OVERVIEW

PARTS OF THE FINANCIAL AND COMPLIANCE AUDIT MANUAL

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Structure of the Financial and Compliance Audit Manual
PURPOSE AND FOCUS OF THE MANUAL

The manual has been written to help the Court's auditors produce high-quality financial and compliance audits. It sets out the principles underlying the Court'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 COURT’S AUDIT METHODOLOGY

The financial and compliance audit manual (FCAM) sets out principles contained in the International Standards on Auditing (ISAs) 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) which are relevant to the Court’s audit, together with guidance on how they are to be applied in the Court’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, and by the Court's electronic audit support system.

The FCAM does not provide 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. Similarly, the Court’s Audit Policies and Standards (CAPS) set out a number of important principles of application for all the Court’s audits. Accordingly, the FCAM should be read together with the text of the CAPS.

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1 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.

2 ISSAIs: International Standards of Supreme Audit Institutions.

3 Decision No 26-2010 laying down the rules for implementing the rules for procedures of the Court of Auditors states in Article 76 that “The Court shall adopt its audit policies and standards and the detailed rules which result therefrom for the planning, implementation and publication of its work.” Article 40(2)b) also states that “… the Directors and Heads of Unit shall be responsible for ensuring that audit tasks are carried out in accordance with the Court’s audit policies and standards.”
The Court's Audit Policies and Standards state: “In carrying out its duties and responsibilities within its mandate as laid down in the Treaty and the Financial Regulation, the European Court of Auditors (ECA) conducts its audits in accordance with the IFAC and INTOSAI International Auditing Standards and Codes of Ethics, in so far as these are applicable in the European Union context.

Auditors are required to respect the ECA Audit Manuals 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 Court's financial and compliance audits;
- principles and procedures for audits of the reliability of the accounts;
- principles and procedures for audits of compliance with applicable laws and regulations.

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 Court'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.
PART 1. GENERAL

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1.1 DEFINITION OF AN ASSURANCE ENGAGEMENT

The Court 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 accounts or compliance with applicable laws and regulations. The Court’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:

- 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...");

- 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 Court’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

The text of the manual mostly refers to the general budget of the European Union and to the Commission, as these constitute the Court’s main audit area. However, this framework applies to all annual financial and compliance audits carried out by the Court, 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 COURT REQUIRED TO AUDIT?

The Treaty on the Functioning of the European Union (TFEU), Article 287, as well as the Regulations for the EDF and agencies, set out the Court's legal obligations for financial and compliance audits, and define the terms of the
Court's engagements in this regard. For example, the TFEU specifies that the Court of Auditors:

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

"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)

"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

"may also, at any time, submit observations, particularly in the form of special reports, on specific questions..." The latter statement allows the Court 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”.

  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 is included in the European Court of Auditors’ Annual Report on the implementation of the general budget, which also contains specific assessments for each major policy group.

- **Annual report**
  
  As required by the applicable Regulations, a similar DAS-type opinion and Annual Report is produced for the EDFs. Audit reports are also produced for

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4 Commonly referred to as the DAS (an abbreviation of the French term “déclaration d'assurance”).
the Court's audits of the accounts of agencies, offices and similar 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 THE COURT’S LEGAL RIGHT OF ACCESS

The TFEU (Article 287) gives the Court 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 the Court to audit down to final beneficiary level.

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. The extensive rights of access to information that are accorded to the Court mean that this duty of discretion is particularly important, especially as the information handled by staff is frequently of a sensitive nature.

1.6 COURT’S PROFESSIONAL OBLIGATIONS REGARDING FINANCIAL AND COMPLIANCE AUDITS

The Court’s Audit Policy is to conduct its audits in accordance with the IFAC and INTOSAI International Auditing Standards and Codes of Ethics, insofar as they are applicable in the EU context. The ISAs and INTOSAI standards 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 THE COURT

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

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5 Staff Regulations of Officials of the EC, Articles 17-19; Conditions of Employment of Other Servants of the EC, Article 11.
(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 for reliability is to establish whether the 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).

- 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 accounts or (ii) preventing or detecting and correcting illegal and irregular revenue and expenditure.

1.8 AUDIT 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**

(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.

(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.

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.

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.

Table 1: Types and objectives of financial and compliance audits

<table>
<thead>
<tr>
<th>Subject</th>
<th>Financial Audits</th>
<th>Compliance Audits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reliability of annual accounts</td>
<td>Legality and regularity of underlying transactions</td>
</tr>
<tr>
<td></td>
<td>Effectiveness of internal control systems</td>
<td></td>
</tr>
<tr>
<td>Task type</td>
<td>Recurrent tasks: audit programme for these audits remains generally unchanged from year to year</td>
<td>Selected task: audit programme depends on the specific objective of the audit</td>
</tr>
<tr>
<td>Task substance</td>
<td>Examine accounts, determine if they give a true and fair view</td>
<td>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.</td>
</tr>
<tr>
<td>DAS work comprises majority of financial and compliance audits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assertions</td>
<td>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</td>
<td>Occurrence; completeness; accuracy; cut-off; existence; rights and obligations; valuation; and eligibility.</td>
</tr>
<tr>
<td>Proper design, maintenance and continuous effective operation of systems</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

A substantial proportion of the Court's financial and compliance audit resources is devoted to reliability and legality/regularity audits of the general EU budget (known as the DAS, as stated by the TFEU). The remainder is devoted to reliability and legality/regularity audits of the EDFs, agencies, offices and similar bodies, as well as selected audits.

7 Effectiveness of internal control systems - the system has been properly designed and maintained, and was in continuous effective operation throughout the period.
1.9 OVERVIEW OF THE FINANCIAL AND COMPLIANCE AUDIT PROCESS

The Court'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.

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

**PLANNING**
- Assess material risks through understanding the audit environment
  - collect and analyse information
- Design audit procedures

**EXAMINATION**
- Perform audit procedures
  - tests of control, analytical and other substantive procedures
- Evaluate results in light of expectations
  - revise approach if necessary

**REPORTING**
- Form audit conclusion and/or opinion
- Draft report
1.10 DOCUMENTATION OF AUDIT WORK

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 ISAs and applicable legal and regulatory requirements.

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 the Court's electronic audit support system, which contains standard audit programmes, workpapers and, where appropriate, in hard 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.

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, where applicable, reviewed.

1.11 QUALITY CONTROL

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

(a) The Court and its personnel comply with professional standards and applicable legal and regulatory requirements; and

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

1.11.1 Definition of quality control

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 Court 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 the Court.
(b) Relevant ethical requirements.
(c) Acceptance and continuance.
(d) Human resources.
(e) Engagement performance (quality control).
(f) Monitoring (quality assurance).

The Court 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.
PART 1. GENERAL

SECTION 2 - PLANNING

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2.1 Planning overview

2.2 Determining materiality

2.3 Identifying and assessing risks through understanding the entity and its environment, including the Court's Assurance Model

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

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

The Court'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

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Annual Work Programme

The discharge authority or supervisory body

Programming
Decide on audit tasks, allocate resources to audits

Planning
Decide why, what, where, how, when, who, design audit procedures

Examination
Prepare, communicate and analyse information, collect and evaluate evidence

Reporting
Summarise and confirm results, form opinion, write report

Auditee

Court's Strategy
Annual Work Programme of the Court
Annual Work Programmes of the Audit Chambers
Preliminary Study
Audit Steps
Working Papers
Follow-up Letter
Observations
Statement of Preliminary Findings
Auditee

Preliminary Observations
Contradictory procedure with auditee
Statement of Assurance
Audit Report

Working Papers
Observations
Statement of Preliminary Findings

Contradictory procedure with auditee
Statement of Assurance
Audit Report
2.1.2 What is meant by planning an audit

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).

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 should not be started until the APM has been adopted by the CEAD Chamber.

2.1.3 Importance and nature of planning

Basis for quality audit

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.

Iterative process

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.

requiring judgment and scepticism

It must be recognised that a financial or compliance audit is not a series of mechanical steps to be completed. Most importantly, professional judgment and scepticism should be exercised when planning, as well as performing and reporting on audits. Auditors should also take account of knowledge obtained from relevant performance audits in the area.

2.1.4 Steps in the planning phase

The auditor needs to plan how (s)he will:

Determine materiality

(a) determine materiality, both from a quantitative and qualitative perspective;
Identify and assess material risks

Design audit procedures

Draw up an Audit Planning Memorandum (APM) and audit programme.

(b) *identify and assess material risks* through understanding the entity and its environment, including its internal control;

(c) *design audit procedures* regarding the nature, timing and extent of the audit work to be performed in response to the risks identified;

(d) *draw up an Audit Planning Memorandum (APM) and audit programme.*

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

## 2.2 DETERMINING MATERIALITY

<table>
<thead>
<tr>
<th>IssAI 1320</th>
<th>The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.</th>
</tr>
</thead>
<tbody>
<tr>
<td>[ISA 320]</td>
<td></td>
</tr>
<tr>
<td>IssAI 1450</td>
<td></td>
</tr>
<tr>
<td>[ISA 450]</td>
<td></td>
</tr>
</tbody>
</table>

### 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

Variety of users

Professional judgment

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. Thus, materiality must be assessed with reference to the auditor's understanding of users' expectations. In the Court'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.

Users of information in the EU context, who must be considered when determining materiality, are primarily the Parliament and the 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
2.2.3 Reasons for establishing materiality

Setting materiality limits helps the auditor to plan the audit so as to ensure that material deviations are detected by audit tests and the Court’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:

- **Planning**, to help assess material risks and determine the nature, timing and extent of audit procedures;
- **Examination**, when considering new information that may require planned procedures to be revised, and evaluating the effect of deviations;
- **Reporting**, 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.

(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.

- For the Court, 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.
- 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.

Because the Court'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.

(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**: 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**: 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 the Court's report. Issues that are material by nature or context are to be disclosed; however, only in exceptional cases- to be decided by the Court - 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 RISKS THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT, INCLUDING THE COURT’S ASSURANCE MODEL

**ISSAI 1315 [ISA 315]**

The objective of the auditor is to identify and assess the risks to the audited entity not meeting its objectives, 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

**Definition of assurance and audit risk**

It is not 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 have reasonable assurance, which is obtained from audit work.

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 Court 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%.

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.

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

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8 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.
assurance for their conclusions.

<table>
<thead>
<tr>
<th>Audit risk (AR) = Inherent risk (IR) x Control risk (CR) x Detection risk (DR)</th>
</tr>
</thead>
</table>

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 is contributing 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.

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.

The entity's own risk-assessment process can be a source of information. For example, at the European Commission, the Annual Management Plan (AMP) contains the critical risks identified 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

<table>
<thead>
<tr>
<th>Risk assessment procedures</th>
<th>Sources of information</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Analysis</strong> of relationships in and between financial and non-financial information,</td>
<td>Financial and non-financial information, in order to provide a broad initial indication</td>
</tr>
<tr>
<td>through a study of plausible relationships, including trends and ratios. Examples include</td>
<td>of unusual or unexpected relationships.</td>
</tr>
<tr>
<td>comparison of actual information against budget, licence income to number of licences, and</td>
<td></td>
</tr>
<tr>
<td>import duties to physical import data.</td>
<td></td>
</tr>
<tr>
<td><strong>Inspection</strong> consists of examining records or documents, whether internal or external,</td>
<td>Visits to the entity's premises and facilities</td>
</tr>
<tr>
<td>in paper form, electronic form, or other media, or tangible assets.</td>
<td></td>
</tr>
<tr>
<td><strong>Observation</strong> consists of looking at a process or procedure being performed by others.</td>
<td>Observation of entity activities and operations being carried out</td>
</tr>
<tr>
<td>It provides information about the performance of the process or procedure, but is limited</td>
<td></td>
</tr>
<tr>
<td>to the point in time at which the observation takes place.</td>
<td></td>
</tr>
<tr>
<td><strong>Inquiry</strong> consists of seeking information of knowledgeable persons, inside or outside</td>
<td>Those charged with governance, management and others within the entity</td>
</tr>
<tr>
<td>the audited entity.</td>
<td></td>
</tr>
</tbody>
</table>

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*.

**2.3.2 Understanding the entity and its environment**

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.

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9 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.
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.

While the Commission is responsible for overall implementation of the budget (Article 317 of the TFEU), the Financial Regulation 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.

- **Centralised** basis. Used mainly in external actions, internal policies and administrative expenditure, it involves direct management which is the responsibility of the Commission's Directorates-General, or indirect management when the Commission entrusts budget implementation to Union agencies and public- or private-sector bodies (internal policies);
- **Shared or decentralised management**. Shared management involves delegation of implementation tasks to Member States and mainly concerns expenditure on agricultural and structural operations, and revenue. Decentralised management involves the delegation of implementation

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tasks to beneficiary countries, as in the case of external aid;

- *joint management* with international organisations; this method involves the delegation of implementation tasks to international organisations, generally in the area of external actions.

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.

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.

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**

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.

**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**

<table>
<thead>
<tr>
<th>CONTROL COMPONENT</th>
<th>PURPOSES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control environment</td>
<td>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.</td>
</tr>
<tr>
<td>Risk assessment</td>
<td>To identify and analyse internal and external risks to the achievement of the entity's objectives. In the Commission, all activities must have objectives that are intended to be specific, measurable, achievable, relevant and timely (SMART), as well as risk analysis and risk management of the main activities.</td>
</tr>
<tr>
<td>Control activities</td>
<td>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.</td>
</tr>
<tr>
<td>Information &amp; communication</td>
<td>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.</td>
</tr>
<tr>
<td>Monitoring</td>
<td>To ensure ongoing assessment of performance. This includes internal audit and evaluation, as well as the annual review of internal control.</td>
</tr>
</tbody>
</table>
The auditor should obtain an understanding of these control components.

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).

11 Definition as per INTOSAI guidelines for internal control standards for the public sector.
2.3.5 Understanding the entity's 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 the Court'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:

(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).

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.
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.

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>
<thead>
<tr>
<th>Status of internal control</th>
<th>Control risk</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excellent</td>
<td>Low</td>
<td>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.</td>
</tr>
<tr>
<td>Good</td>
<td>Medium</td>
<td>Internal control appears to be in place and properly designed, and is likely to operate effectively and continuously throughout the period under review.</td>
</tr>
<tr>
<td>Poor</td>
<td>High</td>
<td>Internal control is non-existent, poorly designed or appears to be poorly implemented.</td>
</tr>
</tbody>
</table>
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.

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.

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, 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 Court 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.

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

- 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.

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).

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

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12 The Court’s assurance model is based on the audit risk model taking due consideration of the particular characteristics of the Court’s audit environment.
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 the Court'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 x CR).

Table 5: Assurance model

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

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 the Court 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, RELEVANCE AND RELIABILITY OF AUDIT EVIDENCE

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 What is audit evidence?

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).

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.13

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13 See Assurance Model, chapter 2.3.8.
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.

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 of audit evidence

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

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);
- in documentary form, whether paper, electronic, or another medium, rather than verbal statements;
- provided by original documents rather than photocopies or faxes.

2.4.5 Corroboration or triangulation of audit evidence

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.

2.4.6 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

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

#### 2.4.7 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

<table>
<thead>
<tr>
<th>Audit procedures to obtain evidence</th>
<th>Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PHYSICAL</strong></td>
<td></td>
</tr>
<tr>
<td>Direct inspection or observation</td>
<td>While usually the most persuasive evidence, the auditor must be aware that his/her presence may distort reality.</td>
</tr>
<tr>
<td>of people, property or events</td>
<td></td>
</tr>
<tr>
<td><strong>DOCUMENTARY</strong></td>
<td></td>
</tr>
<tr>
<td>Review of accounting documents</td>
<td>Useful information may not always be documented, necessitating the use of other approaches.</td>
</tr>
<tr>
<td>and records, manuals, management</td>
<td></td>
</tr>
<tr>
<td>representations</td>
<td></td>
</tr>
<tr>
<td><strong>ORAL</strong></td>
<td></td>
</tr>
<tr>
<td>Enquiry or interviews of auditee</td>
<td>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.</td>
</tr>
<tr>
<td>staff or third parties, documented</td>
<td></td>
</tr>
<tr>
<td>or corroborated where possible.</td>
<td></td>
</tr>
<tr>
<td><strong>ANALYTICAL</strong></td>
<td></td>
</tr>
<tr>
<td>Analysis through reasoning,</td>
<td>Such evidence is obtained by using professional judgment to evaluate physical, documentary and oral evidence.</td>
</tr>
<tr>
<td>reclassification, computation and</td>
<td></td>
</tr>
<tr>
<td>comparison.</td>
<td></td>
</tr>
</tbody>
</table>

2.4.8 Audit procedures to obtain audit evidence

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.

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.
2.4.9 Access to audit evidence

The TFEU\textsuperscript{14} 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 the Court of Auditors 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.

2.4.10 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.

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

2.4.11 Documentation of audit evidence

Auditors should adequately document the audit evidence in working papers in the Court'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.

\textsuperscript{14} Article 287(3) of the Treaty on the Functioning of the European Union.
### 2.5 DESIGNING AUDIT PROCEDURES

**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

**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:
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;
2.5.3 How to design audit procedures

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

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

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, the Court relies primarily on its direct testing of transactions.

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**

The 95% assurance generally required from the Court'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).
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.

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.

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.

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. 

Figure 7: Tests of controls

1. Obtain an understanding
   - Obtain an understanding of the control structure
   - Document the understanding

2. Initial assessment and response to control risk
   - Initial assessment of control risk
   - Set level of control risk
   - Response to control risk
   - Identify relevant controls
   - Evaluate weaknesses

3. Final assessment based on tests of controls
   - Prepare audit planning memorandum and audit programme
   - Perform tests of control
   - Evaluate sufficiency of evidence and reassess internal control risk

Audit procedures:
- nature
- timing
- extent

Nature:
- inquiry
- observation
- inspection
- reperformance

Timing
Extent

Reduce or no change
Reduce or increase risk?

15 In the EU context internal control comprises also the supervisory and control systems of the Member States in order to cover the delegation risk.
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.

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**

<table>
<thead>
<tr>
<th>Main Categories of Tests of Controls</th>
<th>Description</th>
</tr>
</thead>
</table>
| Tests of **key controls** over individual transactions processed by a system | Key controls are part of transactions processing, often manual or semi-automated, and may include:  
  - evidence of authorisation of a selected transaction;  
  - evidence of review by another official, e.g. correct computation;  
  - evidence of check of compliance with budgetary rules, etc. |
| Tests of **automated application controls** | Application controls are built into the auditee’s systems and are applied to individual transactions or to batches of similar transactions. The auditor should 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. |
| Tests of **management and monitoring controls** | 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:  
  - top level reviews by senior management;  
  - review of internal reconciliations/reconciliations with external data;  
  - review of management information systems. |
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

<table>
<thead>
<tr>
<th>Tests of Controls carried out:</th>
<th>Evidence to obtain</th>
</tr>
</thead>
<tbody>
<tr>
<td>at a point in time</td>
<td>the auditor only obtains audit evidence that the controls operated effectively at that time.</td>
</tr>
<tr>
<td>throughout the period</td>
<td>the auditor obtains audit evidence that the control operated effectively at relevant times.</td>
</tr>
<tr>
<td>during an interim period</td>
<td>additional audit evidence <strong>should</strong> 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.</td>
</tr>
<tr>
<td>in prior audits</td>
<td>the auditor <strong>should</strong> obtain audit evidence whether changes in those specific controls have occurred after the prior audit through enquiry, in combination with observation or inspection.</td>
</tr>
<tr>
<td>in prior audits - controls over significant risks</td>
<td>the auditor may not rely on evidence obtained in prior audits for controls that mitigate a significant risk: those controls <strong>should</strong> be tested in the current period.</td>
</tr>
<tr>
<td>in a prior audit, if controls changed since last tested</td>
<td>the operating effectiveness of such controls <strong>should</strong> be tested in the current audit. Changes may mean there is no basis for continued reliance.</td>
</tr>
<tr>
<td>in a prior audit, if controls unchanged since last tested</td>
<td>the auditor <strong>should</strong> 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.</td>
</tr>
</tbody>
</table>

(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.

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.

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.

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.

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

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 basis for the auditor to draw conclusions about the population from which the sample is drawn.

Introduction

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.

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.

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 risk16, that:

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16 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.
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 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.

**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 chapter 2.5 of the Reliability and Compliance parts for Court-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.

**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 CEAD Chamber).

**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. policy groups for DAS). 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 the Court'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 for help with sample size calculations.

Tools such as Microsoft Excel or ACL, both available at the Court, are used to select samples. Excel, which is more widely used in the audit units, has a
MUS function. The CEAD Chamber can support other Units which need to run MUS sampling on specific populations.

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**

![Flowchart of sample selection method]

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**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:

\[
\text{MLE} = \frac{1}{n} \times \text{sum of } t \text{ (in %)} \text{ or }
\text{MLE} = \text{sum of } t \times \text{ASI (in €)}
\]

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. Judgemental 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

The objective of the auditor is to:

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

in order to reduce audit risk to an acceptably low level.

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:

- a short introduction;
- a description of the audit field, 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;
- the audit objectives (the reliability of accounts and main assertions to be addressed; for compliance audits, the objectives depend on the type of audit to be conducted);
- the audit scope (accounting periods to be covered and locations to be visited; the same for compliance audits, plus control systems to be tested

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2.6.2 Audit Programme

2.6.3 Changes to planning decisions during the audit

2.6.4 Documentation
and sample to be audited);

- identification of materiality;
- a preliminary assessment of risks (e.g. changes in the accounting or internal control systems and evaluation of inherent and control risk);
- the audit approach, 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 of audit work: resources (including recourse to the work of other auditors and experts), timetable (including the reporting objectives of the audit), budget and documentation in the Court's electronic audit support system; and
- quality control arrangements for the direction, supervision and review of the audit.

For DAS audits, the APM should be approved by the Chamber and adopted by the CEAD Chamber; for non-DAS audits, the APM should be adopted by the Chamber prior to the start of the audit.

### 2.6.2 Audit Programme

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 the Court's electronic audit support system. Audit units can adapt the audit programmes, including those for the 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. policy area) and are made available in the Court’s electronic audit support system library. The audit programmes are then approved by the Unit responsible for DAS coordination, 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 the Court'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.
 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

The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.

The objective of the auditor is to perform audit procedures appropriate to the purpose, on each item selected.

3.2.1. Audit procedures to obtain audit evidence

Auditors should be aware that audit tests which are not performed correctly during the examination phase of the audit do not provide the required evidence.

3.2.2 Performing tests of controls

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).

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.

3.2.3 Performing substantive procedures - tests of details

3.2.4 Documenting the results of audit tests

Perform audit tests correctly

Mixture of tests of controls and substantive procedures

Balance the reliability of evidence against the cost of obtaining it

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

<table>
<thead>
<tr>
<th>Obtain evidence of:</th>
<th>By performing these audit tests:</th>
</tr>
</thead>
<tbody>
<tr>
<td>The quality of the controls and data input.</td>
<td>Testing application controls</td>
</tr>
<tr>
<td></td>
<td>• Based on mapping of application controls, identify the key processes,</td>
</tr>
<tr>
<td></td>
<td>master files, interfaces with other modules and systems, the link to the</td>
</tr>
<tr>
<td></td>
<td>accounting records and management reports. The control objectives (completeness, accuracy,</td>
</tr>
<tr>
<td></td>
<td>validity, restricted access) addressing the specific risks (access, input, rejection,</td>
</tr>
<tr>
<td></td>
<td>processing) for each component <strong>should</strong> be determined.</td>
</tr>
<tr>
<td></td>
<td>• The key controls designed to meet these control objectives <strong>should</strong> be tested through</td>
</tr>
<tr>
<td></td>
<td>enquiry, observation, inspection and some re-performance.</td>
</tr>
<tr>
<td>The completeness and reliability of the transactions the controls are expected to</td>
<td>Testing the assertions addressed</td>
</tr>
<tr>
<td>cover.</td>
<td>• Identify key controls that ensure completeness and reliability of transactions and ensure</td>
</tr>
<tr>
<td></td>
<td>they are effective through re-performance if needed.</td>
</tr>
<tr>
<td>How controls were applied, and their consistency, at relevant times during the</td>
<td>Walkthrough testing of controls</td>
</tr>
<tr>
<td>period.</td>
<td>• Understand/document the transaction flow and policies &amp; procedures of the control.</td>
</tr>
<tr>
<td></td>
<td>• Confirm the process, data used for controls and time the control is in place.</td>
</tr>
<tr>
<td></td>
<td>• Interview individuals performing the control on the type of information they look for, how</td>
</tr>
<tr>
<td></td>
<td>they detect errors, deviations and/or anomalies, and how they treat them.</td>
</tr>
<tr>
<td>Testing individual items</td>
<td>Testing individual items</td>
</tr>
<tr>
<td></td>
<td>• If the auditor cannot obtain sufficient audit evidence using walkthrough testing, then (s)he</td>
</tr>
<tr>
<td></td>
<td>can use sampling procedures to test individual items.</td>
</tr>
<tr>
<td></td>
<td>• The sample used is either drawn for controls alone (single purpose testing) or is the same</td>
</tr>
<tr>
<td></td>
<td>as for substantive testing (multipurpose testing).</td>
</tr>
<tr>
<td>The correction of detected errors.</td>
<td>• Review of corrective actions and enquiry about their follow-up.</td>
</tr>
<tr>
<td>The evidence and documentation supporting the application of the controls.</td>
<td>Reviewing evidence of controls</td>
</tr>
<tr>
<td></td>
<td>• Evidence of authorisation of a selected transaction (signature of the authorising officer,</td>
</tr>
<tr>
<td></td>
<td>the <strong>ex-ante</strong> unit, etc.),</td>
</tr>
<tr>
<td></td>
<td>• Evidence of review by another official (of correct data computation, etc.),</td>
</tr>
<tr>
<td></td>
<td>• Evidence of check of compliance with budgetary rules, legality/regularity, and</td>
</tr>
<tr>
<td></td>
<td>documentation.</td>
</tr>
<tr>
<td>The sensitivity of management and monitoring controls.</td>
<td>Testing management and monitoring controls.</td>
</tr>
<tr>
<td></td>
<td>• Ensure that management and monitoring controls have been operating</td>
</tr>
<tr>
<td></td>
<td>regularly and consistently during the period under review.</td>
</tr>
<tr>
<td></td>
<td>• Check that management analysed results of the controls and took</td>
</tr>
<tr>
<td></td>
<td>corrective action.</td>
</tr>
</tbody>
</table>
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

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

- 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

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.

3.3.1 Nature and cause of errors in general

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.

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:

- 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.

- 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.

- 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:

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

### 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>
<thead>
<tr>
<th>The rate of deviation (tests of controls) or projected rate of error plus known error(s) (tests of details):</th>
<th>Interpretation</th>
</tr>
</thead>
</table>
| 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:

- 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
• 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

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;
• is material by value (exceeding the materiality threshold), nature or context, based on the above. The auditor then determines if the error is “serious” (quantifiable error: equals or exceeds 2%; non quantifiable error: concerns 10% or more of the item audited) or “limited” (quantifiable error: between 0.5% and 2%; non quantifiable error: concerns between 2.5% and 10% of the item audited);
• 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.

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 the Court.

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 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):
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 the Court is usually obliged to use the third of these possibilities – alternative audit procedures providing additional assurance – to obtain additional assurance.
3.4 ANALYTICAL PROCEDURES

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

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 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.

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**

1. Define audit objective for which these analytical procedures are being used
2. Determine appropriateness of using analytical procedures
3. Prior period annual accounts and transactions
4. Disaggregated financial and non-financial data
5. Information about the entity’s environment
6. Identify the type of analytical procedures to be applied
7. Check reliability of data
8. Develop an expectation
9. Define a tolerable difference
10. Compare the expectation to recorded amount
11. Is the difference greater than the tolerable difference?
   - Yes
     - Investigate difference. Consider patterns, trends, relationships and possible causes. Make enquiries of management and obtain corroborative evidence.
   - No
     - Are explanation(s) and corroborative evidence adequate?
       - Yes
         - Conduct other audit procedures or propose an audit adjustment
       - No
         - Document results
12. Accept amount
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**

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

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 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

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

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:

(i) written acknowledgement by management of its responsibilities;

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

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:

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

(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;

(iii) believes all information relevant to the audit has been made available to the auditor.

Examples are (i) the representation letter for the European Union's annual accounts, signed by the Accounting Officer; (ii) the Annual Activity Report and declaration by each Director-General; and (iii) the Commission's Synthesis Report.

3.5.3 Specific written representations on material matters

A specific written representation may be necessary to corroborate other audit evidence, particularly where judgment, intent or completeness is involved. The auditor should determine whether specific written representations for specific assertions are necessary.

3.5.4 Evaluating the reliability of written representations

If the written representation is inconsistent with other audit evidence, the auditor should 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).

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 should assess the effect on the reliability
of written representations.

When relevant parties do not provide the general representations regarding management's responsibilities or any specific representations requested, the auditor should 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.

- representations unreliable

If (s)he deems the written representations regarding management's responsibilities not to be reliable, the auditor should consider the effect on the auditor's report.

Disclaimer

The auditor shall disclaim an opinion on the financial statements if:

(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]
ISSAI 1610
[ISA 610]
ISSAI 1620
[ISA 620]

Using the work of another auditor
Using the work of an internal auditor
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 Capabilities and 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

(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 the Court. 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;

(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

<table>
<thead>
<tr>
<th>ISSAI 1600 [ISA 600]</th>
<th>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.</th>
</tr>
</thead>
</table>

**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. The Court 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.¹⁷

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

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¹⁷ 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.
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 the Court'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, 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.

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.

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 the Court'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, the Court's auditor should discuss these findings with the other auditor and consider whether it is necessary to carry out additional audit testing him/herself.

(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, the Court'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, the Court'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 Court and the SAIs.

(c) When using the work of external auditors from the private sector, the Court'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. The Court’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

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.

When considering using the work of internal audit, including the Internal Audit Service (or the Internal Audit Capabilities of the Commission), 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;
- the effect of any constraints placed on internal audit by management.

Using the work of internal audit

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.

in the case of financial audits

Internal Audit Capability

The auditor should:

- contact the relevant internal audit function (e.g. in the case of the European Union's annual accounts, this is DG Budget's Internal Audit Capability) at the audit planning phase, in order to determine whether any specific audit tests on the accounts are planned or have been carried out by internal audit, in order to avoid duplication of effort and increase audit efficiency;
- follow up reports by the Internal Audit Capability concerning the reliability of the accounts (e.g. on reconciliation and clearing of accounts) in
order to assess the potential risks uncovered and remedial action (to be) taken.

**Internal Audit Service**

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 Internal Audit Service (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 the Court 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\(^{18}\). In addition, the IAS’s Mission Charter requires the European Commission’s Internal Auditor to provide an overall opinion each year on the state of control at the Commission. In 2011, the IAS issued its first “Overall opinion” on the state of the Commission’s financial management, based on work carried out by IAS and IAC over a three-year period and taking account of the Court’s reports.

Regarding the Internal Audit Capability, the auditor **should**, following the end of the financial year, assess internal audit work carried out insofar as it contributes to the drafting of the Director-General’s declaration concerning the financial year (see chapter 3.5 on written representations).

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

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\(^{18}\) Article 86 of the Financial Regulation states: "The internal auditor shall advise his/her institution by issuing independent opinions on the quality of management and internal control systems and by issuing recommendations for improving the conditions of implementation of operations and promoting sound financial management".
3.6.4 Using the work of an auditor's expert

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.

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 Director of Audit Support, Quality and Development is the authorising officer for the budget line concerned and sectors should liaise with this Directorate as soon as the need to employ an expert has been identified.

If technical expertise is required that is not available within the audit team or the Court, 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 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 the Court. The role of the expert is typically to assist the audit team, which remains responsible for forming and putting an audit opinion to the Court. 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.

Experts employed by the Court 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 Court decisions) and be prepared to advise experts accordingly. In addition, it is the responsibility of the CEAD-A Directorate to ensure that appropriate confidentiality clauses are systematically included in experts' contracts of employment.

3.7 OTHER AUDIT PROCEDURES

3.7.1 Related parties

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

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.

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\(^{19}\). 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 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 at the European Commission.

**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

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\(^{19}\) European Union accounting rule no 15.
in the normal course of business and carry no higher risk than transactions with unrelated parties.

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.

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.

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.

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;

(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.

The medium used to present findings to the auditee is the Statement of Preliminary Findings (SPF). The purpose of the SPF 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 SPF setting out the findings should be sent to the auditee upon completion of a mission, within the Court’s standard timeframes. The auditee is required to respond to the SPF. The auditor should analyse this response, ensuring that valid issues raised by the auditee are taken into account when drafting the final report.
PART 1. GENERAL

SECTION 4 - REPORTING

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4.1 Reporting overview

4.2 The Court'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

Audit reports are the Court’s main product. The purpose of audit reports is to communicate the results of the Court’s work to the discharge authority, the auditee and the general public. By publishing reports, the Court 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.

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.

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 Court, the contradictory procedure with the auditee, adoption of the final report by the Court, its translation, presentation to the discharge authority and publication in the Official Journal.

4.1.2 Types of audit reports

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

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

In addition, the Court is required to provide the European Parliament and the Council with a Statement of Assurance as to the reliability of the accounts of the European Union and the legality and regularity of the underlying transactions for the financial year. The Financial Regulation\(^\text{20}\)

\(^{20}\) Article 129(4).
requires that, for the DAS audit, the final consolidated accounts be published in the Official Journal, together with the Statement of Assurance.

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 EDF.

- The Court 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 the Court to audit the reliability of their accounts and the legality and regularity of the underlying transactions.

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

The following table summarises these three different types of reports:

<table>
<thead>
<tr>
<th>Specific Annual Reports</th>
<th>Special Reports</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Court produces <em>Specific Annual Reports</em> for its recurrent annual financial and compliance audits of other EU bodies, offices and agencies. The TFEU and regulations of such entities require the Court to audit the reliability of their accounts and the legality and regularity of the underlying transactions.</td>
<td>The Court may also, at any time, submit observations, particularly in the form of <em>Special Reports</em>, on specific matters selected by the Court based on their priority. These Special Reports are discussed in the Compliance part of the manual.</td>
</tr>
</tbody>
</table>
Table 14: Types of reports published by the Court

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

*except the European Central Bank.

** 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 the Court **should** have the following qualities:

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

Figure 12: Users of the Court's reports
4.1.5 Naming of third parties in the Court's reports

As regards the naming of third parties in the Court's reports, the judgment in the Ismeri case\(^\text{21}\) 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:

- *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.

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

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\(^{21}\) 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 THE COURT'S STATEMENT OF ASSURANCE - FORMING AN OPINION

The objectives of the auditor are to:

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

Express clearly that opinion through a written report that explains the basis of the opinion.

4.2.1 Legal requirements and scope of the Statement of Assurance

In accordance with the TFEU22, 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 the Court’s opinion on the reliability of the annual accounts 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:

- 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 legality and regularity in the Statement of Assurance is based on the

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22 Article 287(1) of the Treaty on the Functioning of the European Union.
specific assessments for each major cluster, comprising policy areas, of EU activity.

4.2.2 Form and content of the Statement of Assurance

Since the Statement of Assurance may (and, in the case of the DAS, 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.

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 Court’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 Court’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 the Court’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 the Court’s responsibility, which includes auditing and reporting the results of audits. In the case of the annual accounts of the European Union and the underlying transactions, the Court’s responsibility is defined in the TFEU\(^{23}\) 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.

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 annual accounts of the European Union and the underlying transactions, this is the TFEU (Articles 310 to 325) 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.

This section **should** be headed “Auditor's responsibility”.

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

- *The Court’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

\(^{23}\) Article 287(1) of the Treaty on the Functioning of the European Union.
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.

- **The Court’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 Court believes that the audit evidence which it has obtained is sufficient and appropriate to provide a basis for its opinion.

The description of the Court’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.

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 accounts**

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

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

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

- **Analysis of annual activity reports and declarations**
- **Examination of work of other auditors**
- **Evaluation of supervisory & control systems**
- **Substantive testing**
  - Professional judgement and materiality
    - Qualitative evaluation of results on work on systems
    - Quantitative evaluation of results of substantive testing
    - Analysis of coherence of audit results
  - Audit conclusions – Specific assessments
  - Audit conclusions – Specific assessments
  - Audit conclusions – Specific assessments

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**Audit opinion – The DAS**
(vii) Other matters

The Court may be required, or may consider it appropriate, to elaborate on matters that provide further explanation of the Court's responsibilities with respect to the audit of the 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 Court’s responsibilities with regard to reporting on fraud and irregularities, the safeguarding of assets and sound financial management could be described here.

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

For the EU annual accounts, the TFEU sets the Court a deadline, currently 15 November, by which the Annual Report, which includes the Statement of Assurance, must be available.

The Court's Statement of Assurance should be signed by the President of the Court on behalf of the Court.

The Statement of Assurance should contain the official address of the European Court of Auditors.

NB: The models of the opinions set out in this manual should always be used whenever an audit opinion is drafted.

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:
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 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
Supplementary information

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. Note 6 to the accounts concerning financial corrections and recoveries following the detection of irregularities is an example of supplementary information.

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

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, 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.

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.
4.3 UNMODIFIED OPINION

4.3.1 When is it appropriate to issue an unmodified opinion?

The financial framework used by European institutions, bodies, offices and agencies is a fair presentation framework (Article 123 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.

The auditor should express an unmodified opinion on the reliability of the accounts when the auditor concludes that the annual accounts 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 the Court’s opinion, the [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].”

In the case of the 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 inspired by IPSASs.

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

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 the Court’s opinion, [the transactions underlying the annual accounts] of [the auditee] for the [period] is 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 final annual accounts of the European Union and for the annual accounts of an agency, are included in Appendix III.
4.4 MODIFIED OPINION

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

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.

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

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
4.4.2 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 that inability 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 that inability 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

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

4.4.3 Nature and consequence of an inability to obtain sufficient appropriate audit 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 279) and the Financial Regulation (Article 140,142) give the Court the right to access any document or information necessary to carry out its task. These legal bases give the Court the power to request and obtain sufficient appropriate audit evidence and do not afford much opportunity for auditee management to impose a limitation on the Court’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

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 the Court’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. The Court only presents audit opinions at the overall level of the underlying transactions recorded in the accounts, not at that of the specific assessments. Determining whether errors are pervasive is also done at the level of the overall opinion.

Further information regarding pervasiveness is provided in Appendix IV.

4.4.5 Basis for Modification 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.

If a material misstatement of the annual accounts or error in the underlying transactions relates to specific amounts, the auditor should include in the

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24 Thus, the question whether error is pervasive in the sense used by the standards within a policy group does not arise, and so the conclusions in the individual chapters of the Annual Report do not include any reference to pervasive effects.
Basis for Modification paragraph a description and quantification of the effects of the misstatement or error, unless impracticable. If it is not practicable to quantify the effects, the auditor should state as much in the Basis for modification paragraph.

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.

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.

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.

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.

When the auditor expresses a qualified opinion, (s)he should formulate the opinion as follows:

- A qualified opinion on the reliability of the annual accounts:

  “In the Court’s opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph, the [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 the Court’s opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph, [the transactions underlying the annual accounts] of [the auditee] for the [period] comply, is 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.

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 the Court’s opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph, the [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 the Court’s 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.”

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, the Court does not express an opinion on the 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, the Court does 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 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

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.

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”).

However, with regard to the opinion on the legality and regularity of the underlying transactions for the EU budget (the DAS), separate conclusions are presented for individual policy groups, as this provides better decision-making information for the budgetary authority and such conclusions or opinions are supported by sufficient audit work in each policy group. This approach is supported by the TFEU25 which allows for specific assessments. In addition, ISSAI 420026 permits the Court to use customary reporting.

25 Article 287(1) of the Treaty on the Functioning of the European Union.

26 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

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 appropriate 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

In rare 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.

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.

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.

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

(a) include it immediately after the Opinion paragraph in the auditor’s report;
(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 heading “Other Matter(s)” is placed after the auditor’s opinion and any Emphasis of Matter paragraph.

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

The objectives of the auditor are to:

(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.

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, the Court'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. Fraud normally results 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 CEAD Chamber, which informs OLAF, the Commission's Anti-Fraud Office.
### 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;
4. **Inherent risk factors associated with economic or technical circumstances**

- 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.

5. **Inherent risk factors associated with the audited entity**

- frequent conflicts over pay, working conditions, social matters;
- lack of turnover/mobility of personnel and/or personnel not taking holidays 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.

6. **Inherent risk factors associated with the audited entity’s management policies and practices**

- 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.
# APPENDIX II - DETAILS RELATING TO INTERNAL CONTROL COMPONENTS

<table>
<thead>
<tr>
<th>Component</th>
<th>Component elements</th>
<th>How to gain understanding</th>
</tr>
</thead>
</table>
| **Control environment** | 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:  
- communication/enforcement of integrity/ethical values  
- commitment to competence  
- participation by those charged with governance  
- management philosophy and operating style  
- organisational structure  
- assignment of authority and responsibility  
- human resource policies and practices | Inquiries  
Observation  
Inspection of documents, e.g. Code of Conduct |
| **Entity's risk assessment process** | As the basis of the auditor's own risk assessment, (s)he considers how management manages business risk, and in particular how it:  
- identifies risks relevant to financial reporting & compliance  
- estimates its significance  
- assesses the likelihood of occurrence  
- decides upon actions to manage it. | Review of the entity's risk-assessment process and documents such as the AMP and AAR |
| **Information systems and Communication** | As the repository of all the entity's records and transactions, it is crucial that the auditor acquires an understanding of:  
- significant classes of transactions  
- procedures to initiate, record, process and report transactions  
- accounting records  
- financial reporting process  
- processing of exceptionally large or unusual transactions  
- reprocessing of rejected transactions | Inquiries as to how transactions are originated and processed  
Walk-through  
Inspection |
| **Control activities** | The auditor's focus is on how control activities, individually or in combination, reduce risk, with a particular emphasis on:  
- authorisation  
- performance reviews  
- information processing  
- physical controls  
- segregation of duties | Inquiries  
Observation |
| **Monitoring of controls** | 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:  
- management and supervisory activities  
- internal audit  
- information from third parties (e.g. complaints)  
- evaluations | Inspection of sources of monitoring information  
Inquiries |
APPENDIX III - THE COURT'S STATEMENT OF ASSURANCE 2010

THE COURT'S STATEMENT OF ASSURANCE PROVIDED TO THE EUROPEAN PARLIAMENT AND THE COUNCIL – INDEPENDENT AUDITOR’S REPORT

I. Pursuant to the provisions of Article 287 of the Treaty on the Functioning of the European Union (TFEU) the Court has audited:

a) the annual accounts of the European Union which comprise the consolidated financial statements and the consolidated reports on implementation of the budget for the financial year ended 31 December 2010; and

b) the legality and regularity of the transactions underlying those accounts.

Management's responsibility

II. In accordance with Articles 310 to 325 of the TFEU and the Financial Regulation, management is responsible for the preparation and fair presentation of the annual accounts of the European Union and the legality and regularity of the transactions underlying them:

a) Management's responsibility in respect of the annual accounts of the European Union includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies, on the basis of the accounting rules adopted by the Commission's accounting officer, and making accounting estimates that are reasonable in the circumstances. According to Article 129 of the Financial Regulation, the Commission approves the annual accounts of the European Union after the Commission's accounting officer has consolidated them on the basis of the information presented by the other institutions and bodies and established a note, accompanying the consolidated accounts, declaring, inter alia, that he has reasonable assurance that they present a true and fair view of the financial position of the European Union in all material aspects.

b) The way in which management exercises its responsibility for ensuring the legality and regularity of underlying transactions depends on the method of implementation of the budget foreseen in the Financial Regulation. Implementation tasks have to comply with the principle of sound financial management, requiring designing, implementing and maintaining effective and efficient internal control including adequate supervision and appropriate measures to prevent irregularities and fraud and, if necessary, legal proceedings to recover funds wrongly paid or used. Regardless of the method of implementation applied, 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).

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27 The consolidated financial statements comprise the balance sheet, the economic outturn account, the cash flow table, the statement of changes in net assets and a summary of significant accounting policies and other explanatory notes (including segment reporting).

28 The consolidated reports on implementation of the budget comprise the consolidated reports on implementation of the budget and a summary of budgetary principles and other explanatory notes.

29 The accounting rules adopted by the Commission's accounting officer are derived from International Public Sector Accounting Standards (IPSAS) issued by the International Federation of Accountants or, in their absence, International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. In accordance with the Financial Regulation, the consolidated financial statements for the 2010 financial year were prepared (as they have been since the 2005 financial year) on the basis of these accounting rules adopted by the Commission’s accounting officer, 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 cash movements.
III. The Court's responsibility is to provide, on the basis of its 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. The Court conducted its 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 the Court plans and performs the audit to obtain reasonable assurance whether the annual 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 are selected based 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 assessing those risks, the auditor considers internal control relevant to the preparation and fair presentation of the consolidated accounts and supervisory and control systems implemented to ensure legality and regularity of underlying transactions, in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and reasonableness of accounting estimates made, as well as evaluating the overall presentation of the consolidated accounts and the annual activity reports.

V. In the context of revenue, the Court’s audit of Value Added Tax- and Gross National Income-based own resources takes as its starting point the receipt by the Commission of the macroeconomic aggregates prepared by the member states, and then assesses the Commission's systems for processing the data until they are included in the final accounts and the contributions by the member states have been received. For traditional own resources, the Court examines the accounts of the customs authorities and analyses the flow of duties until the amounts are recorded in the final accounts and received by the Commission.

VI. The Court considers that the audit evidence obtained is sufficient and appropriate to provide a basis for its statement of assurance.

Reliability of the accounts

Opinion on the reliability of the accounts

VII. In the Court's opinion, the annual accounts of the European Union present fairly, in all material respects, the financial position of the Union as of 31 December 2010, and the results of its operations and its cash flows for the year then ended, in accordance with the provisions of the Financial Regulation and the accounting rules adopted by the Commission's accounting officer.

Emphasis of matter in relation to the reliability of the accounts

VIII. Without calling into question the opinion expressed in paragraph VII, the Court draws attention to a change in the Commission's accounting policy concerning pre-financing payments establishing or contributing to Financial Engineering Instruments which have not yet been used in the form of loans, guarantees or equity investments. This required the Commission to restate the 2009 annual accounts of the European Union on which the Court issued an unmodified opinion\(^{30}\) (see notes 2.5, 2.9, 2.10 and 3.4 to the 2010 annual accounts of the European Union explaining the adjustments made).

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\(^{30}\) See OJ C 303, 9.11.2010, pp. 10 - 12.
Legality and regularity of the transactions underlying the accounts

Revenue

Opinion on the legality and regularity of revenue underlying the accounts

IX. In the Court’s opinion, revenue underlying the accounts for the year ended 31 December 2010 is legal and regular in all material respects.

Commitments

Opinion on the legality and regularity of commitments underlying the accounts

X. In the Court’s opinion, commitments underlying the accounts for the year ended 31 December 2010 are legal and regular in all material respects.

Payments

Basis for adverse opinion on the legality and regularity of payments underlying the accounts

XI. The Court concludes that overall the supervisory and control systems are partially effective in ensuring the legality and regularity of payments underlying the accounts. The policy groups Agriculture and Natural Resources and Cohesion, Energy and Transport are materially affected by error. The Court’s estimate for the most likely error rate for payments underlying the accounts is 3.7%.

Adverse opinion on the legality and regularity of payments underlying the accounts

XII. In the Court’s 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 2010 are materially affected by error.

8 September 2011

Vítor Manuel da SILVA CALDEIRA

President

European Court of Auditors
12, rue Alcide De Gasperi, Luxembourg, LUXEMBOURG
APPENDIX IV - PERVERASIVENESS AS A BASIS FOR DETERMINING THE
TYPE OF MODIFICATION TO THE COURT'S DAS AUDIT OPINIONS

Paragraphs

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BACKGROUND

1. Pursuant to the provisions of Article 287 of the Treaty on the Functioning of the European Union (TFEU) the Court's responsibility is to provide, on the basis of its 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 (DAS). This statement may be supplemented by specific assessments for each major area of Union activity.

2. The Court conducts its DAS-audit in accordance with the International Standards of Supreme Audit Institutions (ISSAIs). The first complete set of ISSAIs was endorsed at the INTOSAI Congress in South Africa end of 2010 and is effective for audits of financial statements for periods beginning on or after 15 December 2009.

3. The ISSAIs require that the Court plans and performs the DAS-audit to obtain reasonable assurance whether the annual accounts of the EU (EU accounts) are free from material misstatement and the transactions underlying them are legal and regular. Reasonable assurance is a high level of assurance. It is achieved when the Court has obtained sufficient appropriate audit evidence to reduce audit risk (that is the risk that the Court, in the context of its DAS, expresses an inappropriate audit opinion) to an acceptably low level.

4. ISSAIs 1705 “Modifications to the Opinion in the Independent Auditor’s Report” and 4200 “Compliance Audit Guidelines – Compliance Audit related to Audits of Financial Statements” deal with the Court’s responsibility to take appropriate decisions in circumstances when, in preparing its statement of assurance, the Court concludes that a modification to its audit opinion is necessary. Three different types of modified opinions are possible: a qualified opinion, an adverse opinion, and a disclaimer of opinion.

5. The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the EU accounts are materially misstated/the transactions underlying them are materially affected by error or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated/affected by error; and

31 The annual accounts of the EU comprise the consolidated financial statements (consisting of the balance sheet, the economic outturn account, the cash flow table, the statement of changes in net assets and a summary of significant accounting policies and other explanatory notes, including segment reporting) and the consolidated reports on implementation of the budget (including also a summary of budgetary principles and other explanatory notes).


33 See ISSAIs 1700 “Forming an Opinion and Reporting on Financial Statements” and 4200, sections 8 “Evaluating Evidence and Forming Conclusions” and 9 “Reporting”.

FCAM - Part 1 - Appendices
(b) The auditor’s judgment about the pervasiveness of the effects or possible effects of the matter on the accounts/transactions underlying them (for details see annex 1).

6. Due to the differences of the subject matters to be covered by the DAS, the Court prepares in the context of its statement of assurance four different audit opinions. The first subject matter of the DAS (“reliability of the accounts”) is covered by one single audit opinion. The second subject matter of the DAS (“legality and regularity of underlying transactions”) is covered by three different audit opinions: one on revenue, one on commitments and one on payments.

7. The Court’s audit opinions have been unmodified for revenue and commitments since the first DAS which was issued concerning the financial year 1994 and for the reliability of the EU accounts since the DAS 2007. Furthermore, the Court has never been confronted with cases of inability to obtain sufficient appropriate audit evidence for providing an audit opinion. The only matter giving rise to a modification to one of its audit opinions has, since four years, been the material level of error affecting payments.

8. The following analysis of a possible approach for the implementation of the concept of pervasiveness therefore focuses on the issue of the legality and regularity of payments underlying the EU accounts. It takes into consideration the audit results for the DAS 2010 for which the Court for the first time analysed pervasiveness and considered that the audit opinion on payments should clearly be adverse.

**Application of pervasiveness is limited to audit opinions**

9. The Court’s DAS approach is based on an assurance model which is designed to provide the Court with reasonable assurance (i.e. a confidence level of 95%) as to whether the payments underlying the EU accounts, taken as a whole, are free, in all material respects, from errors as regards legality and regularity. This concept is, in a first round, applied to the different policy groups and allows drawing adequate conclusions at the level of the specific assessments. In a second round, the audit conclusions obtained for the different policy groups are consolidated in the form of an overall audit opinion.

10. While the ISSAIs contain no guidance for different types of audit conclusions, the requirements as regards the modifications to audit opinions are very strict. According to ISSAIs 1705 and 4200 the Court, having obtained sufficient appropriate audit evidence on whether payments are materially affected by error, shall express:

(a) A qualified opinion concerning the payments underlying the EU accounts when it concludes that compliance deviations are material but not pervasive; and

(b) An adverse opinion concerning the payments underlying the EU accounts when it concludes that compliance deviations are both material and pervasive.

11. The concept of pervasiveness is not to be applied at the level of audit conclusions contained in the specific assessments. However, as will be shown below, the application of pervasiveness in the context of the audit opinion will be facilitated by the fact that the Court applies an appropriate approach for being able to obtain a high level of assurance for its audit conclusions concerning the different policy groups.

**Definition of pervasiveness**

12. Pervasive is a term used, in the context of the Court’s compliance audits, to describe the effects of a material level of error on the population of payments underlying the EU accounts. Pervasive effects of a most likely error above 2% on the payments underlying the EU accounts can be classified into three categories. According to ISSAI 1705, they are those that, in the Court’s judgment:

(a) Are not confined to specific elements, accounts or items of the EU accounts;

(b) If so confined, represent or could represent a substantial proportion of the payments underlying the EU accounts; or

(c) In relation to disclosures, are fundamental to users’ understanding of the EU accounts.

13. Neither the ISSAIs themselves nor papers analysing comments received during the exposure process, literature on audit methodology or other documents contain precise guidance, for example in the form of

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34 Issues linked to Court’s audit opinions on the reliability of the accounts, revenue and commitments as well as to the inability to obtain sufficient appropriate audit evidence (which would lead to a disclaimer of opinion) are not covered.

35 This approach is based on ISSAIs (see for example ISSAI 1200, paragraph 5).

36 See paragraph P5 of the Practice Note on ISSAI 1705.

37 See ISSAI 1705, paragraph 5. ISSAI 4200 does not include such a precise definition. However, it applies an identical approach for determining the type of modification of the audit opinion (see paragraphs 169 and 170) and refers to the guidance included in ISSAI 1705 (see paragraph 175).

38 As the third category of pervasive effects is not relevant in relation to the Court’s audit opinion concerning the legality and regularity of payments, it will not be covered in the present paper (see also paragraphs 7 and 8).
quantitative thresholds, on how the key terms “confined” or “substantial” of the definition of pervasiveness should be interpreted. As regards the latter, the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) took the view “that what would be considered a substantial proportion of the financial statements would ultimately depend on the auditor’s professional judgment in the circumstances.”\(^{40}\) While the IAASB did not make a similar statement concerning the term “confined”, it seems logic that it should be treated in the same way.

14. The ISSAIs define professional judgment as “the application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.”\(^{41}\) On the basis of this guidance, an attempt is made in the following to develop a possible approach for implementing the concepts “confined” and “substantial” in the specific environment of the Court’s compliance audits of payments underlying the EU accounts, taking into consideration the structure and the financial importance of the policy groups for the DAS 2010 and 2011, as well as the real and hypothetical audit results\(^{42}\). In addition, it is examined how other SAIs apply pervasiveness in their specific context.

**First step of determining pervasiveness: Focus on the term “confined”**

15. In the context of the Court’s audit opinion on payments, a material level of error is pervasive if it is not confined to specific elements, accounts or areas of the overall population of payments underlying the EU accounts. Due to the approach applied for the DAS, the Court will, in general, obtain the necessary reasonable assurance (i.e. a confidence level of 95\%) for calculating the most likely error only at the level of the different policy groups. The audit work executed concerning the different member states, third countries, Commission DGs, supervisory and control systems, budget lines, etc. normally will not suffice to achieve the required precision for estimating the level of error\(^{43}\). Therefore, the policy groups have, in general, to be the units which serve as a basis for determining whether a material level of error is confined.

16. In a first step, it has therefore to be examined how many of the policy groups are affected by a material level of error. As can be seen in table 1 of annex 2, the ratio for the DAS 2010 was 2 out of 5 (40\%). Had the new structure for policy groups foreseen for 2011 already been applied in 2010 (see table 2 of annex 2), the ratio would have been 2 out of 7 (29\%).

17. Where exactly the line for pervasiveness has to be drawn is not clear, in particular because no SAI, so far, has published documents or issued audit opinions explaining how it applied this concept. As will be shown below, professional judgments of the Court on this issue should, in order to be meaningful, also take into consideration the proportion of the total financial volume of policy groups affected/not affected by material error.

**Second step of determining pervasiveness: Focus on the term “substantial”**

18. In the context of the Court’s audit opinion on payments, a material level of error is also pervasive if it affects a substantial proportion of the overall population of payments underlying the EU accounts. Due to the facts described above, the Court will, in general, obtain the necessary reasonable assurance (i.e. a confidence level of 95\%) for calculating the most likely error only at the level of the different policy groups. Therefore, the policy groups have, in general, also to be the units which serve as a basis for determining whether a material level of error is present in a substantial proportion of payments underlying the EU accounts.

19. Thus, the second step for determining pervasiveness consists in the calculation of the proportion of the total financial volume of policy groups affected by a material level of error as compared to the overall population of payments underlying the EU accounts. Table 1 of annex 2 shows that, in the context of the DAS 2010, policy groups representing 80\% of the overall amount of payments were characterized by a most likely error higher

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\(^{39}\) See for example the two papers of the International Federation of Accountants, “Basis for Conclusions: ISA 705 (Revised and Redrafted), Modifications to the Opinion in the Independent Auditor’s Report”, (paragraphs 4 to 10) or “Basis for Conclusions: Close-off Documents – ISA 705 (Revised), Modifications to the Opinion in the Independent Auditor’s Report, and ISA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor’s Report” (paragraphs 17 to 24), which have been prepared by the staff of the International Auditing and Assurance Standards Board.

\(^{40}\) Papers of IFAC, “Basis for Conclusions: Close-off Documents – ISA 705 (Revised), Modifications to the Opinion in the Independent Auditor’s report, and ISA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor’s Report”, paragraph 20.

\(^{41}\) See ISSAI 1200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing”, paragraph 13(k).

\(^{42}\) The hypothetical scenario presented in table 2 presents the most likely error rates for the new policy groups foreseen for the Annual Report 2011, independently of the level of confidence achieved, on the basis of the results of the DAS 2010 audit of transactions. The four hypothetical scenarios presented in table 3 are simply used to illustrate possible outcomes of DAS audits (applying also the structure of the Annual Report 2011) without any consideration of previous audit results. The impact of the revised definition of underlying transactions and the harmonized approach concerning public procurement is not taken into consideration.

\(^{43}\) In the context of the DAS 2010, the Court’s audit results on IACS were an exception. As the upper error limit was 1,8\%, the Court had 99,3\% assurance that this area was not affected by a material level of error.
than 2%. Had the new structure for policy groups foreseen for 2011 already been applied in 2010, the percentage would have dropped to 38% (see table 2 of annex 2).

20. Where exactly the line for pervasiveness has to be drawn is not clear, in particular because no SAI, so far, has published documents or issued opinions explaining how it applied this concept. However, it seems that 38% represent a considerable share of the population. For this reason, it may be difficult in such a scenario for the Court to conclude that a “non-substantial” proportion of the payments underlying the EU accounts is affected by a material level of error and consequently a qualified opinion (“except for (…), payments underlying the accounts are not materially affected by error”) is adequate.

21. As the ISSAIs do not foresee the fixing of precise “pervasiveness thresholds”, the consequences of different professional judgments of the Court will be illustrated hereafter on the basis of hypothetical examples of audit results (see also scenarios presented in table 3 of annex 2). Starting point of the examples is the hypothesis that the “grey zone” between a “substantial proportion” and a “non-substantial proportion” may lie somewhere between 20% and 30% of the overall amount of payments underlying the EU accounts.

(a) If the biggest or the second biggest policy groups were affected by material error, pervasiveness would always be given if the Court considered 27% as being a substantial part of the overall population of payments.

(b) As long as the Court considers that policy groups affected by a material level of error should not exceed 26% of the overall population, it would be sufficient for rejecting pervasiveness if the three biggest policy groups were characterized by a most likely error rate below 2%. If the accepted maximum was 20%, the three biggest policy groups plus one other (with the exception of the smallest) would be necessary.

Combination of the first and second step: Conditions for a meaningful determination of pervasiveness

22. It is self-evident that the two-step determination of pervasiveness on the basis of a single representative DAS sample (consisting of the minimum number of transactions) would not be in line with the requirements of the ISSAIs. Such an approach would, in general, provide reasonable assurance for estimating the most likely error of the payments underlying the EU accounts. But it would, in general, not provide sufficient appropriate evidence which allows assessing whether:

(a) The material level of error is confined to specific elements, accounts or items of the EU accounts; or,

(b) If so confined, the total financial volume of problem areas represents a substantial proportion of the overall population.

23. Furthermore, the examples of the section above show that bigger policy groups have an over-proportional importance for the determination of pervasiveness. In extreme cases, imbalances between the financial volumes of the different policy groups could even make the results of the combined determination of the first and second aspect of pervasiveness meaningless.

24. From the perspective of being able to determine pervasiveness in a clear and consistent manner, the introduction of the new structure of policy groups has to be considered as a positive step because the imbalances between the financial volumes of the different policy groups have been reduced. In addition, the Court will obtain more audit evidence allowing distinguishing between problem areas and areas for which the risk of error is adequately managed.

25. The implementation of a too rigid, mechanic approach for determining pervasiveness on the basis of

(a) A fixed number of policy groups affected by a material level of error as compared to the total number of policy groups; and

(b) A fixed percentage for the proportion of the overall financial volume of policy groups affected by a material level of error as compared to the overall population of payments underlying the EU accounts would not be adequate. Instead a high degree of professional judgment has to be applied which takes into account the structure of the policy groups and all audit results obtained. Particular attention has to be given to the financial volume of policy groups affected/not affected by error.

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44 This is due to the fact that the most likely error rates for the new policy groups Agriculture and European Social Fund, contrary to the policy groups in which they were included before, are below 2%.

45 The only quantified information was identified concerning the US Government Accountability Office. For example, it considered in its report GA-10-637T “Centres for Medicare and Medicaid Services – Pervasive Internal Control Weaknesses hindered Effective Control Management”. “Our October 2009 report identified pervasive deficiencies in internal control over contracting and payments to contractors ... Based on the results of our work, we are 95 percent confident that the percentage of contract actions did not meet three or more control tests is at least 37.2 percent.” (see page 6, footnote 18).

46 E.g. types of management modes, supervisory and control systems.

47 E.g. effectiveness of supervisory and control systems, types of payments affected by a material level of error.
**Relation between materiality and pervasiveness**

26. In the exposure process of ISA 705, which forms an integral part of ISSAI 1705, the IAASB did not support the view presented by a few respondents “that the concept of materiality needed to be incorporated into the definition of pervasive; in developing the requirements in ED-ISA 705, the IAASB had previously considered whether the word ‘material’ should be subsumed into ‘pervasive’; however the IAASB agreed that in practice the phrase ‘material and pervasive’ was frequently used and well understood.”

27. The methodology underlying the new ISSAIs concerning necessary modifications to audit opinions requires therefore clearly an independent analysis of both the level of error (in order to determine whether the materiality threshold is exceeded) and the spread of error (which takes into consideration pervasiveness). However, a determination of pervasiveness is only necessary in cases where a material level of error has been identified.

28. A combined assessment of these two aspects (for example by introducing a link between the level of the most likely error and the number of policy groups or the proportion of the overall population affected by material error considered as being compatible with non-pervasiveness) would not respect the requirements of ISSAIs 1705 and 4200.

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48 Paper of IFAC, “Basis for Conclusions: ISA 705 (Revised and Redrafted), Modifications to the Opinion in the Independent Auditor’s report”, (paragraph 9).
## Impact of pervasiveness on the type of opinion to be expressed

<table>
<thead>
<tr>
<th>Nature of matter giving rise to a modification</th>
<th>Courts judgment about the effects or possible effects on the EU accounts/Transactions underlying the EU accounts</th>
</tr>
</thead>
</table>
| EU accounts are materially misstated / Transactions underlying the EU accounts are materially affected by error | Material but not pervasive: Qualified opinion  
Material and pervasive: Adverse opinion |
| Inability to obtain sufficient appropriate audit evidence | Material but not pervasive: Qualified opinion  
Material and pervasive: Disclaimer of opinion |

*Source: The table contained in paragraph A1 of ISSAI 1705 has been adapted to the subject matters of the Court’s DAS, as defined in Article 287 TFEU.*
### Table 1: DAS 2010 Results - Policy groups as in Annual Report 2010

<table>
<thead>
<tr>
<th>Policy Group</th>
<th>Payments in 2010</th>
<th>% of total payments</th>
<th>Material level of error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture and Natural Resources</td>
<td>56 841,00</td>
<td>47%</td>
<td>x</td>
</tr>
<tr>
<td>Cohesion, Energy and Transport</td>
<td>40 630,00</td>
<td>33%</td>
<td>x</td>
</tr>
<tr>
<td>External Aid, Development and Enlargement</td>
<td>6 543,00</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Research and other Internal Policies</td>
<td>8 953,00</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>Administrative and other expenditure</td>
<td>9 264,00</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>122 231,00</strong></td>
<td><strong>100%</strong></td>
<td></td>
</tr>
</tbody>
</table>

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 (1)

<table>
<thead>
<tr>
<th>Policy Group</th>
<th>Payments in 2010</th>
<th>% of total payments</th>
<th>Material level of error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>43 990,00</td>
<td>36%</td>
<td>x</td>
</tr>
<tr>
<td>Rural Development, Environment, Fisheries and Maritime Affairs, Health and Consumer Protection</td>
<td>12 851,00</td>
<td>11%</td>
<td>x</td>
</tr>
<tr>
<td>European Regional Development Fund, Energy and Transport</td>
<td>33 554,00</td>
<td>27%</td>
<td>x</td>
</tr>
<tr>
<td>European Social Fund</td>
<td>7 076,00</td>
<td>6%</td>
<td>x</td>
</tr>
<tr>
<td>External Aid, Development and Enlargement</td>
<td>6 543,00</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Research and other Internal Policies</td>
<td>8 953,00</td>
<td>7%</td>
<td></td>
</tr>
<tr>
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<td>9 264,00</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>122 231,00</strong></td>
<td><strong>100%</strong></td>
<td></td>
</tr>
</tbody>
</table>

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%

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(1) 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.
2. RELIABILITY OF THE ACCOUNTS

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Section 2 - Planning

Section 3 - Examination

Section 4 - Reporting

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Appendix II - Example of a representation letter regarding the reliability of the financial statements (provisional annual accounts 2010)
PART 2. RELIABILITY

SECTION 1 - FRAMEWORK

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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 accounts 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.

The objective of the auditor is to obtain reasonable assurance about whether the accounts as a whole are free from material misstatement, whether due to fraud or error, and to report on the accounts 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:

- 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\(^4^9\) 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:

- comply with relevant ethical requirements, as required by Court Audit Policies and Standards;
- plan and perform an audit with an attitude of professional scepticism, recognising that the accounts may be materially misstated;
- obtain sufficient appropriate audit evidence to have reasonable assurance regarding the audit conclusion and opinion.

1.5 GENERAL OBJECTIVE OF AN AUDIT OF RELIABILITY

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 (available on Budgweb\(^5^0\)), which are derived from the International Public Sector Accounting Standards.

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\(^4^9\) The accounting rules are applicable to those institutions and entities included in the consolidation perimeter.

\(^5^0\) Budgweb: http://intracomm.cec.eu-admin.net/budg/index_en.html.
(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.

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:

(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.  

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.
(b) Assertions about account balances at period-end

Existence—an 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 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.

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

1.6.1 Specific elements of the accounts to be audited

The specific elements of the accounts to be audited are as follows:

(i) Economic Outturn Account:

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) Balance Sheet

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) **Statement of Cash Flows**
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.
PART 2. RELIABILITY

SECTION 2 – PLANNING

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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

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

The auditor plans to undertake the following steps in the audit of reliability of the 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 Court issues a separate and explicit opinion on the reliability of the accounts.
2.2 DETERMINING MATERIALITY

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

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.

2.2.2 Quantitative and qualitative materiality regarding reliability

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.

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.
2.2.3 Material items in the accounts

Since accruals-based accounting was adopted in 2005 by the Union’s institutions, agencies and executive agencies, offices and similar bodies, some new items have appeared in the balance sheet, which now recognises the assets and liabilities independently of the cash recovery or disbursement. For example, a liability must be recognised by the Commission towards a contractor who completed a service at year-end, even though no invoice had yet been received. Those new items (pre-financing, invoices to be paid, and the cut-off of accrued charges) are significant elements, as their amount is generally material.

2.3 IDENTIFYING AND ASSESSING RISKS THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT, INCLUDING ITS INTERNAL CONTROL

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

Definition of audit risk

Audit risk for reliability is the risk that the Court 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:
The auditor should identify and assess the risks of material misstatement at the 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 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 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").

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).

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**

<table>
<thead>
<tr>
<th>Area</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity structure</td>
<td>Changes in the entity such as reorganisation or unusual events</td>
</tr>
<tr>
<td></td>
<td>Complex alliances or joint ventures</td>
</tr>
<tr>
<td>Transactions</td>
<td>Significant transactions with related parties</td>
</tr>
<tr>
<td></td>
<td>Significant amount of non-routine or non-systematic transactions at period-end</td>
</tr>
<tr>
<td>Accounting</td>
<td>Application of new accounting rules or pronouncements (e.g. introduction of accrual accounting)</td>
</tr>
<tr>
<td></td>
<td>Accounting measurements that involve complex processes</td>
</tr>
<tr>
<td></td>
<td>Events or transactions involving significant measurement uncertainty, including accounting estimates</td>
</tr>
<tr>
<td>Personnel</td>
<td>Lack of personnel with appropriate accounting and financial reporting skills</td>
</tr>
<tr>
<td></td>
<td>Changes in key personnel, including departure of key executives, staff rotation</td>
</tr>
<tr>
<td>Information Technology (IT)</td>
<td>Changes in the I.T. environment</td>
</tr>
<tr>
<td></td>
<td>Installation of significant new IT systems for financial reporting (e.g. ABAC)</td>
</tr>
<tr>
<td></td>
<td>Insufficient controls over data transfer between IT systems</td>
</tr>
<tr>
<td>Past or current problems</td>
<td>History of misstatements or significant adjustments at period-end</td>
</tr>
<tr>
<td></td>
<td>Weaknesses in internal control, especially those not addressed by management</td>
</tr>
<tr>
<td></td>
<td>Enquiries into the entity by regulatory or government bodies</td>
</tr>
<tr>
<td></td>
<td>Pending litigation and contingent liabilities</td>
</tr>
</tbody>
</table>

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 accounts and proper disclosure in the annual accounts. In particular, in the case of the Commission, the Accounting Officer is directly responsible for the 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.

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 annual accounts comprise:

- the financial statements, which consist of:
  - the Balance Sheet(s);
  - the Economic Outturn Account, including segment reporting;
  - the Statement of Cash Flows;
  - the Statement of Changes in Net Assets;
  - the Notes to the Accounts;

- the report(s) on implementation of the budget
  - the Budgetary Outturn Account (Aggregate Reports for the European Union general budget);
  - the Notes.

Some of the main items in the accounts are:

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: 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: 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. (Details of the various cut-off methodologies per DG are available from the ARR Unit.)

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.

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 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.

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.

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:

### Control systems to be considered:

#### - 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”.

**Accrued charges:**
- **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.
- **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

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 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

The audit procedures employed to obtain audit evidence regarding reliability include:

<table>
<thead>
<tr>
<th>Procedure</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computation</td>
<td>- arithmetic check of the accounts</td>
</tr>
<tr>
<td></td>
<td>- verification of the correctness of consolidation, where appropriate</td>
</tr>
<tr>
<td></td>
<td>- 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</td>
</tr>
<tr>
<td></td>
<td>- agree figures, e.g. to trial balance and general ledger</td>
</tr>
<tr>
<td>Analysis</td>
<td>- analytical review of the consistency of the accounts</td>
</tr>
<tr>
<td></td>
<td>- analysis of reconciliations performed by the entity, e.g. bank reconciliations</td>
</tr>
<tr>
<td></td>
<td>- analysis of accounting rules and policies</td>
</tr>
<tr>
<td></td>
<td>- analysis of valuation methods</td>
</tr>
<tr>
<td></td>
<td>- analysis of budgetary execution</td>
</tr>
<tr>
<td>Inspection</td>
<td>- records and documents</td>
</tr>
<tr>
<td></td>
<td>- tangible assets</td>
</tr>
<tr>
<td>Confirmations</td>
<td>- confirmation (circularisation) of bank balances, debtors, creditors</td>
</tr>
<tr>
<td></td>
<td>- confirmation with third parties (e.g. legal counsel for outstanding court cases that may need to be disclosed as contingencies)</td>
</tr>
</tbody>
</table>
2.5 DESIGNING AUDIT PROCEDURES

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.

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2.5.1 Relating the assessed risk of material misstatement to 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:
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 reliability 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% for the EU consolidated balance sheet);
- 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
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-financements 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 DRAWING UP THE AUDIT PLANNING MEMORANDUM AND AUDIT PROGRAMME

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.

2.6.1 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

SECTION 3 – EXAMINATION

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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

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

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.

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:

(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:

(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;

(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;

(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 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.

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

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.

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. (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 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

**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.*

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.*

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:*

(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

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.

“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.

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.

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.

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.

The auditor should evaluate whether the estimates and related disclosures are reasonable or misstated.

### 3.7.2 Subsequent events

**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:

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.

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 Court’s Legal Service.

In the public sector, once the financial statements have been issued they cannot be revised and the auditor’s report cannot be reissued. Thus, 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

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.

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.

(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.

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

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**;
- **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**.

Audit findings **should** be cleared through the SPF process, as outlined in [Chapter 3.8 of the general part of this manual](#).
PART 2. RELIABILITY

SECTION 4 – REPORTING

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4.2 Statement of Assurance – Forming an audit opinion

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4.4 Emphasis of Matter and Other Matters Paragraphs

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4.1 REPORTING – OVERVIEW

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.

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 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.

4.2.1 Introduction

The main output of audits of the reliability of the accounts is a Statement of Assurance.

However, the reliability of the 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.
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 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 annual accounts are prepared and presented, in all material respects, in accordance with the specific 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 annual accounts adequately disclose the significant accounting policies selected and applied, and significant interpretations by management of regulatory or legal requirements;
- 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 annual accounts is relevant, reliable, comparable and understandable;
- the annual accounts provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the annual accounts, meaning the entity's
financial position, financial performance and cash flows;
• the terminology used in the annual accounts, including their titles, is appropriate;

(d) the annual accounts achieve fair presentation, including consideration of:
• the overall presentation, structure and content of the annual accounts; and
• whether the annual accounts, including the related explanatory notes, faithfully represent the underlying transactions and events in a manner that achieves fair presentation;

(e) the 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 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 annual accounts as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor’s evaluation whether the 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 annual accounts in accordance with the applicable financial reporting framework and adequately describing that framework in the annual accounts. That description is important because it advises users of the annual accounts of the framework on which the annual accounts are based.

A description that the annual accounts are prepared and presented in accordance with a particular applicable financial reporting framework is appropriate only if the annual accounts comply with all the requirements of that framework effective on the date of the 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\textsuperscript{52}. The latter states that, when adopting such rules the accounting officer shall be guided by the internationally accepted accounting standards for the public sector but may depart from them where justified by the specific nature of the Union's activities.

A description of the applicable financial reporting framework that contains imprecise qualifying or limiting language (e.g. “the 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 annual accounts.

### 4.2.7 Fair presentation

There may be cases where the 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 2010 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.

\textsuperscript{52} Financial Regulation, Article 133.
4.3 MODIFIED OPINIONS

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
(b) when the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the annual accounts are free from material misstatement.

4.3.1 Nature of material misstatements

A material misstatement of the 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 annual accounts, i.e. (i) all required disclosures are not included; (ii) disclosures in the annual accounts are not presented in accordance with the applicable financial reporting framework; or (iii) the annual accounts do not provide the disclosures necessary to achieve fair presentation.
4.3.2 Pervasiveness of the matter(s) giving rise to a modification

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 annual accounts, or if confined, the misstatements represent or could represent a substantial proportion of the annual accounts; or (ii) in relation to disclosures, when the misstated disclosures are fundamental to users’ understanding of the 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 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 annual accounts.
4.3.3 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.
4.3.4 Form and content of the auditor’s report when the opinion is modified

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

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 appropriate to draw users’ attention to a matter presented or disclosed in the annual accounts, or to any other matter which may be relevant to his/her understanding of the annual accounts or the audit.

4.4.1 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.

4.4.2 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.

4.5 COMPARATIVE INFORMATION

The objective of the auditor is to obtain sufficient appropriate audit evidence about whether the comparative information included in the annual accounts complies, in all material respects, with the applicable financial reporting framework.

4.5.1 Introduction

Comparative information represents the amounts and disclosures included in the 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 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.

4.5.2 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:

(a) the comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated; and

(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.

4.5.3 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 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 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 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 annual accounts, modified with respect to the
corresponding figures included therein.
When the prior period 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 COURT

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:

<table>
<thead>
<tr>
<th>Audit scope</th>
<th>Format of audit report</th>
<th>Legal base for the audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>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 121)</td>
<td>Statement of Assurance (SoA) opinion + supporting observations</td>
<td>Art 287 of the Treaty on the Functioning of the European Union</td>
</tr>
<tr>
<td>Financial statements and report on financial implementation of the European Development Funds (EDF FR Article 96)</td>
<td>SoA opinion + supporting observations</td>
<td>Art 287 (by analogy) and EDF Financial Regulation</td>
</tr>
<tr>
<td>Accounts of the European Schools</td>
<td>Report on the accounts</td>
<td>Financial Regulation of the Schools, Art 78</td>
</tr>
<tr>
<td>Accounts of agencies, offices and other bodies</td>
<td>SoA-type opinion</td>
<td>Relevant Council Regulation for each agency and satellite body</td>
</tr>
</tbody>
</table>
APPENDIX II

Example of a representation letter regarding the reliability of the financial statements
(provisional annual accounts 2010)

(Entiy Letterhead)

To the President of the European Court of Auditors

Subject: Representation letter: provisional annual accounts for 2010

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 2010 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 2010 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 2010 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

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)
3. COMPLIANCE WITH APPLICABLE LAWS AND REGULATIONS

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PART 3. COMPLIANCE

SECTION 1 - FRAMEWORK

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1.2 Legal requirements for the Court 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.

<table>
<thead>
<tr>
<th>ISSAI 1250 [ISA 250]</th>
<th>The objectives of the auditor in performing audit of the reliability of financial statements are:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>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;</td>
</tr>
<tr>
<td></td>
<td>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;</td>
</tr>
<tr>
<td></td>
<td>c) to respond appropriately to non-compliance or suspected non-compliance with laws and regulations during the audit.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ISSAI 4200</th>
<th>The objectives of the auditor in performing compliance audit in connection with the audit of financial statements are to:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>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</td>
</tr>
<tr>
<td></td>
<td>b) report the findings and judgments to the legislature or other bodies, as appropriate.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ISSAI 4100</th>
<th>The objective of the auditor in performing separate compliance audits are to:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>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;</td>
</tr>
<tr>
<td></td>
<td>b) report the findings and judgments to the legislature or other bodies, as appropriate.</td>
</tr>
</tbody>
</table>

### 1.2 LEGAL REQUIREMENTS FOR THE COURT TO CONDUCT COMPLIANCE AUDITS

The Court has the authority to conduct two different types of compliance audit:
(i) Legality and regularity audits

Article 287 of the TFEU requires the Court 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 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 the Court 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 the Court, 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 the Court to carry out selected compliance audits. Such compliance audits are undertaken on the basis of their priority, as determined by the Court, 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, relevant to the various phases of compliance audit, and have thus been used by analogy for the material contained in this compliance part of the manual.

ISSAI 4000 Series, which address the Compliance Audits, are also applicable in the context of the Court’s compliance audit work.

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 the Court to be applicable, as providing opinions by policy group 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.

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.

The objectives of selected compliance audits will vary, depending on the subject matter.
1.5 LEGALITY AND REGULARITY AUDITS

1.5.1 Definition of underlying transactions

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.

The Court 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.

The transactions underlying the accounts 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.

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.

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 accounts for expenditure/expenses.

53 [Text provisionally agreed by the CEAD Chamber on 5 April 2011 (see minutes and CH 122/11).]
balance sheet or as an expense in the economic outturn account.

The Court is able to make a valid and robust judgment on the legality and 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/regularity part of the DAS and the audit approach to be applied will be determined by the vertical Audit Chambers together with the CEAD Chamber when preparing the different DAS APMs.

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/regularity part of the DAS 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, the CEAD-B Directorate will provide further guidance on sampling and extrapolation.

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 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

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54 After all legal remedies have been exhausted (see Article 85a of implementing rules of the Financial Regulation).
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 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 Education and Citizenship policy groups, 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 CEAD-B’s ASC Unit 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

Criteria for the legality 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.

Irregularity means 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 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)).

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, the Court does not make a distinction between the two concepts. Thus, the Court 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 Measures), 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\(^{55}\). 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\(^{55}\).

\(^{55}\) Article 76 of the Financial Regulation.
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.

**Figure 1: Requirement for double legal basis and budgetary appropriations**

56 See Article 49 of the Financial Regulation.
1.5.4 General and specific objectives of an audit of legality and regularity

**General objectives**

The general audit objective for an audit of the legality and regularity of underlying transactions is to determine whether, *in all material respects*, the underlying transactions are legal and regular.

**Assertions**

The specific objectives, or assertions, for which the auditor should ultimately draw conclusions are:

- **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.
PART 3. COMPLIANCE

SECTION 2 - PLANNING

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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

The objective of the auditor is to plan the audit so that it is carried out in an effective manner.

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:

- **Structure**
  - complex structure: 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;

- **Rules**
  - complex rules 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;

- **Many beneficiaries**
  - a high percentage of the payments made is based on claims submitted by many and diverse final beneficiaries in the Member States and some even in third countries. This further highlights the need for good planning in 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.

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.

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.

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 the Court's compliance audits may be:

- defined by the legal framework;
- determined by the Court for selected compliance audits. The auditee should be informed, in keeping with the Court's "no surprises" approach.
2.2 DETERMINING MATERIALITY

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 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, the Court applies extrapolation.

2.2.2 Quantitative materiality

Determining quantitative materiality involves a judgment as to the maximum level of non-compliance that is acceptable. It is the Court'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 policy group or total revenue of the EU budget;
- for the EDF, the materiality threshold is set at 2% of the total expenditure or total revenue of the EDF 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 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 the Court's report. Issues that are material by nature or context are to be disclosed; however, only in exceptional cases, to be decided by the Court, 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%.

If the most likely error rate exceeds 2%, the internal control system is rated
either “partially effective” or “not effective”. The classification depends on the extent to which the internal controls prevent or detect and correct inherent errors. The ICS is “partially effective” if the controls eradicate many errors but not enough for the most likely error rate to fall below 2%. The ICS is rated “not effective” if the controls do not eradicate many errors and the error rate is above 2%.

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\textsuperscript{57}.

### 2.3 IDENTIFYING AND ASSESSING RISKS THROUGH UNDERSTANDING THE AUITEE AND ITS ENVIRONMENT

**ISSAI 1315**

The objective of the auditor is to identify and assess the risks of material non-compliance with applicable laws and regulations, through understanding the entity’s laws and regulations, thereby providing a basis for designing and implementing audit procedures.

#### 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;

\textsuperscript{57} 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 \((0.2 \cdot >10\% = >2\%)\).
• 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 European Commission’s Annual Management Plan (AMP) contains the critical risks identified for the Directorate-General (DG) concerned;
• the information in the Commission's synthesis report and the Annual Activity Reports (AARs) and declarations by the Directors-General for the preceding financial year(s), provided that these are confirmed by the Court'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 analyses and the related risk management action plans;
• relevant reports by the various control bodies of the Commission (including the Internal Audit Service - IAS - and the Internal Audit Capabilities - IACs) and Member States, or other auditors;
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.

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 59) 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.

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 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.

Some risk factors and potential mitigating controls that the auditor may consider are:

**Table 1: Risks to compliance and related controls**

<table>
<thead>
<tr>
<th>Risk</th>
<th>Description</th>
<th>Mitigating controls</th>
</tr>
</thead>
</table>
| 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. | • Agreed and documented procedures for the translation of statutory requirements into operating instructions.  
• 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 lose 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 claims.  
• Physical inspection of claimants’ records, etc. to confirm eligibility.  
• Procedures for assessing the financial standing of claimants before awarding a grant and for monitoring continuing solvency.  
• Independent certification of the application of grant by an external auditor. |
2.4 CONSIDERING THE SUFFICIENCY, RELEVANCE AND RELIABILITY OF AUDIT EVIDENCE

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 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.

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.

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

- 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.

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**
  - arithmetic checks of amounts, e.g. on an invoice;

- **Analysis**
  - analytical review of the consistency of expenditures compared to budget or prior years;
  - analysis of decisions to check compliance with rules and regulations;

- **Inspection**
  - invoices, records and documents;
  - tangible items, e.g. livestock, bridges and roads.
2.5 DESIGNING AUDIT PROCEDURES

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.

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, the Court's deadlines for issuing compliance audit 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

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

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

<table>
<thead>
<tr>
<th>Central level (e.g. Commission)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Legal Base</td>
</tr>
<tr>
<td>For any &quot;significant Union action&quot;, the existence of the required legal base (e.g. the TFEU; Financial Regulation; Interinstitutional Agreement; Council Decision; Council Regulation; Commission Regulation; Council Directive).</td>
</tr>
<tr>
<td>2(a). Selection Procedure – direct expenditure (where applicable)</td>
</tr>
<tr>
<td>• Compliance with the regulations on calls for tender.</td>
</tr>
<tr>
<td>• Respect of the principles of proportionality, transparency, equal treatment and non-discrimination as laid down in the Financial Regulation.</td>
</tr>
<tr>
<td>• The coherence and consistency of the contracts and any amendments with the selection procedures (call for tender, evaluation report, recommendations for selection, etc.).</td>
</tr>
<tr>
<td>2(b). Selection Procedure – grants (where applicable)</td>
</tr>
<tr>
<td>Call for proposals, eligibility criteria, evaluation committee recommendation and authorising officer decision.</td>
</tr>
<tr>
<td>3. Financing decision, budgetary and legal commitment</td>
</tr>
<tr>
<td>• The adoption of the financing decision before any budgetary commitment.</td>
</tr>
<tr>
<td>• The existence of the budgetary commitment prior to a legal commitment.</td>
</tr>
<tr>
<td>• The grant agreement includes the elements required and is dated and signed by the duly authorised official.</td>
</tr>
<tr>
<td>4. Payment authorisation</td>
</tr>
<tr>
<td>• Payment in accordance with the specifications of the related budgetary commitment (supporting documentation) and paid by the regulatory deadline.</td>
</tr>
<tr>
<td>• 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.).</td>
</tr>
<tr>
<td>• The payment instruction refers to the correct recipient (name and bank account).</td>
</tr>
<tr>
<td>• The payment was actually processed (bank statement).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Member State, intermediary and final beneficiary level (to the extent applicable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Claims exist and eligibility requirements are satisfied.</td>
</tr>
<tr>
<td>• Project receipts (including interest on pre-financing) are correctly declared and calculated; cofinancing requests are correctly calculated.</td>
</tr>
<tr>
<td>• Respect of contractual provisions (e.g. regarding subcontracting, payment delays, allocation funds within the consortium, etc.).</td>
</tr>
<tr>
<td>• Contractually agreed deliverables.</td>
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</table>
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 the Court's reports.

Errors detected and corrected on the initiative of the audited entity, independently of the checks carried out by the Court, are not taken into account, since they demonstrate that the internal control system works efficiently. 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

ISSAI 1300
[ISA 300]

The objective of the auditor is to establish the overall strategy for the audit in the Audit Planning Memorandum, and to develop an audit programme in order to reduce audit risk to an acceptably low level.

Guidance on the content of the APM is given in Chapter 2.6 of the general part of the manual.
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

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

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

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 Union contribution; in cases of co-financing (mainly with the Member States), a distinction is made between the proportion financed by the Union...
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 DAS audits the Court's electronic support system automatically calculates the amount and percentage error based on the input of identified information.

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.

Errors detected 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;
3. whether errors are:
   - “serious” (exceeding 2% of the whole payment or an important proportion affected);
   - “limited” (between 0.5% and 2%, or a significant proportion of the payment affected); or
   - “insignificant”;
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 Court, are not taken into account in the DAS, since they demonstrate the efficient working of the Community 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

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
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

For example, regarding the DAS legality and regularity audits, such representations are made in the representation letter for the European Union's annual accounts, signed by the Accounting Officer in the Commission's Synthesis Report, Annual Activity Reports (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 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 regarding particular assertions.
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

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<th>ISSAI 1600 [ISA 600]</th>
<th>Using the work of another auditor</th>
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<tr>
<td>ISSAI 1610 [ISA 610]</td>
<td>Using the work of an internal auditor</td>
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<tr>
<td>ISSAI 1620 [ISA 620]</td>
<td>Using the work of an auditor’s expert</td>
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</tbody>
</table>

3.6.1 Using the work of another auditor

*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.*

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

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.

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

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.

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 the Court, 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 the Court's requirements regarding the engagement of auditor's experts.
3.7 OTHER AUDIT PROCEDURES

3.7.1 Subsequent Events

3.7.2 Related Parties

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.

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.

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

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<th>ISSAI 1260</th>
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<th>ISSAI 1705</th>
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<tr>
<td>[ISA 260]</td>
<td>[ISA 265]</td>
<td>[ISA 705]</td>
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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;
- 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.

Audit findings should be cleared through the SPF process, as outlined in Chapter 3.8 of the general part of this manual.
PART 3. COMPLIANCE

SECTION 4 - REPORTING

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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 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 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 annual accounts of the European Union, it may also be published as a stand-alone document together with the annual accounts of the auditee.

The Statement of Assurance contains an opinion on the legality and regularity of transactions underlying the annual accounts of the auditee.

In the case of the Court’s Annual Report on the implementation of the EU general budget, the Court may give separate opinions on the legality and regularity of transactions underlying the annual accounts for each policy group. 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

The objectives of the auditor are to:
form an opinion on the legality and regularity of the transactions underlying the annual accounts based on an evaluation of the conclusions drawn from the audit evidence obtained;
express clearly that opinion through a written report that explains the basis of the opinion.

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
4.2.1 Introduction

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 policy group) are free from material errors and irregularities. This conclusion should take into account his/her evaluation as to whether:

(a) sufficient appropriate audit evidence has been obtained;

(b) identified errors or irregularities are material, individually or in aggregate;

(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 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:

- 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 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 2010 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

**ISSAI 1705 [ISA 705]**

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.

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:

(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.

(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

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 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 appropriate 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 the Court’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, the Court'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.

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 annual accounts of the European Union, there is a specific assessment for each policy group, 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
4.7.1. Introduction
4.7.2 Form and content of special audit reports

4.7.1 Introduction

The form of special (non-DAS) 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
h) 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

When significant amounts of data are included to support audit findings, such data should be more appropriately included in appendices.

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.

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.

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
1. Under Article 317 of the TFEU, the Commission is responsible for the implementation of the Union’s budget in cooperation with the Member States and therefore for:
   a.) forecasting (planning);
   b) organising implementation;
   c) monitoring implementation;
   d) reporting.
2. 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\textsuperscript{58}, Union expenditure passes through an inordinate number of systems. Due to limited resources, the Court can only evaluate a very limited number of management systems per year and cannot reach any overall conclusions.
3. 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 the Court to monitor the development of the situation in each field from one year to the next.

\textsuperscript{58} EAGGF - Guarantee and Structural Funds in particular.
4. 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 the Commission with the information it needs to guarantee that objectives are achieved in accordance with the relevant legal, regulatory and/or contractual provisions.

5. 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

6. 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/regularity of the underlying operations.

7. 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 the Court 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.

8. 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

9. 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.\(^{59}\). A warning system must be introduced to notify existing inadequacies and remedy them.

10. 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**

11. 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.

12. 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".

13. 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. The annual work programme of the internal audit capabilities must also be based on risk assessment. It is in the areas where risks are high that the supervisory and control systems must be examined in detail.

14. 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, their own internal audit capabilities and the Court, as well as the measures taken in response to these reports. They must then draw up action plans aimed atremedying the shortcomings and monitoring the implementation of these plans. The Court 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**

15. 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:

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\(^{59}\) See the Commission's internal control standards.
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 the Court can obtain from them for the field as a whole.

16. Thus, the following elements must be included in the sectoral APMs:

a) the actual audit programmes, procedures and work carried out by the Commission departments\(^\text{60}\) 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*

17. 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.

18. 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 Community level\(^\text{61}\) 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 15.

*Key control objectives*

19. Given the size and complexity of the operations financed by the Community 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.

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\(^{60}\)Where applicable, the departments of other institutions.

\(^{61}\)These are systems provided for in the Regulations which do not overlap directly with the elements introduced by the reform of the Commission.
20. In order to guarantee sufficient coverage and a consistent approach to analysis by the Court’s various audit units/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).

Key control objectives

<table>
<thead>
<tr>
<th>Key objective</th>
<th>Elements to be covered by the supervisory and control systems</th>
<th>IFAC(1) terminology</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reality and measurement</td>
<td>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.</td>
<td>Occurrence/accuracy</td>
</tr>
<tr>
<td>Eligibility of the underlying transactions</td>
<td>Verify that the systems in place ensure that the various Community eligibility criteria are met for the underlying transactions.</td>
<td>Legality and regularity(2)</td>
</tr>
<tr>
<td>Compliance with other regulatory requirements</td>
<td>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 Community transactions, etc.</td>
<td>Legality and regularity(2)</td>
</tr>
<tr>
<td>Correctness of calculations</td>
<td>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.</td>
<td>Accuracy</td>
</tr>
<tr>
<td>Completeness and accuracy of accounting</td>
<td>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.</td>
<td>Completeness/Accuracy/Annuality</td>
</tr>
</tbody>
</table>

(1) This refers to the IFAC categories corresponding to the information contained in the financial statements.

(2) 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".

21. 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.

22. 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.

23. 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.

24. 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

25. 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.

26. 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 DAS 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.
27. 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."

Identification of a control deficiency/weakness of a supervisory and control system

28. 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.

29. 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".

\[^{62}\text{FECED, page 1.}\]
Decision tree 7: Evaluating exceptions found in the operating effectiveness of supervisory and control systems

Examine and understand cause, quality and results of exceptions. Was the objective of the control tests met (e.g. was the actual deviation rate less than or equal to the planned deviation rate or does the key control concerned have no link to the legality and regularity of underlying transactions)?

No

Considering the results of the control tests and the understanding of cause, quality and results of exceptions, could additional control tests support a conclusion that the observed exceptions are not representative of the whole population?

No

Extend tests of controls and re-evaluate. Was the test's objective met?

Yes

Negligible exception not to be considered as a control deficiency/weakness of the supervisory and control system

=

Supervisory and control system is excellent(1)

No

Control deficiency

=

Weakness of the supervisory and control system

(1) This preliminary result has to be corroborated with the result of substantive testing.
30. 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**

31. 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 DAS and the audit conclusion at the level of the specific assessments.
Decisions 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

1. Is the real or potential magnitude (in monetary terms) regards the audit opinion on the level of the DAS and the audit conclusion on the level of the specific assessment (error rate < 0.5%, financial volume of underlying transactions concerned < 0.25% of financial volume of relevant population)?
   - Yes
   - No

2. Are there compensating controls that were tested and evaluated that achieve the same control objective?
   - Yes
   - No

3. Would a prudent official conclude that the control deficiency/weakness of the supervisory and control system is at least a significant control deficiency/weakness of the supervisory and control system concerning the audit opinion on the level of the DAS and the audit conclusion on the level of the specific assessment?
   - Yes
   - No

   If insignificant control deficiency/weakness of the supervisory and control system:
   - Supervisory and control system is excellent

   If significant control deficiency/weakness of the supervisory and control system:
   - Supervisory and control system is poor

Step 2: Determine whether a material control deficiency/weakness of a supervisory and control system exists

1. Is the real or potential magnitude less than material in regards the audit opinion on the level of the DAS and the audit conclusion on the level of the specific assessment (error rate < 2%, financial volume of underlying transactions concerned < 10% of financial volume of relevant population)?
   - Yes
   - No

2. Are there compensating controls that were tested and evaluated that reduce the real or potential magnitude of errors in regards the audit opinion on the level of the DAS and the audit conclusion on the level of the specific assessment to less than material (error rate < 2%, financial volume of underlying transactions concerned < 10% of financial volume of relevant population)?
   - Yes
   - No

3. Do additional evaluation result in a judgment that the likelihood of material errors (error rate > 2%) as regards the audit opinion on the level of the DAS and the audit conclusion on the level of the specific assessment is remote?
   - Yes
   - No

   If significant control deficiency/weakness of the supervisory and control system:
   - Supervisory and control system is poor

   If material control deficiency/weakness of the supervisory and control system:
   - Supervisory and control system is poor
32. 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".

33. 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.

34. 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.

35. 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.

36. 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 DAS 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.

37. Given the experience acquired since the first DAS, 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".
38. 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".

39. 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.

40. 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

<table>
<thead>
<tr>
<th>Overall assessment of design effectiveness</th>
<th>Global evaluation of operating effectiveness (after completion of control tests)</th>
<th>Evaluation of exceptions found in testing operating effectiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excellent</td>
<td>Supervisory and control systems are designed in such a way as to provide a high expectation that operational failures will be prevented or detected</td>
<td>No control deficiency/weakness of supervisory and control system</td>
</tr>
<tr>
<td>Excellent</td>
<td>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</td>
<td>Objective of control tests was met (i.e. actual deviation rate was less than or equal to the planned deviation rate)</td>
</tr>
<tr>
<td>Good</td>
<td>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</td>
<td>Insignificant control deficiency/weakness of supervisory and control system</td>
</tr>
<tr>
<td>Good</td>
<td>Significant control deficiency/weakness of supervisory and control system</td>
<td>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</td>
</tr>
<tr>
<td>Poor</td>
<td>Control risk is too high for the auditor to rely on the supervisory and control system</td>
<td>Material control deficiency/weakness of supervisory and control system</td>
</tr>
<tr>
<td>Poor</td>
<td>Material control deficiency/weakness of supervisory and control system</td>
<td>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 significant but not material</td>
</tr>
<tr>
<td>Good</td>
<td>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</td>
<td>Significant control deficiency/weakness of supervisory and control system</td>
</tr>
<tr>
<td>Good</td>
<td>Significant control deficiency/weakness of supervisory and control system</td>
<td>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</td>
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</tr>
<tr>
<td>Poor</td>
<td>The design of the supervisory and control systems is inadequate</td>
<td>Material control deficiency/weakness of supervisory and control system</td>
</tr>
<tr>
<td>Poor</td>
<td>Real or potential magnitude of control deficiency/weakness of supervisory and control system is material</td>
<td>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 significant but not material</td>
</tr>
</tbody>
</table>

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)
Glossary of Terms and Acronyms

**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 Court 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 Court'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 Court'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 ISAs, are deemed appropriate in the circumstances (type of report envisaged, specific objectives and constraints, etc.) to achieve the objective(s) of the audit.

**AUDIT STRATEGY**

The audit approach and audit procedures selected to meet the objectives defined for a specific audit task, and set out in the APM.

**AUDIT TASK**

A discrete and identifiable piece of audit work which is intended to result in the Court issuing an opinion, report or contribution to a report.

**CASH-BASED ACCOUNTING**

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.

**COMPARATIVE FINANCIAL INFORMATION**

Corresponding amounts and other disclosures of the preceding financial period(s), presented for comparative purposes.

**COMPENSATING CONTROL**

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 control activities)

**COMPLETENESS**

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 audit objective and assertions)

**COMPLIANCE**

Activities, financial transactions and information are in accordance with the applicable laws and regulations.

**COMPUTATION**

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 audit procedure)

**COMPUTER-ASSISTED AUDIT TECHNIQUES (CAATs)**

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.
COMPUTERISED INFORMATION SYSTEM (CIS)  
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.

CONFIDENCE LEVEL  
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 Court’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.

CONFIRMATION  
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 audit procedure)

CONTROL ACTIVITIES  
The policies and procedures that help ensure that management directives are carried out, and are a component of internal control. Specific control activities include:
- authorisation;
- performance reviews;
- information processing;
- physical controls;
- segregation of duties. (see internal control)

CONTROL ENVIRONMENT  
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 internal control)

CONTROL RISK  
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 audit risk)

CORROBORATIVE EVIDENCE  
Evidence from a second source, which supports other evidence obtained.

CRITERIA  
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.

DETECTION RISK  
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 audit risk)

DISCLOSURE  
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 4th Council Directive, as well as by the needs of the users of financial statements.

ELIGIBILITY  
Declared costs are eligible in that all required conditions are fulfilled, time limits are respected, authorisations are properly given and procedures are correctly applied.

ENQUIRY  
Seeking information of knowledgeable persons, both financial and non-financial, inside or outside the audited entity. (see audit procedure)
ENTITY'S RISK ASSESSMENT PROCESS

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”.


**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 \textit{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 \textit{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**
An unqualified opinion cannot be expressed but the effect of any disagreement with management or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion.

**OPINION - ADVERSE**
When the effect of a disagreement is so material and pervasive that the auditor concludes that a qualification of the report is not adequate.

**OPINION – DISCLAIMER**
When the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is thus unable to express an opinion.

**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 \textit{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 \textit{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 \textit{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 \textit{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 \textit{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.

REPERFORMANCE

The auditor's independent execution of procedures or controls originally performed as part of the entity's internal controls.

SAMPLING RISK

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.

SAMPLING UNIT

The individual items constituting the population, e.g. invoices, debtors' balances, or monetary units.

SEGMENT INFORMATION

Information in the accounts regarding distinguishable components of an entity.

SELECTED AUDIT

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.

SIGNIFICANT RISK

A risk that requires special audit consideration.

STATISTICAL SAMPLING

Any approach to sampling that is based on random selection and the use of probability theory to evaluate results.

STRATIFICATION (OF THE POPULATION)

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 population)

SUBSEQUENT EVENTS

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.

SUBSTANCE OVER FORM

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.

SUBSTANTIVE PROCEDURES

Audit procedures used to obtain substantive audit evidence that is sufficient, relevant, and reliable. They include tests of details and substantive analytical procedures.

SUFFICIENT (AUDIT EVIDENCE)

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 audit evidence). The quantity needed is affected by its quality.
### Glossary of Terms and Acronyms

#### Tests of Controls
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 non-compliance (compliance audits).

#### Tolerable Error or Deviation
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.

#### Total Error
Either the rate of deviation, or total misstatement or non-compliance.

#### Uncertainty
A matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the accounts.

#### Valuation
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 audit objective)

### Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>AAR</td>
<td>Annual Activity Report</td>
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<tr>
<td>ABB</td>
<td>Activity Based Budgeting</td>
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<td>ABM</td>
<td>Activity Based Management</td>
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<tr>
<td>AMP</td>
<td>Annual Management Plan</td>
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<td>AP</td>
<td>Audit Programme</td>
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<td>APM</td>
<td>Audit Planning Memorandum</td>
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<tr>
<td>AR</td>
<td>Audit Risk</td>
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<tr>
<td>ASI</td>
<td>Average Sampling Interval</td>
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<tr>
<td>ASSYST</td>
<td>Audit Support System (the Court’s electronic tool)</td>
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<tr>
<td>AWP</td>
<td>Annual Work Programme</td>
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<tr>
<td>CAATs</td>
<td>Computer-Assisted Audit Techniques</td>
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<tr>
<td>CAPS</td>
<td>Court Audit Policies and Standards</td>
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<tr>
<td>CEAD</td>
<td>Coordination, Evaluation, Assurance, Development (Chamber of the Court)</td>
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<tr>
<td>CR</td>
<td>Control Risk</td>
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<tr>
<td>DAS</td>
<td>Statement of Assurance (from French Déclaration d’assurance)</td>
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<tr>
<td>DG</td>
<td>Directorate-General</td>
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<tr>
<td>DR</td>
<td>Detection Risk</td>
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<tr>
<td>EAGF</td>
<td>European Agricultural Guarantee Fund</td>
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<tr>
<td>EAGGF</td>
<td>European Agricultural Guidance and Guarantee Fund</td>
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<tr>
<td>EDFs</td>
<td>European Development Funds</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>FCAM</td>
<td>Financial and Compliance Audit Manual</td>
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<td>FR</td>
<td>Financial Regulation</td>
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<tr>
<td>Acronym</td>
<td>Term</td>
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<tr>
<td>IACs</td>
<td>Internal Audit Capabilities</td>
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<td>IAS</td>
<td>Internal Audit Service</td>
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<td>ICS</td>
<td>Internal Control System</td>
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<td>IFAC</td>
<td>International Federation of Accountants</td>
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<td>INTOSAI</td>
<td>International Organisation of Supreme Audit Institutions</td>
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<td>IPSASs</td>
<td>International Public Sector Accounting Standards</td>
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<td>IR</td>
<td>Inherent Risk</td>
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<td>ISAs</td>
<td>International Standards on Auditing</td>
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<tr>
<td>ISSAIes</td>
<td>International Standards of Supreme Audit Institutions</td>
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<tr>
<td>IT</td>
<td>Information Technology</td>
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<tr>
<td>KE</td>
<td>Known Error</td>
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<tr>
<td>LEL</td>
<td>Lower Error Limit</td>
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<tr>
<td>MLE</td>
<td>Most Likely Error</td>
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<tr>
<td>MRL</td>
<td>Management Representation Letter</td>
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<td>MUS</td>
<td>Monetary Unit Sampling</td>
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<tr>
<td>OLAF</td>
<td>The Commission's Anti-Fraud Office (<em>Office européen de lutte anti-fraude</em>)</td>
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<tr>
<td>PPS</td>
<td>Probability proportional to size</td>
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<td>RAL</td>
<td>an abbreviation of the French terminology “reste à liquider”</td>
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<tr>
<td>SAI</td>
<td>Supreme Audit Institution</td>
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<tr>
<td>SPF</td>
<td>Statement of Preliminary Findings</td>
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<tr>
<td>TFEU</td>
<td>Treaty on the Functioning of the European Union</td>
</tr>
<tr>
<td>UEL</td>
<td>Upper Error Limit</td>
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