)* – the source and reasons giving rise to the conditions observed
- d) *Impact (effect)* – the impact and consequences of the conditions observed (the materiality of the findings, their impact on the budget, etc).

When significant amounts of data are included to support audit findings, such data should be more appropriately included in appendices.

**(vi) Conclusions and recommendations**                      The primary purpose of the *conclusions and recommendations* section of the report is two-fold:

- a) to provide clear answers (conclusions) to the audit questions (identified criteria), and
- b) to provide constructive and practical recommendations for improvement where appropriate.

Recommendations are most effective when they are positive in tone and results-oriented, setting out clearly what needs to be done. Cost considerations should be borne in mind when determining the practicality of recommendations. While constructive and practical recommendations assist in promoting sound management, the auditor should not provide such detailed recommendations so as to be taking on the role of management and thereby impairing his own objectivity.

**(vii) Responses from the audited entity**                      The principle of contradiction – agreeing facts and incorporating responses – should be applied in preparing special compliance audit reports.

Responses from the audited entity to issues raised may be incorporated in the report, either verbatim or in summary. They are included in a separate section of the report.

**(viii) Appendices**

Where appropriate, appendices may be used to provide users with detailed or supplementary information related to the audit. The information may be in text or table format, or it may be more graphical in nature such as diagrams, charts or pictures. Such information may assist users in understanding the audit findings, as well as the causes and effects thereof.

## APPENDIX I - ASSESSMENT OF HOW THE SUPERVISORY AND CONTROL SYSTEMS WORK

Definition of supervisory and control systems

Audit approach

Assessment of the environment of the supervisory and control systems

Tests of control

General aspects

Centralised and decentralised management

Shared management

Key control objectives

Assessing materiality of weaknesses identified

Framework proposed

Identification of a control deficiency/weakness of a supervisory and control system

Assessment of the magnitude of a control deficiency/weakness of a supervisory and control system

### Definition of supervisory and control systems

Under Article 317 of the TFEU, the European Commission is responsible for the implementation of the European Union's budget in cooperation with the Member States and therefore for:

- a.) forecasting (planning);
- b) organising implementation;
- c) monitoring implementation;
- d) reporting.

A system is composed of all the detailed procedures for the issuing of guidelines, mobilisation and controls applying to a homogeneous series of operations down to the level of the final beneficiary. Seen in this way, the increase in the number of environments (measures, organisations, countries, regions) means that, for certain fields<sup>53</sup>, Union expenditure passes through an inordinate number of systems. Due to limited resources, ECA can only evaluate a very limited number of management systems per year and cannot reach any overall conclusions.

On the other hand, the number of procedures provided for in the Union Regulations or decisions of organisations for guaranteeing the sound working of management systems (supervisory and control systems) is much more limited and, by evaluating these, it is possible to arrive at overall conclusions. An audit of this type should, in principle, enable ECA to monitor the development of the situation in each field from one year to the next.

Supervisory and control systems aim to obtain reasonable assurance concerning the legality and regularity of revenue and expenditure by attesting that the procedures function properly. They provide

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<sup>53</sup> EAGGF - Guarantee and Structural Funds in particular.

the Commission with the information it needs to guarantee that objectives are achieved in accordance with the relevant legal, regulatory and/or contractual provisions.

Supervisory and control systems are found at various levels of management. Some are identical for both direct and indirect Commission management, whereas others are not only specific to the type of management, but also to the fields or measures concerned.

### **Audit approach**

The evaluation of the supervisory and control systems relating to the various chapters of the financial perspective constitutes a key component of the audit of the legality and regularity of underlying operations. The objective of the audit of the supervisory and control systems is to assess their capacity to:

- a) supply the Commission with the information that it needs to ensure that the relevant legal, regulatory and contractual provisions have been complied with and, where applicable, take corrective action;
- b) give a reasonable assurance with regard to the legality and regularity of the underlying operations.

The audit consists in evaluating the supervisory and control systems and, to this end, includes tests of control. In this context, substantive tests can be used to assess the effectiveness of the supervisory and control systems. The substantive tests must supply analytical results which, together with the assessment of the supervisory and control systems, will enable ECA to understand the causes of legality/regularity errors in the underlying operations and limit them. In short, it is a matter of appraising the consequences of the weaknesses in the supervisory and control systems and contributing towards their improvement.

Where the supervisory and control systems are judged to be sound, the auditor will expect to find few or no errors and if the substantive checks show this to be the case he will come to an unmodified audit conclusion. In the opposite scenario, he will expect to find a large number of errors, and if this is actually the case he will come to a qualified or adverse audit conclusion. Where the latter is the case, the auditor will be able to explain what the nature of the problem is because the analysis of the supervisory and control systems will have revealed the weaknesses and the substantive tests will have given him confirmation of this and possibly some additional information. Other hypothetical cases are dealt with in the body of the document.

### **Assessment of the environment of the supervisory and control systems**

The Commission and the other parties involved in the supervisory and control systems must set up appropriate management, monitoring and audit departments with a sufficient number of qualified staff. These departments must create the mechanisms to ensure that the methods and procedures applied comply with the generally accepted standards (clear definition of mission and tasks, deontology and integrity, sensitive functions, delegation, registration of mail and filing system, documentation concerning procedures, separation of responsibilities, record of exceptions, continuity of operations, ad hoc

information in the field of management, work programme, evaluation and management of risk, etc.<sup>54</sup>). A warning system must be introduced to notify existing inadequacies and remedy them.

In the context of the evaluation of the supervisory and control systems, the audit chambers/units must first identify the Commission departments and third parties responsible for supervision in connection with the legality and regularity of revenue and expenditure. They must then evaluate whether the control environment of these departments corresponds to the principles presented above.

## **Tests of control**

### ***General aspects***

For each field, a programme of tests of control must be established in order to evaluate the functioning of the supervisory and control systems. Subsequently, depending on the degree of management decentralisation, it will be necessary to specify the scope and geographical location of the tests of control so as to obtain a satisfactory coverage. The samples for the substantive tests may, where applicable, serve as a basis for the tests of control and may be differentiated according to the levels of management.

In the context of the preparation of the programmes for the tests of control, the audit units/chambers must make use of the work of the Commission as specified in internal control standards Nos 6 "Risk management process" and 9 "Management supervision".

Under internal control standard No 6, each Commission Directorate-General or department must, at least once a year, analyse the risks linked to its main activities. On the basis of the results obtained, the departments must draw up action plans to enable them to bring the risks under control and allocate staff to the implementation of these plans.

Internal control standard No 9 requires that the Commission's Directorates- General and departments examine annually the recommendations given in the audit reports issued by the Commission's internal audit service, and ECA, as well as the measures taken in response to these reports. They must then draw up action plans aimed at remedying the shortcomings and monitoring the implementation of these plans. ECA must assess the merits and implementation of these plans in the context of its audit of the operation of the supervisory and control systems.

### ***Centralised and decentralised management***

In the fields under centralised and decentralised management, the examination of the regulatory and contractual framework must lead to the identification of the procedures and mechanisms that ensure the legality and regularity of revenue or expenditure. Once this information has been obtained, the auditor must :

- a) examine how the controls are carried out, in particular down to final beneficiary level;
- b) evaluate their scope;
- c) analyse the results;
- d) assess the degree of assurance that ECA can obtain from them for the field as a whole.

Thus, the following elements must be included in the sectoral APMs:

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<sup>54</sup> See the European Commission's internal control standards.

- a) the actual audit programmes, procedures and work carried out by the Commission departments<sup>55</sup> in the field of administrative expenditure (centralised direct management).
- b) the actual audit programmes, procedures and work carried out by the Commission departments, intermediary agencies and all other third parties involved in the supervisory and control systems in the internal policies and research field (centralised indirect management);
- c) the actual audit programmes, procedures and work carried out at the Commission and at the Commission's delegations and all the other parties involved in the supervisory and control systems in the field of external activities (decentralised management).

### ***Shared management***

The fields under shared management are those where expenditure is partially managed by the national authorities of the beneficiary countries (Member State or Non-Member State). This applies to the fields of agriculture, the Structural Funds and most of the own resources field. Some external aid can be included here by virtue of its decentralised implementation.

For each consistent set, the audit units/chamber must establish what supervisory mechanisms are required by the Regulations on the basis of their knowledge of the field. These mechanisms may have been put in place by the Commission at EU level<sup>56</sup> or at national, regional or local level (for example, at operational programme level for the Structural Funds, at paying body level for agriculture, at national level for own resources, etc.). On this basis, for each field, it will be necessary to establish a control area that will enable overall audit conclusions to be drawn. That is to say, no elements must be excluded where their omission might, in itself, affect the overall picture. The fields under shared management require greater discernment. Once this information has been collected, the same work must be carried out as described in paragraph 14.

### ***Key control objectives***

Given the size and complexity of the operations financed by the EU budget, the Commission must be able to base its work on a global strategy concerning the permanent operation of supervisory and control systems covering all operations of a given type (EU revenue and expenditure) at all management levels concerned.

In order to guarantee sufficient coverage and a consistent approach to analysis by ECA's various audit chambers the audit procedure to be followed aims to examine the manner in which the supervisory and control systems covered by the APMs ensure compliance with the five key control objectives in the implementation of Union policies (see table below).

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<sup>55</sup> Where applicable, the departments of other institutions.

<sup>56</sup> These are systems provided for in the Regulations which do not overlap directly with the elements introduced by the reform of the European Commission.

### Key control objectives

Key objective	Elements to be covered by the supervisory and control systems	IFAC <sup>(1)</sup> terminology
<b>Reality and measurement</b> (determination of physical quantities) of the underlying transactions	Verify that the systems in place ensure that the underlying operations exist as described - in time and substance - and physical quantities (such as land surfaces, number of trainees, etc.) are accurately determined.	Occurrence/accuracy
<b>Eligibility</b> of the underlying transactions	Verify that the systems in place ensure that the various EU eligibility criteria are met for the underlying transactions.	Legality and regularity <sup>(2)</sup>
<b>Compliance</b> with other regulatory requirements	Verify that the systems in place ensure that other (i.e. non-eligibility) criteria are met. These include such requirements as compliance with tendering procedures, provision of reports, separate identification of EU transactions, etc.	Legality and regularity <sup>(2)</sup>
<b>Correctness of calculations</b>	Verify that the systems in place ensure that all calculations are correctly undertaken in terms of mathematical accuracy as well as use of correct bases and factors, etc.	Accuracy
<b>Completeness and accuracy of accounting</b>	Verify that the systems in place ensure that all transactions are accounted for, are not included more than once, and are recorded in the correct accounting period and at the value undertaken.	Completeness/Accuracy/ Annuality

<sup>(1)</sup> This refers to the IFAC categories corresponding to the information contained in the financial statements.

<sup>(2)</sup> The legality/regularity aspect is not explicitly mentioned in ISA 500 but is mentioned in ISA 250 "Consideration of laws and regulations in an audit of financial statements" and in paragraph 42 of ISA 315 "Understanding the entity and its environment and assessing the risks of material misstatement".

Compliance with the key control objectives should be examined in respect of the three following aspects:

- a) design of the Regulations and, in particular, the provisions relating to the supervisory and control systems;
- b) transposition of these rules and provisions by the Commission, the Member States, third countries or other parties concerned;
- c) continuous and efficient operation of supervisory and control systems.

The auditors must therefore assess in particular by using audit tests, whether the design and transposition of the supervisory and control systems (at least once every three years, except when the system changes) and the way they operate (each year) makes it possible to identify risks of errors likely to occur for each key audit objective (inherent risk) and determine whether control procedures are in place that make it possible to avoid or detect such errors and correct them without delay (control risk). The auditors must then carry out tests on the basis of representative samples so as to assess the legality and regularity of the transactions.

Given the practical constraints of on-the-spot audits, the tests of control and substantive tests can be carried out simultaneously on the basis of the same samples, each pursuing their respective objectives. On the other hand, all the supervisory and control systems affected by a given transaction must be audited. This methodology also guarantees that the audit results will be fairly representative.

In short, it is therefore a matter of analysing, at each level examined, how the Commission implements its responsibility as the guarantor of the sound implementation of the budget. The auditor must therefore answer the question of whether the Commission is really in control as regards the verification of the legality and regularity of the transactions financed by the Union budget.

### **Assessing materiality of weaknesses identified**

#### ***Framework proposed***

The FECED ("A Framework for Evaluating Control Exceptions and Deficiencies" outlines a suggested framework for the assessment of the materiality of exceptions and deficiencies identified on the basis of the evaluation of a company's internal control over financial reporting. In the following, these guidelines are adapted to the EU environment. It may be useful for assessing the materiality of weaknesses of supervisory and control systems. Furthermore, this instrument could be used to determine the quality of the supervisory and control systems when applying the proposed assurance model and when examining the validity of the annual activity reports and declarations of the Directors-General.

Because of the variety of control types, population characteristics and test exception implications, the expert group developing the FECED did not undertake to develop a purely quantitative model. Instead the framework considers quantitative and qualitative factors which are in line with the criteria proposed by the SoA project team:

- a) The quantitative considerations are essentially the same as in a financial audit and relate to whether errors that are not prevented or detected and corrected by supervisory and control systems, individually or collectively, have or could have a quantitatively significant or material effect on the areas of the financial perspective or the EU budget as a whole.
- b) The qualitative considerations apply to evaluating materiality with respect to the seriousness of the weaknesses of the supervisory and control systems as well as to additional factors that relate to the perceived needs of reasonable persons that are interested in these elements.

The assessment of the materiality of weaknesses of supervisory and control systems is an iterative process. Although the guidelines and the illustrative decision trees 7 and 8 depict the assessment process as a linear progression, it may be appropriate at any point in the process to return to and reconsider any previous step based on new information. In this context, the expert group underlined: "The framework represents a thought process that will require significant judgement. The objective of the

framework is to assist knowledgeable and experienced individuals in evaluating deficiencies in a consistent manner. The mere mechanical application of this framework will not, in and of itself, necessarily lead to an appropriate conclusion. Because of the need to apply judgement and to consider and weigh quantitative and qualitative factors, different individuals evaluating similar fact patterns may reach different conclusions."<sup>57</sup>

***Identification of a control deficiency/weakness of a supervisory and control system***

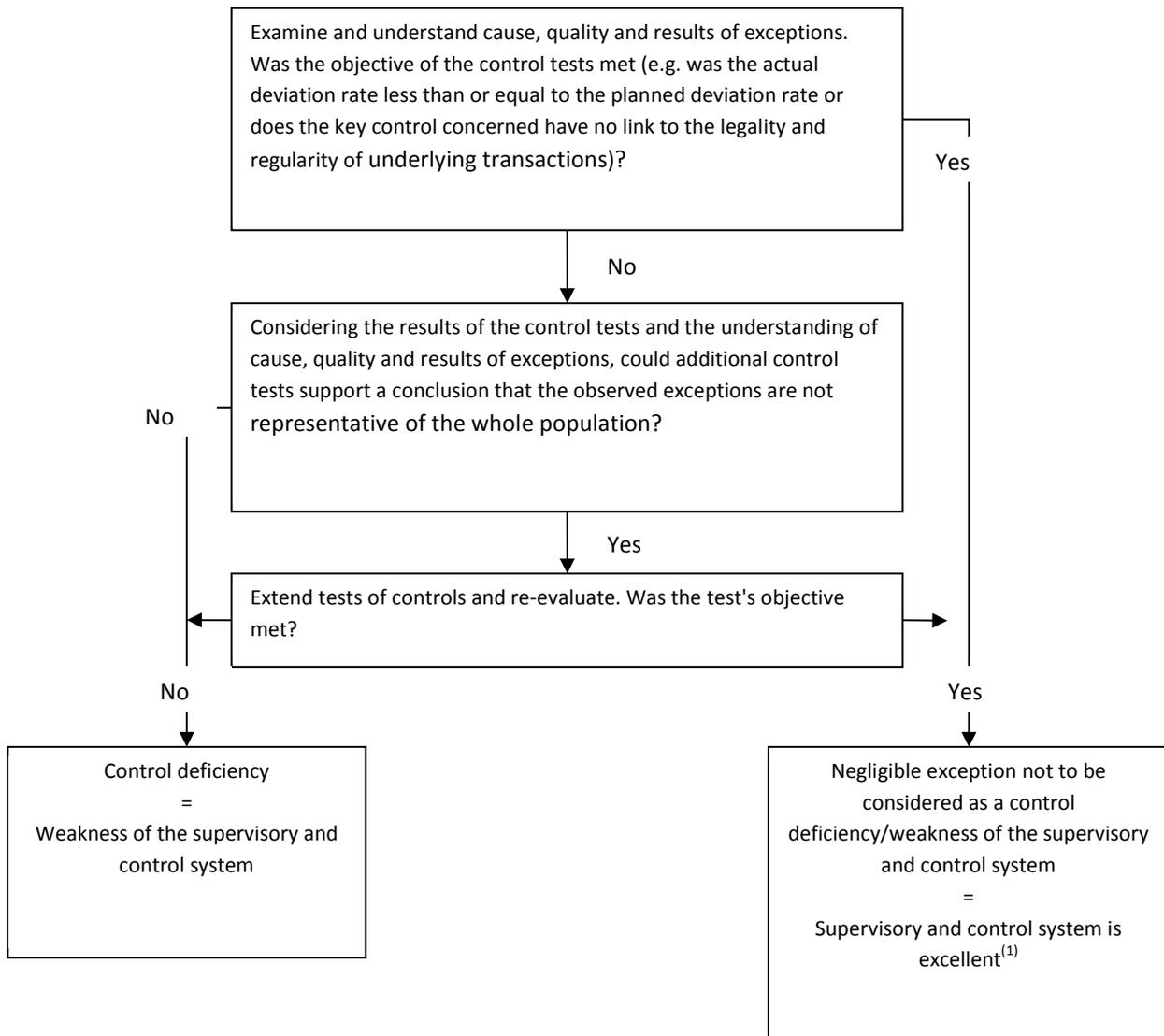
The testing of operating effectiveness will only be carried out if the overall conclusion of the design effectiveness of the supervisory and control system is not "poor". It generally relates to significant processes and major classes of transactions. The purpose of tests of controls is to achieve a sufficient assurance that controls are operating effectively. The magnitude of a systems weakness (i.e. insignificant deficiency, significant deficiency or material weakness corresponding respectively to excellent, good or poor supervisory and control systems) is evaluated based on known and/or potential illegal or irregular revenue or expenditure caused by the deficiency.

Decision tree 7 illustrates the process leading to the identification of a control deficiency/weakness of a supervisory and control system. The auditor should examine and understand cause, quality and results of exceptions. If the actual deviation rate was less than or equal to the planned deviation rate or if the malfunctioning does not concern a key control having a link to the legality and regularity of underlying transactions, the control deficiency is negligible and the supervisory and control system has to be considered "excellent".

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<sup>57</sup> FECED, page 1.

**Decision tree 7: Evaluating exceptions found in the operating effectiveness of supervisory and control systems**



<sup>(1)</sup> This preliminary result has to be corroborated with the result of substantive testing.

If the test objective is not met, consideration should be given to whether additional testing could support a conclusion that the deviation rate is not representative of the total population. If the observed exception and resulting non-negligible deviation rate are not believed to be representative of the population, the test may be extended and re-evaluated. In the other case, the exceptions are considered to be a control deficiency/weakness of the supervisory and control system and its magnitude is evaluated.

***Assessment of the magnitude of a control deficiency/weakness of a supervisory and control system***

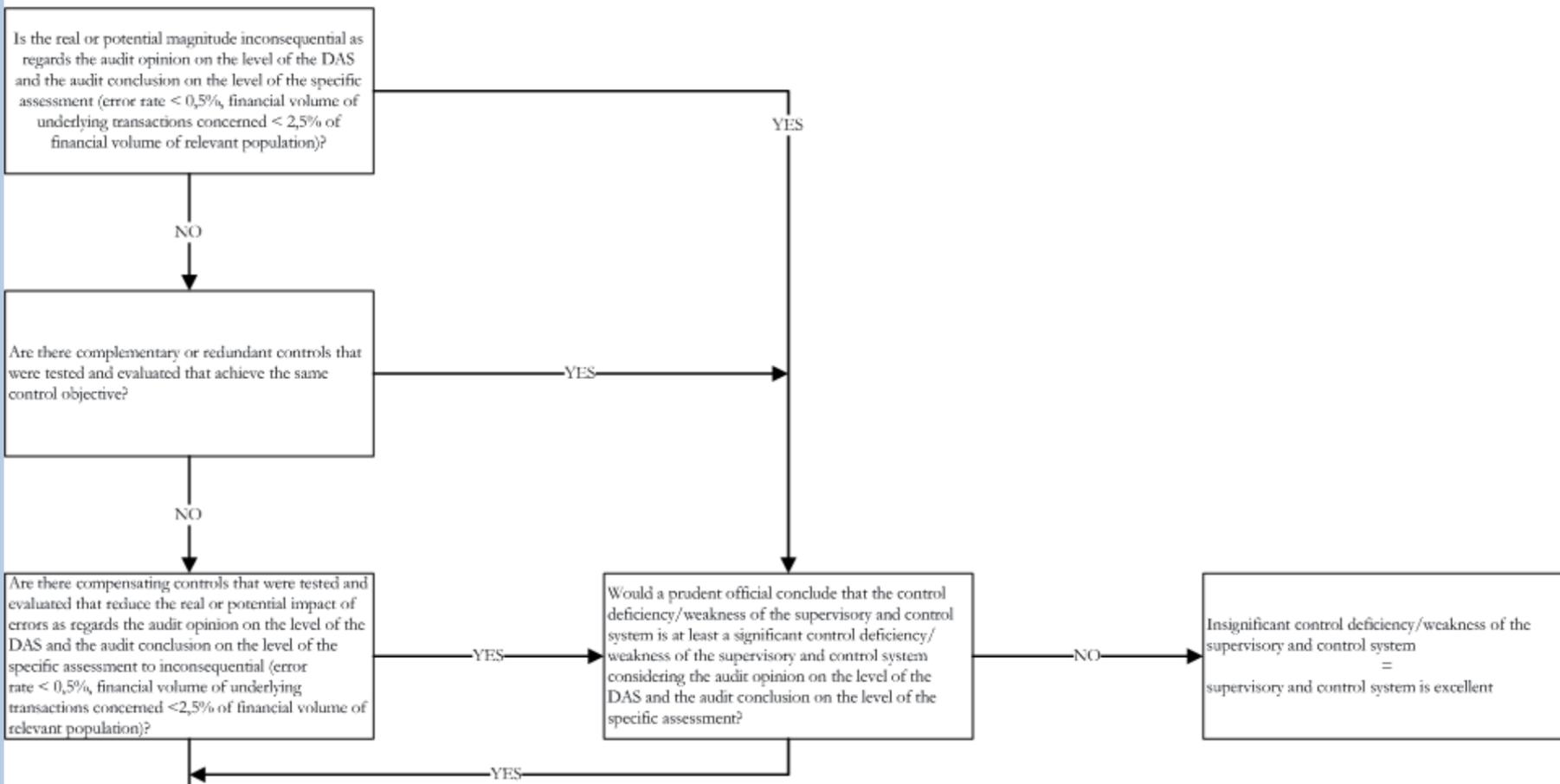
Decision tree 8 illustrates how the magnitude of a control deficiency/weakness of a supervisory and control system (inconsequential, more than inconsequential, being significant or material) should be assessed. The evaluation is based on the real or potential effect on both the audit opinion at the level of the SoA and the audit conclusion at the level of the specific assessments.

Decision tree 8 - Assessing the materiality of control deficiencies / weaknesses of supervisory and control systems

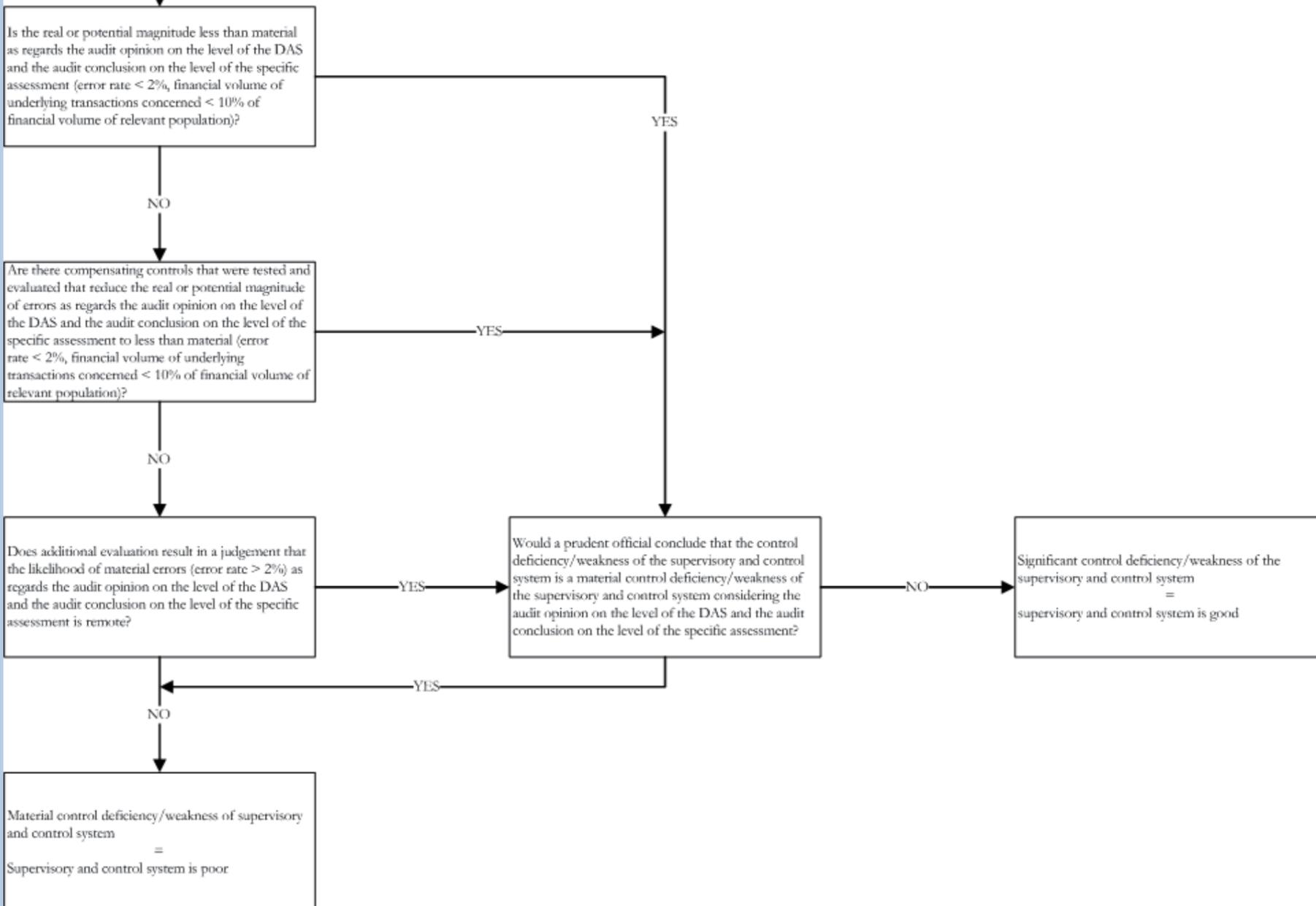
This decision tree may be used for analysing the impact of audit results derived from the following sources:

- Evaluation of design effectiveness of supervisory and control systems;
- Testing of operating effectiveness of supervisory and control systems (see decision tree 7);
- Substantive testing of underlying transactions;
- Analysis of the total financial volume of underlying transactions concerned by control deficiencies/weaknesses of supervisory and control systems

Step 1: Determine whether a significant control deficiency/weakness of a supervisory and control system exists



Step 2: Determine whether a material control deficiency/weakness of a supervisory and control system exists



If the real or potential magnitude of errors is inconsequential (that is to say, the error rate is < 0,5% or the total amount of transactions concerned is < 2,5% of the relevant budget), then the systems weakness concerned is classified as an insignificant control deficiency. In such cases the supervisory and control system is to be considered "excellent".

If there are controls that effectively mitigate a systems weakness, it is also classified as only an insignificant deficiency. Such controls include complementary or redundant controls that achieve the same control objective and compensating controls that operate at a level of precision that would result in the prevention or identification and correction of more than inconsequential errors.

An unmitigated systems weakness that results in a control objective not being met related to a significant real or potential financial volume of illegal or irregular operations (error rate > 0,5% or financial volume of underlying transactions concerned > 2,5% of the relevant budget) results in a more than remote likelihood of a more than inconsequential error and, therefore, is at least a significant deficiency.

Whether a material weakness exists has then to be determined in the following way: if the resulting real or potential error does not exceed the materiality threshold (error rate < 2% or financial volume of underlying transactions concerned < 10% of the relevant budget), the systems weakness is classified as only a significant control deficiency. The supervisory and control system is then deemed to be "good". Compensating controls that operate at a level of precision that would result in the prevention or identification and correction of material errors may justify that the control deficiency is not considered a material weakness.

In an additional evaluation it has to be evaluated whether the likelihood of material errors (error rate > 2%) is remote. This analysis includes but is not limited to the following elements:

- a) The seriousness of the control deficiency detected;
- b) The cause and frequency of known or detected exceptions in the operating effectiveness of controls;
- c) The interaction or relationship with other controls;
- d) The indication of increased risk evidenced by the results of substantive testing in the current SoA exercise;
- e) The indication of increased risk evidenced by a history of errors detected in previous substantive testing;
- f) The nature of the underlying transactions involved and their susceptibility to problems as regards legality and regularity;
- g) The complexity of the rules to determine eligibility.

Given the experience acquired since the first SoA, it is normally only in extremely rare circumstances that this additional evaluation could result in a judgement that the control deficiency is not material because the likelihood of a more than significant error rate is remote. Generally, the weakness will be considered material and the supervisory and control system classified as "poor".

When evaluating the magnitude of a control deficiency, the auditor should also determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs (e.g.

Directors-General when preparing their annual activity reports and declarations) that they have reasonable assurance that supervisory and control systems ensure legality and regularity of underlying transactions. If the auditor determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance, then the auditor should deem the weakness to be either a significant or a material control deficiency. Given the result of the subsequent analysis, the supervisory and control system then has to be considered "good" or "poor".

The auditor must further evaluate the control deficiency to determine whether individually, or in combination with other deficiencies, it is a material weakness. Aggregation of control activity deficiencies is necessary since the existence of multiple weaknesses of supervisory and control systems increases the likelihood of errors.

Table 7 gives an overview of the different categories as regards the quality of supervisory and control systems and indicates which of the different cases may be considered equivalent.

Table 7: Overall evaluation of supervisory and control systems

Overall assessment of design effectiveness		Global evaluation of operating effectiveness (after completion of control tests)		Evaluation of exceptions found in testing operating effectiveness	
Excellent	Supervisory and control systems are designed in such a way as to provide a high expectation that operational failures will be prevented or detected	Excellent	Supervisory and control systems are designed and operate in such a way as to provide a high expectation that operational failures will be prevented or detected	No control deficiency/weakness of supervisory and control system	Objective of control tests was met (i.e. actual deviation rate was less than or equal to the planned deviation rate)
				Insignificant control deficiency/weakness of supervisory and control system	Real or potential magnitude of control deficiency/weakness of supervisory and control system is inconsequential or complementary/redundant controls achieve the same control objective or compensating controls reduce real or potential magnitude of errors to inconsequential
		Good	Supervisory and control systems, the design of which is excellent, operate in such a way as to provide a reasonable expectation that operational failures will be prevented or detected	Significant control deficiency/weakness of supervisory and control system	Real or potential magnitude of control deficiency/weakness of supervisory and control system is more than inconsequential but less than material or compensating controls reduce real or potential magnitude of errors to more than inconsequential but less than material or likelihood of material errors is remote or prudent official concludes that control deficiency/weakness of supervisory and control system is significant but not material
Good	Supervisory and control systems are designed in such a way as to provide a reasonable expectation that operational failures will be prevented or detected	Poor	Control risk is too high for the auditor to rely on the supervisory and control system	Material control deficiency/weakness of supervisory and control system	Real or potential magnitude of control deficiency/weakness of supervisory and control system is material and compensating controls do not reduce real or potential magnitude of errors to less than material and likelihood of material errors is not remote or prudent official concludes that control deficiency/weakness of supervisory and control system is material
		Good	Supervisory and control systems, the design of which is good, operate in such a way as to provide a reasonable expectation that operational failures will be prevented or detected	Significant control deficiency/weakness of supervisory and control system	Real or potential magnitude of control deficiency/weakness of supervisory and control system is more than inconsequential but less than material or compensating controls reduce real or potential magnitude of errors to more than inconsequential but less than material or likelihood of material errors is remote or prudent official concludes that control deficiency/weakness of supervisory and control system is significant but not material
Poor	The design of the supervisory and control systems is inadequate	Poor	Control risk is too high for the auditor to rely on the supervisory and control system	Material control deficiency/weakness of supervisory and control system	Real or potential magnitude of control deficiency/weakness of supervisory and control system is material and compensating controls do not reduce real or potential magnitude of errors to less than material and likelihood of material errors is not remote or prudent official concludes that control deficiency/weakness of supervisory and control system is material
		-	-	-	-
				Source: FECED	

## GLOSSARY OF TERMS AND ACRONYMS

### GLOSSARY OF TERMS

**ACCOUNTABILITY** The obligations of persons or entities, including public enterprises and corporations, entrusted with public resources to be answerable for the fiscal, managerial and programme responsibilities that have been conferred on them and to report to those that have conferred these responsibilities on them.

**ACCOUNTING ESTIMATE** An approximation of the amount of an item in the absence of precise means of measurement.

**ACCOUNTING RECORDS** Generally include the records of initial entries and supporting records, e.g. invoices, contracts, ledgers, journal entries, reconciliations, etc.

**ACCOUNTING SYSTEM** The series of tasks and records of an entity by which transactions and events are processed as means of maintaining financial records. Such systems identify, assemble, analyse, calculate, classify, record, summarise and report transactions and other events.

**ACCOUNTS** Encompasses several different meanings. Firstly, it is used to refer to the individual records in which the organisation registers a type of transaction and/or event that pertain to it. Secondly, it is used to refer to the accounting records as a whole. And lastly, it is often used as a synonym for “financial statements”, especially in the EU context.

**ACCRUALS-BASED ACCOUNTING** A basis of accounting under which transactions and other events are recognised when they occur (and not only when cash or its equivalent is received or paid). Therefore, the transactions and events are recorded in the accounting records and recognised in the financial statements of the periods to which they relate. The elements recognised under accrual accounting are assets, liabilities, net assets/equity, revenue and expenses.

**ANOMALY** A misstatement or non-compliance which is demonstrably not representative of misstatements or non-compliance in the population.

**ANALYTICAL PROCEDURES** The analysis of significant relationships, trends and ratios, which are mainly used during the audit planning stage of an audit and as part of an overall review at the end of the audit. Additionally, a further form of analytical procedure, called predictive testing, may be used in certain limited circumstances to provide substantive evidence concerning the reliability of financial statements. (see [audit procedure](#))

**APPLICABLE FINANCIAL REPORTING FRAMEWORK** The accounting rules adopted by EU entities, which are derived from International Public Sector Accounting Standards (IPSASs) issued by IFAC or, in their absence, the International Accounting Standards

(IASs)/International Financial Reporting Standards (IFRSs) of the International Accounting Standards Board.

**APPLICATION CONTROLS IN INFORMATION TECHNOLOGY**

Manual or automated procedures, whether preventive or detection-oriented, that are designed to ensure the integrity of the accounting records. They relate to procedures used to initiate, record, process and report transactions or other financial data.

**APPROPRIATE(AUDIT EVIDENCE)**

Encompasses the qualities of both the relevance and reliability of audit evidence. (see [audit evidence](#); relevant [audit evidence](#); reliable [audit evidence](#))

**ASSERTIONS**

Representations by management, explicit or otherwise, that are embodied in financial statements and transactions. These assertions are the specific audit objectives about which the auditor wishes to reach a conclusion. Assertions include:

Reliability assertions about:

classes of transactions and events for the period under audit: occurrence; completeness; accuracy; cut-off; classification; and legality and regularity (budgetary allocations are available);

account balances at period-end: existence; rights and obligations; completeness; valuation and allocation;

presentation and disclosure: occurrence and rights and obligations; completeness; classification and understandability; accuracy and valuation.

Legality and regularity assertions about:

compliance and eligibility.

**ASSURANCE ENGAGEMENT**

An engagement in which the ECA expresses a conclusion designed to enhance the degree of confidence of intended users other than the responsible party about the outcome of the measurement of subject matter against criteria.

A reasonable assurance engagement reduces assurance engagement risk to an acceptably low level (i.e. a high but not absolute level of assurance) as the basis for a positive form of expression of the ECA's conclusion.

A limited assurance engagement reduces assurance engagement risk to an acceptable level as the basis for a negative form of expression of the ECA's conclusion.

**AUDIT**

The objective of an **audit** of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an identified reporting framework.

The objective of an **audit** of compliance is to enable the auditor to

conclude as to whether the activities, financial transactions, and information comply, in all material respects, with the applicable legal and regulatory framework.

**AUDIT EVIDENCE**

All of the information used by the auditor in arriving at the conclusions or opinion. Audit evidence must be *sufficient* to support the conclusions or opinion. In addition, it must be *appropriate* i.e. *relevant* to the audit objectives and *reliable*. Typically, audit evidence is persuasive rather than conclusive.

**AUDIT FIELD**

Describes the subject (entity or activity) to be audited.

**AUDIT OBJECTIVE**

Financial audits of reliability and compliance audits of legality and regularity have audit objectives which mirror the assertions defined above (see "[assertions](#)"). Selected compliance audits have audit objectives which depend on the particular task. For example, for *systems audits*, the objective may be to assess whether the system prevents, or detects and corrects, errors.

Within each audit task, it is necessary to define, as part of the planning process, the specific audit objectives of the task.

**AUDIT OPINION**

A clear written expression of opinion on the subject matter, whether reliability or legality and regularity. There are five types of opinion: unqualified (or "clean") opinion, unqualified opinion with an emphasis of matter, qualified opinion (whether due to limitation of scope or disagreement which is material but not pervasive), disclaimer of opinion (limitation of scope that is material and pervasive) and adverse opinion (disagreement that is material and pervasive).

**AUDIT PROCEDURE**

The method used to obtain and analyse the necessary audit evidence. For tests of control and tests of details, there are five types of procedures that the auditor can use. These are analytical procedures, inspection, observation, enquiry/confirmation and computation.

**AUDIT PROGRAMME**

Sets out in detail the nature, timing and extent of the planned audit testing required to implement the audit planning memorandum. It serves as a set of instructions to staff directly involved in executing the audit and as a means to control and record the proper execution of the work.

**AUDIT RISK**

The risk that the auditor may express an opinion that the accounts are reliable when in fact they are not, or that the underlying transactions are legal and regular when this is not the case. Audit risk can be broken down into three components: inherent risk, control risk and detection risk.

**AUDIT SCOPE**

The audit procedures that, in the auditor's judgment and based on the ISSAIs, are deemed appropriate in the circumstances (type of report envisaged, specific objectives and constraints, etc.) to achieve the

objective(s) of the audit.

<b>AUDIT STRATEGY</b>	The audit approach and audit procedures selected to meet the objectives defined for a specific audit task, and set out in the APM.
<b>AUDIT TASK</b>	A discrete and identifiable piece of audit work which is intended to result in the ECA issuing an opinion, report or contribution to a report.
<b>CASH-BASED ACCOUNTING</b>	An accounting method of recording transactions by which revenues are recorded only when cash is received and expenditures are recorded only when cash is disbursed.
<b>COMPARATIVE FINANCIAL INFORMATION</b>	Corresponding amounts and other disclosures of the preceding financial period(s), presented for comparative purposes.
<b>COMPENSATING CONTROL</b>	A control procedure, not initially identified as a key control that achieves the same objective as the key control being evaluated or tested. The auditor may seek to identify, evaluate and test a compensating control as a substitute for a key control that is found not to be operating effectively, consistently and continuously. (see <a href="#">control activities</a> )
<b>COMPLETENESS</b>	The financial audit objective of completeness seeks to ensure that all transactions and, for the balance sheet, all assets and liabilities (including off-balance sheet items) proper to the period are entered into the accounting records. (see <a href="#">audit objective</a> and <a href="#">assertions</a> )
<b>COMPLIANCE</b>	Activities, financial transactions and information are in accordance with the applicable laws and regulations.
<b>COMPUTATION</b>	An audit procedure that consists of checking the arithmetical accuracy of source documents and accounting records by re-performing the calculations or by verifying their accuracy by performing different calculations. (see <a href="#">audit procedure</a> )
<b>COMPUTER-ASSISTED AUDIT TECHNIQUES (CAATs)</b>	The application of audit procedures using the computer as an audit tool, e.g. computer programs carrying out audit tests, retrieving, sorting or selecting data, or obtaining evidence on the correctness of processing.
<b>COMPUTERISED INFORMATION SYSTEM (CIS)</b>	A system in which a computer of any type or size is involved in the processing by the entity of information of significance to the audit, whether that computer is operated by the entity or by a third party.
<b>CONFIDENCE LEVEL</b>	Also known as the assurance level, it is the converse of audit risk. The higher the degree of confidence desired the more audit testing that must be done. The ECA's policy is that the confidence level for financial and compliance audits be set at 95% and thus an audit risk of 5% is accepted.
<b>CONFIRMATION</b>	A specific type of enquiry that is the process of obtaining a representation of information or of an existing condition directly from a third party. (see <a href="#">audit procedure</a> )

<b>CONTROL ACTIVITIES</b>	The policies and procedures that help ensure that management directives are carried out, and are a component of internal control. Specific control activities include: <ul style="list-style-type: none"> <li>- authorisation;</li> <li>- performance reviews;</li> <li>- information processing;</li> <li>- physical controls;</li> <li>- segregation of duties. (see <a href="#">internal control</a>)</li> </ul>
<b>CONTROL ENVIRONMENT</b>	Includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management regarding the entity's internal control and its importance within the entity. The control environment is a component of internal control. (see <a href="#">internal control</a> )
<b>CONTROL RISK</b>	The risk that internal control procedures will fail to prevent or detect and correct on a timely basis material errors or material failures in financial management. Such a failure may arise either because of the absence of appropriate control procedures or because existing internal control procedures do not operate effectively, continuously and consistently. (see <a href="#">audit risk</a> )
<b>CORROBORATIVE EVIDENCE</b>	Evidence from a second source, which supports other evidence obtained.
<b>CRITERIA</b>	Benchmarks used to evaluate or measure subject matter. Suitable criteria are required for reasonably consistent evaluation or measurement of subject matter within the context of professional judgment.
<b>DETECTION RISK</b>	The risk that the auditor's substantive procedures will fail to detect an error or failure in financial management which, individually or when aggregated with other errors/failures, could be material. (see <a href="#">audit risk</a> )
<b>DISCLOSURE</b>	The presentation of certain information (usually in the financial statements and related notes). Disclosure requirements for the various EU bodies differ. In general, these requirements are set out in the bodies' Financial Regulations and Implementing Rules (or equivalent). Disclosure requirements are also determined by the Directive 2013/34/EU of 26 June 2013, as well as by the needs of the users of financial statements.
<b>ELIGIBILITY</b>	Declared costs are eligible in that all required conditions are fulfilled, time limits are respected, authorisations are properly given and procedures are correctly applied.
<b>ENQUIRY</b>	Seeking information of knowledgeable persons, both financial and non-financial, inside or outside the audited entity. (see <a href="#">audit procedure</a> )
<b>ENTITY'S RISK ASSESSMENT PROCESS</b>	A component of internal control, it is the entity's process for identifying business risks relevant to financial reporting or compliance objectives, and deciding about actions to address those risks and the results thereof. (see

[\*internal control\*](#))

**ERROR**

**regarding reliability of the accounts** is an unintentional misstatement in the financial statements or report on budget implementation, including the omission of an amount or disclosure.

**regarding compliance** is when a transaction, or parts thereof, and/or actions linked to it have not been carried out in accordance with the applicable legal and regulatory provisions.

**ERROR - ISOLATED OR NON-SYSTEMATIC**

An error that arises from an isolated event that has not recurred other than on specifically identifiable occasions. It is thus not representative of errors in the population and in the context of a sample should not be projected to the population.

**ERROR - KNOWN**

Those errors which have not been identified on the basis of audits directly linked to a representative sample, but rather during supplementary work carried out (e.g. as part of Special Reports, etc). They are not projected to the entire population, but are taken into consideration on the basis of the absolute amounts or number of errors involved.

**EXISTENCE AND OWNERSHIP**

The financial audit objective of existence and ownership for balance sheets seeks to ensure that the asset or liability exists on the balance sheet date and is proper to the reporting entity. (see [\*audit objective\*](#))

**EXPECTED ERROR**

The error the auditor expects to be present in the population.

**EXTRAPOLATE**

to project, extend, or expand the results from a sample onto the whole population, so as to be able to draw conclusions about that population. (see [\*project\*](#))

**GOVERNANCE**

Describes the role of persons entrusted with the supervision, control and direction of an entity. They are ordinarily accountable for ensuring that the entity achieves its objectives.

**INFORMATION SYSTEM AND COMMUNICATION**

A component of internal control, it comprises:

- the **information system**: the procedures and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity;
- **communication**: providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting and compliance and may take such form as policy manuals and financial reporting and compliance manuals. (see [\*internal control\*](#))

**INHERENT RISK**

The risk related to the nature of the activities, operations and management structures that errors or failures in financial management will occur which,

assuming that there were no related internal controls, would cause the accounts to be unreliable or the underlying transactions to be materially illegal or irregular. (see [audit risk](#))

**INSPECTION**

Examining records or documents, whether internal or external, or tangible assets. (see [audit procedure](#))

**INTERNAL AUDIT**

An appraisal activity established within an entity as a service to the entity. In contrast to internal control, internal audit is independent of the audited procedures/activities. Its functions include examining, evaluating and monitoring the adequacy and effectiveness of accounting and internal control systems.

**INTERNAL CONTROL**

An integral process (i.e. a series of actions that permeate an entity's activities) that is effected by an entity's management and personnel and is designed to address risks and to provide reasonable assurance that, in pursuit of the entity's mission, the following general objectives are being achieved:

- executing orderly, ethical, economical, efficient and effective operations;
- fulfilling accountability obligations;
- complying with applicable laws and regulations; and
- safeguarding resources against loss, misuse and damage.

It comprises the following components:

- the control environment;
- the entity's risk-assessment process;
- the information system, including the related business processes, relevant to financial reporting, and communication;
- control activities;
- monitoring of controls.

**IRREGULARITY**

In the EU context: "any infringement of a provision of Community law resulting from an act or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly on behalf of the Communities, or by an unjustified item of expenditure".

(Council Regulation (EC, Euratom) No 2988/95 of 18 December 1995 (OJ L312, 23.12.1995))

**LEGALITY AND REGULARITY**

Seeks to ensure that a transaction conforms to the applicable laws and regulations and is covered by sufficient budgetary appropriations. (see [audit objective](#))

**LIMITATION ON SCOPE**

When the auditor cannot obtain sufficient appropriate evidence to form an opinion, whether due to constraints imposed by the auditee or by circumstances, or due to poor records being maintained.

**MATERIALITY**

An expression of the relative significance or importance of an item or group of related items. An item or group of items is material if a deviation therein

would be likely to cause *users* of the information to take different decisions. An item or group of items may be material because of its *value*, *nature* or the *context* in which it occurs.

**MEASUREMENT**

The financial audit objective of measurement for revenue and expenditure seeks to ensure that the amount at which the transaction is recorded is correctly established and entered into the accounting records. (see [audit objective](#))

**MISSTATEMENT**

A misstatement of the accounts that can arise from fraud or error.

**MONETARY UNIT SAMPLING (MUS)**

A statistical sampling technique designed in such a way that the probability of selection is proportional to the size of the transaction. Thus, the larger the value of the transaction, the more likely it is to be selected.

**MONITORING OF CONTROLS**

A process to assess the effectiveness of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions. Monitoring of controls is a component of internal control. (see [internal control](#))

**NON-SAMPLING RISK**

Risk arising from factors, not related to the sample size, that cause the auditor to reach a wrong conclusion.

**OBSERVATION**

Looking at a process or procedure being performed by others. (see [audit procedure](#))

**OPINION**

A clear written expression of opinion, whether on the reliability of the accounts or the legality and regularity of the underlying transactions. An opinion may be unqualified or modified (qualified or adverse, or the auditor may disclaim an opinion).

**OPINION - UNQUALIFIED**

The accounts are presented fairly, in all material respects, in accordance with the applicable financial reporting framework (reliability) or the underlying transactions comply, in all material respects, with the applicable legal and regulatory framework.

**OPINION - QUALIFIED**

The auditor issues a qualified opinion after having obtained sufficient appropriate audit evidence and concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or where the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive

**OPINION – DISCLAIMER**

When the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any,

could be both material and pervasive.

**POPULATION**

The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. A population may be stratified, with each stratum (or sub-population) being examined separately. (see [stratification](#))

**PREDICTIVE TESTING**

An analytical procedure used to obtain substantive audit evidence. The auditor makes predictions about the outturn of certain elements of revenue, expenditure or the balance sheet, and compares these to the figures expressed in the audited entity's financial data. Predictive testing of this sort can only be undertaken on revenue or expenditure streams or account balances that are themselves highly predictable and where reliable data are readily available from an independent source. (see [analytical procedure](#)).

**PRESENTATION OF INFORMATION**

The financial audit objective of presentation of information seeks to ensure that the transaction, asset or liability is disclosed, classified and described in accordance with the applicable financial reporting framework.

**PROFESSIONAL SCEPTICISM**

An attitude that includes a questioning mind and a critical assessment of evidence.

**PROJECT**

To extend, expand or extrapolate the results from a sample onto the whole population, so as to be able to draw conclusions about the population. (see [extrapolate](#))

**REALITY**

The financial audit objective of reality for revenue and expenditure seeks to ensure that the transaction is justified by an event which pertains to the entity and is proper to the period. (see [audit objective](#))

**RELEVANT (AUDIT EVIDENCE)**

That which allows the objectives of the audit to be achieved whilst taking into account any specific inherent and/or control risks. (see [audit evidence](#))

**RELIABILITY OF THE ACCOUNTS**

In the context of a financial audit, the audit objectives relevant to the reliability of the accounts are:

- for revenue and expenditure accounts (commitment and payment appropriations): completeness, reality of operations, measurement, presentation and publication;
- for the balance sheet: completeness, existence and ownership, valuation and presentation and publication. (see [audit objective](#))

**RELIABLE (AUDIT EVIDENCE)**

Audit evidence must be impartial. This impartiality depends upon the sources from which the evidence is obtained and the nature of that evidence. (see [audit evidence](#))

**SAMPLING**

The application of audit procedures to less than 100% of a population, such that all sampling units have a chance of selection, in order to help form a conclusion concerning the population. Sampling may use a statistical or non-statistical approach.

<b>REPERFORMANCE</b>	The auditor's independent execution of procedures or controls originally performed as part of the entity's internal controls.
<b>SAMPLING RISK</b>	Arises from the possibility that the auditor's conclusion, based on a sample selected using a statistical or non-statistical approach, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.
<b>SAMPLING UNIT</b>	The individual items constituting the population, e.g. invoices, debtors' balances, or monetary units.
<b>SEGMENT INFORMATION</b>	Information in the accounts regarding distinguishable components of an entity.
<b>SELECTED AUDIT</b>	An audit task which is selected, as part of the annual work programme process, on the basis of its priority from a list of potential audit tasks drawn up by the Audit Chamber.
<b>SIGNIFICANT RISK</b>	A risk that requires special audit consideration.
<b>STATISTICAL SAMPLING</b>	Any approach to sampling that is based on random selection and the use of probability theory to evaluate results.
<b>STRATIFICATION (OF THE POPULATION)</b>	The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics, such as similar monetary values, exposure to similar risks, etc. (see <a href="#">population</a> )
<b>SUBSEQUENT EVENTS</b>	Events, both favourable and unfavourable, that occur in the period between completion of audit testing procedures and publication of the auditor's report. Subsequent events are significant if, had they been known at the time of preparing the report, they would have merited adjustment or mention in the report.
<b>SUBSTANCE OVER FORM</b>	Transactions and other events in the life of an organisation should be accounted for and presented in accordance with their substance and with financial reality and not merely with their legal form.
<b>SUBSTANTIVE PROCEDURES</b>	Audit procedures used to obtain substantive audit evidence that is sufficient, relevant, and reliable. They include tests of details and substantive analytical procedures.
<b>SUFFICIENT (AUDIT EVIDENCE)</b>	Audit evidence is sufficient if, in terms of quantity, enough audit evidence has been collected to support the conclusions being drawn and thus the (audit) opinion being expressed (see <a href="#">audit evidence</a> ). The quantity needed is affected by its quality.
<b>TESTS OF CONTROLS</b>	Performed to obtain audit evidence as to whether key controls have actually operated as planned - that is to say, continuously, consistently and effectively throughout the period being audited - in preventing, or detecting and correcting, material misstatements (reliability audits) or instances of

<b>TOLERABLE ERROR OR DEVIATION</b>	non-compliance (compliance audits). The maximum error in a population that the auditor is willing to accept, and still conclude that the result from the sample has achieved the audit objective.
<b>TOTAL ERROR</b>	Either the rate of deviation, or total misstatement or non-compliance.
<b>UNCERTAINTY</b>	A matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the accounts.
<b>VALUATION</b>	The financial audit objective of valuation seeks to ensure that the asset or liability is entered into the accounting records at an appropriate value. (see <a href="#">audit objective</a> )

## ACRONYMS

<b>AAR</b>	Annual Activity Report
<b>ABB</b>	Activity Based Budgeting
<b>ABM</b>	Activity Based Management
<b>AMPR</b>	Annual Management and Performance Report
<b>AP</b>	Audit Programme
<b>APM</b>	Audit Planning Memorandum
<b>AR</b>	Audit Risk
<b>ASI</b>	Average Sampling Interval
<b>ASSYST</b>	Audit Support System (the ECA's electronic tool)
<b>AWP</b>	Annual Work Programme
<b>CAATs</b>	Computer-Assisted Audit Techniques
<b>CR</b>	Control Risk
<b>DG</b>	Directorate-General
<b>DR</b>	Detection Risk
<b>DQC</b>	Directorate for Audit Quality Control
<b>EAGF</b>	European Agricultural Guarantee Fund
<b>EAGGF</b>	European Agricultural Guidance and Guarantee Fund
<b>EDFs</b>	European Development Funds
<b>EU</b>	European Union
<b>FCAM</b>	Financial and Compliance Audit Manual

<b>FR</b>	Financial Regulation
<b>IACs</b>	Internal Audit Capabilities
<b>IAS</b>	Internal Audit Service
<b>ICS</b>	Internal Control System
<b>IFAC</b>	International Federation of Accountants
<b>INTOSAI</b>	International Organisation of Supreme Audit Institutions
<b>IPSASs</b>	International Public Sector Accounting Standards
<b>IR</b>	Inherent Risk
<b>ISAs</b>	International Standards on Auditing
<b>ISSAIs</b>	International Standards of Supreme Audit Institutions
<b>IT</b>	Information Technology
<b>KE</b>	Known Error
<b>LEL</b>	Lower Error Limit
<b>MLE</b>	Most Likely Error
<b>MP</b>	Management Plan
<b>MRL</b>	Management Representation Letter
<b>MUS</b>	Monetary Unit Sampling
<b>OLAF</b>	The Commission's Anti-Fraud Office ( <i>Office européen de lutte anti-fraude</i> )
<b>PPS</b>	Probability proportional to size
<b>RAL</b>	an abbreviation of the French terminology “reste à liquider”
<b>SAI</b>	Supreme Audit Institution
<b>SoA</b>	Statement of Assurance
<b>SPF</b>	Statement of Preliminary Findings
<b>TFEU</b>	Treaty on the Functioning of the European Union
<b>UEL</b>	Upper Error Limit