The FP7 Audit Process Handbook

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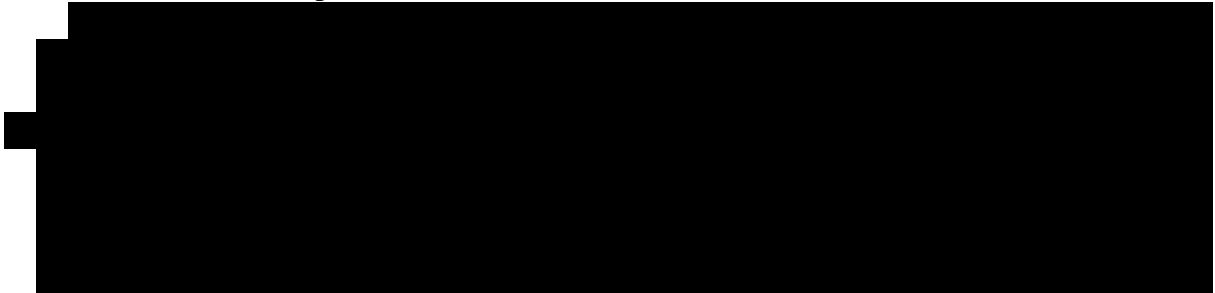
European Commission

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1 Introduction

1.1 Purpose of the Audit Process Handbook

The Audit Process Handbook (APH) constitutes the procedural manual **how to perform ex-post controls (external audits)** on the use of the research budget by beneficiaries of the EC, which are directly carried out by staff of the EC External Audit Services ("own-resource-audits"). In other words the APH navigates the auditor of the EC External Audit Services on how to carry out an audit engagement from the audit assignment & planning phase to the closure and communication of the audit results while respecting the principles and standards set for the external audit of EC research expenditure.

The APH determines the procedural aspects of the audit. It is valid for all external audit engagements under all relevant contractual provisions (i.e. different Research FP, Euratom, Coal & Steel). Therefore the APH is based on a modular concept; the different contractual provisions relevant for an individual audit engagement are included in individual modules related to the respective contractual basis ███████████████████████████

Please note that the Audit Process Handbook does not replace or substitute existing guidelines i.e. the FP7 Audit Manual. These manuals represent mainly interpretational and explanatory guidance on the specific contractual regulations as such and should be consulted and used during a respective audit engagement to familiarise with the contractual requirements and typical errors detected in external audits of these requirements. The Audit Process Handbook provides the procedural framework for the audit process ████████████████
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1.2 Use of the Audit Process Handbook

The APH assists or navigates the auditor to follow the (standard) audit process designed for external audits in EC research. This process is characterised by several phases related to activities to be performed by the auditor(s). In all phases specific procedures are foreseen

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Section 2 of the APH includes a description of the Audit Process to be performed. ████
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The sections 3 to 7 of the APH provide detailed explanation to the steps and procedures to be performed from the assignment to the closure of the audit. However, as the APH follows a modular concept, certain sections require the assigned auditor to customise the audit process relevant to the audit engagement. In other words: (s)he needs to select the relevant modules for the individual audit engagement (s)he intends to perform ████████████████

[REDACTED]

The respective sections of the APH include the information on which procedures [REDACTED] are valid for all audit engagements and which procedures have to be customised.

Standardised procedures and documents can not exist for all (individual) audit engagements. E.g. an audit engagement requires a specific Audit Programme which is not provided as a standard document. Nevertheless, for such audit engagements also the forms and procedures obtainable for 'standard' audit engagements might be taken as a reference for a customised procedure.

1.3 Constraints of and deviations from the Standard Audit Process

The standardised audit process and standard working procedures aim to ensure the performance of high quality audits which also guarantee accordance with the relevant principles and auditing standards of the External Audit Services.

However, standardised processes and procedures may not in all cases guarantee the optimal performance of the audit [REDACTED]. The APH does not replace the responsibility of the individual auditor to carefully plan and perform the audit engagement in accordance with the generally accepted audit standards.

Therefore, in individual cases, deviations from the standard audit process described in the APH might be appropriate. Nevertheless, significant deviations should be well considered, justified and documented and, where relevant, agreed in advance with the senior management of the External Audit Service.

Consequently the APH defines three categories of procedures and documents:

- Mandatory procedures [REDACTED]

- Recommended procedures [REDACTED]

  In these cases the auditor has to provide the justification for deviation and to ensure that the alternative procedure [REDACTED] used is
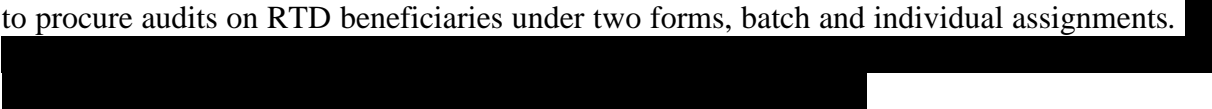
  o in accordance with the general principles and relevant standards,
  o appropriate to replace the recommended procedure [REDACTED]
  o sufficiently documented following the principles of documentation.

[REDACTED]

1.4 Outsourced Audit Engagements

By decision of the Head of the External Audit Service, Audit Engagements can be out-sourced to an external audit company.

The Commission therefore has concluded a framework contract which allows the Commission to procure audits on RTD beneficiaries under two forms, batch and individual assignments.

The Audit Process Handbook is in principle designed for audit engagements, which are directly carried out by staff of the EC External Audit Services ("own-resource-audits"). Specific procedures exist for the management and supervision of the outsourced audit engagements. Nevertheless, elements of the Standard Audit Process Handbook (e.g. the planning and closure procedures) may be useful and could be considered for these audit assignments.

2 The Audit Process for external Auditing in EC Research

2.1 Overview of the Audit Process

In the context of research frameworks-program projects, on-the-spot financial audits aim at verifying the beneficiary's compliance with the financial contractual provisions, in view of assessing the legality and regularity of the transaction underlying the implementation of the Union budget. The legal basis for the financial audit is usually included in one of the annexes to the grant agreement signed between the European Commission and the Beneficiary.[1]

The audit may also include the review of the system of internal controls of the beneficiary in order to assess whether it is adequate and sufficient to ensure that costs incurred by the beneficiary on EC-research funded projects are correctly allocated to those specific projects and recorded as such in the accounting records.

The Audit Process is composed of the following phases:

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        │      │   Audit Planning     │         │
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        │      ┌─────────────────────┐         │
        │      │  Audit Examination   │         │
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        │      │   Audit Reporting    │         │
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        │      └─────────────────────┘         │
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              ┌─────────────────────────────┐
              │ Implementation of Audit Result │
              └─────────────────────────────┘
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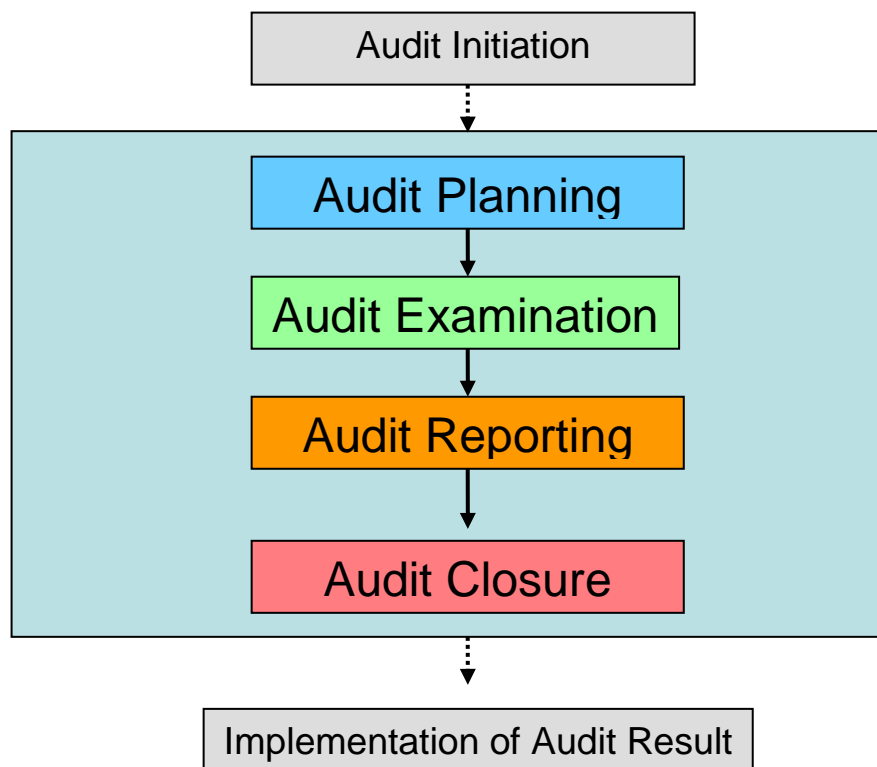
FLOWCHART AUDIT PROCESS

The overall Audit Process covers all stages following the decision to perform a certain, individual audit engagement taken by the management of the external audit service (Audit Decision) until the (formal) closure of the audit including several inherent quality controls (see section 2.3).

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[1] E.g. in Annex II to the contract under FP7

Questions related to the overall selection of audit assignments in the context of the audit strategy and the implementation/ follow-up of audit results are not part of the Audit Process as defined for this Handbook.

The overall audit process is further detailed in the following section. Individual phases of the audit process are outlined in the sections 4-7 of the APH.

2.2 The Audit Process ████████

The audit process requires a number of procedures and actions to be performed in the various phases. ███
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2.3 Process workflow and responsibilities of the parties involved

2.3.1 Involved parties within the External Audit Service ('internal parties')

In most audits during the core work of the audit (examination (2) and reporting (3)) the auditor (respectively the audit team) will be the sole party involved. Occasional needs for support by other parties such as colleagues or administrative support (secretariat or back-office) may arise but will be limited to individual cases. (Such a situation may for example occur when special procedures, e.g. for sensitive cases, have to be followed).

On the contrary high interaction with other parties is necessary in the planning phase (1) and the closure phase (4) of the audit. During these phases activities related to the quality management and supervision of the audit as well as technical and administrative elements require the active involvement of the management of the external audit service, the audit back-office and the secretariat.

More detailed information on the involvement of other 'internal parties' during the audit process ██ in the various phase is provided in the respective sections of this Handbook.

2.3.2 Involvement and responsibilities of the operational services

The services responsible for and concerned with the scientific and financial management of the research project (operational services) represent the operational interface between the EC and the audited organisation. Thus these services may be involved in the Audit Process at various levels.

- The operational services can actively request an audit assignment. Although this is not considered part of the Audit Process as such, this situation usually requires increased cooperation and communication with the operational services to ensure an efficient and effective audit process (i.e. precise scope and terms of engagement – see also section 3).

- The operational service has ownership and direct access to all documents obtained from the audited organisation related to the projects under audit. Thus it is the primary source of information and documentation on the audited organisation prior to the audit. Although standardised lists exist to request relevant information from the operational services, the auditor is advised to always seek direct contact with the responsible operational service to clarify and assess information obtained as well as to include potential 'non-documented' information.

- The operational service is responsible to provide the auditor with all relevant and up-to-date information and documentation on the audited organisation to the extent available. However, the auditor also needs to precisely determine what information (s)he needs to properly plan and prepare the audit. ████████████████████ ██████████████████████████████

- During the audit work and the reporting, questions may arise which require feedback and decisions from the operational services. The auditor is encouraged to actively interact with the operational services at an early stage (e.g. during the audit field work) to avoid potential misunderstandings and be able to perform relevant procedures in due time. Therefore it is recommended that the auditor and the operational services convene on relevant practical arrangements during the audit (i.e. communication arrangements during the audit field work).

- In special cases, it can contribute to the effectiveness and efficiency of the audit for the operational service to actively participate in the audit work. Usually the necessity to perform such 'joint audits' is already included in the phase of the Audit Decision. However, it is in the responsibility of the auditor to eventually suggest such a 'joint audit' to the management of the External Audit Service when considered justified. In such cases a separate agreement with the operational service as well as increased cooperation already in the planning phase of the audit will be necessary.

- The operational service may be consulted on the audit results before finalisation and closure of the audit. The feedback of the operational service could be requested to verify accuracy of the information used and avoid misunderstandings. The consultation also contributes to the quality management of the audit and shall ensure that audit results are understood and sufficiently documented for implementation of the audit results.

- The operational service is responsible for the implementation and follow-up of the audit results. All financial implications (such as recovery orders …) fall under the

responsibility of the authorising officer in the operational service. Feedback and interaction with the audit/ auditor may occur where specific follow-up actions are suggested and have to be performed (e.g. extrapolation of audit results). However, on the level of the Audit Process, such interactions are considered to follow the Audit closure and thus to be outside the Audit Process. Following this, from the procedural perspective a follow-up audit is considered a new audit eventually with a limited scope.

2.3.3 Involvement of the audited organisation

The audited organisation is requested to cooperate in the audit by the grant agreement signed with the EC (different articles depending on research programme). Formally, the audit will be announced to the audited organisation by registered letter of the EC External Audit Service ('letter of announcement'). During the audit the audited organisation has to provide all information relevant to the audit of the project(s) selected.

Besides the abovementioned requirements, the auditor is advised to ensure informal cooperation of the audited organisation. In various phases of the audit process, additional involvement of the audited organisation is either requested (mandatory) or suggested in the APH (e.g. in the planning phase it is suggested that the auditor agrees with the audited organisation on the date and the practical arrangements of the audit field work before sending the letter of announcement; in the reporting phase it is mandatory to consult the audited organisation on the audit results).

2.4 Quality Management and Supervision in the Audit Process

Quality management and supervision constitute substantial elements of professional auditing. The APH foresees various inherent quality controls at different phases and shall ensure appropriate supervision on the audit process by senior management.

Effective quality controls and supervision to a large extent depend on and require appropriate and sufficient documentation of the audit work performed. Consequently, the documentation of the audit work has to follow basic standards and principles which ensure these requirements. By following the APH and the related procedures ▮▮▮▮▮▮ the necessary minimum requirements are considered to be provided. Nevertheless, it remains the responsibility of the auditor to ensure that the supervising authority disposes of the relevant information when performing quality controls.

Inherent supervision and quality controls in the APH include amongst others the review and approval of the audit planning and the audit closure by senior management, the consultation of the audit results with the operational services and the audited organisation and the standardisation of the audit work/ audit process itself.

Additional quality controls and supervision activities (such as peer-reviews of the working papers) may be foreseen by the External Audit Service on a case-by-case and/or on a random basis. However, as these controls are not directly linked to the audit process they are not covered by the APH.

2.5 Documentation of the Audit Process

It is essential that every auditor is aware of the importance of the audit documentation and considers the documentation as an integral part of the audit procedure.

All information collected during the audit should be documented. All supporting documents received during the audit should be filed.

The documentation of the audit is one of the most important parts of the audit process. The purpose of the documentation is to provide (i) a sufficient and appropriate record of the basis for the auditor's report and (ii) evidence that the audit was performed in accordance with the standards and policies of the external audit service of the European Commission. The audit documentation should normally include:

- All **mandatory documents** and documents related to mandatory procedures that form part of the audit process according to this Audit Process Handbook

- Copies of **letters, notes and meeting minutes** concerning audit matters communicated to, or discussed with, the beneficiary

- All relevant **working papers** and documents that support the audit conclusions, e.g.

  o excerpts of the beneficiary's policies and procedures;
  o documentation describing the accounting and internal control systems;
  o documents on individual transactions (invoices, …);
  o other evidence supporting the auditor's analysis and conclusions

Working papers are defined as

"the records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement." [2]

According to this definition, the working papers should not only include the obtained and prepared audit evidence, but also document the audit activities and answer the following questions:

Why was it done?
What was done?
How was it done?
When was it done?
Who did it?
What is the conclusion?

Working papers should be properly identified. In relation to every question investigated, the auditor should prepare the relevant facts, sufficiently complete and detailed, to provide an understanding of the audit activities performed and the result thereof. Regarding the extent of the working papers, the International Federation of Accountants (IFAC) gives the following guidance:

The extent of working papers is a matter of professional judgement since it is neither necessary nor practical to document every matter the auditor considers. In assessing the extent of working papers to be prepared and retained, it may be useful for the auditor to

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[2] American Institute of Certified Public Accountants (AICPA), Statement on Auditing Standards nr 41

consider what would be necessary to provide another auditor who has no previous experience with the audit with an understanding of the work performed and the basis of the principle decisions taken but not the detailed aspects of the audit. That other auditor may only be able to obtain an understanding of detailed aspects of the audit by discussing them with the auditors who prepared the working papers. [3]

Working papers should be kept to such an extent, that another auditor, with no previous experience of the audit, could take over the audit in case of need.

To sum up, the documentation should be logically structured, clear and concentrate on essential topics. In addition, it should be kept in a way that enables evaluation of the audit proceedings. For the filing and documentation of the Audit File refer to the section 7.2.2.

3 Audit Initiation and Audit Decision

As already indicated, audit initiation and decision are not considered part of the audit process in the sense of the APH. However, given the potential impact of these on the audit planning and examination phases (see also section 2.3.2) the principle elements of the audit initiation and decision procedures are outlined in the following.

In total the following flow-chart summarises the Audit Initiation and Decision procedure graphically:

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External audits performed by the Research DGs/agencies have their origin in two different procedures: audits initiated by the External Audit Service and audits initiated by third parties or other services.

3.1 Audits initiated by the External Audit Service

Audits initiated by the External Audit Service represent the majority of audits and core business of the External Audit Service. The initiation of these audits usually follows an overall internal selection process. Selection criteria will usually be determined in accordance with a (multi-) annual audit strategy and/or periodical audit plan. In addition, individual audits may be initiated on a case-by-case basis by the External Audit Service for specific purposes.

The following is characteristic to audits selected by the (management of the) External Audit Service:

- Normally no additional decision by the management of the External Audit Service to perform the audit (Audit Decision) is necessary as both the selection and decision are originated by the same authority;

- Typically a large number of audit engagements will result from a selection by the External Audit Service which usually implies similar audit scope and organisational settings.

3.2 Audits initiated by third parties / other services

Audits initiated by third parties can originate from requests by the operational services, other audit organisations (i.e. ECA), the organisation to be audited itself or other parties involved. Such audits – hereinafter named 'requested audits' – will usually constitute a minor part of the audits to be performed.

The following is characteristic to audits initiated by third parties/ other services:

- An additional decision by the management of the External Audit Service to perform the audit (Audit Decision) is necessary as the request of an audit needs to be analysed and evaluated to determine the effectiveness and efficiency of a potential audit engagement;

- The audit scope and organisational settings depend on the individual audit case and need to be determined in accordance with the party initiating the audit.

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3.3 Specific procedure for audits requests by operational services

As outlined above, the various operational services within the Research DGs/agencies can request the performance of an audit on a specific beneficiary. These requests can be made at any time during the year. Audit requests should be made in writing and addressed to the Head of Unit of the External Audit Service.

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[███]

4 Process Phase 1: Audit Planning

4.1 Overview of the planning phase

Auditors should plan the audit work so as to perform the audit in an effective manner.
An audit plan is the formulation of the general strategy for the audit, which sets the direction for the audit, describes the expected scope and conduct of the audit and provides guidance for the development of the audit program.

For the purpose of this Handbook, Audit Planning is understood being the procedural steps following the Audit Decision and preceding the Audit Preparation under the Audit Examination Phase. Compared to the Audit Preparation the Audit Planning phase is more focussed on the formal assignment, the resources and a preliminary assessment/ determination of the requirements of the audit engagement. However, overlaps e.g. as to the assessment of the Audit Risk and the information collection can exist and procedures under the preparation phase may also be considered for planning purposes.

4.2 The procedural steps during the Planning Phase

███ The Audit Planning ███████

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The Audit Planning is the preliminary assessment on the specific requirements of the audit engagement

The Audit Planning is issued by the assigned (principal) auditor (eventually in cooperation with the members of the audit team). It includes i.e. a general assessment of the Audit Risk, the potential impact of the audit, the Audit Plan and the Audit Program foreseen, the resources needed a declaration as to ethical considerations, and a summary of the audit's objective and scope.

The Audit Planning also includes a summary of the mission plan. The specifications of the mission plan and its formal approval are defined by the relevant Mission Order (MIPS). This should be forwarded to the administrative support function of the External Audit Service. The plan should include all relevant information for the encoding of the mission into the relevant IT systems and the issuing of the formal mission order.

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4.2.2 Other procedures ███████████ in the planning phase

███████████████████████████ the following procedures ███████████ should be followed.

4.2.2.1 Audit Reference Number

With the (positive) Audit Decision or internal selection a future Audit Engagement receives a unique Audit Reference Number which will be used for all documentation related to the Audit Engagement. This number follows internal needs and should be provided to the Auditor by the Management of the External Audit Service or delegated person (based on the information by the Administrative Support Function of the respective External Audit Service).

4.2.2.2 Relevant Information for the planning of the Audit Engagement

4.2.2.2.1 General Information Requirements

The audit planning (and eventually the Audit Decision) usually requires the parties involved to give an assessment/ estimation based on the information about the individual audit engagement. It can be assumed that the more information is obtained the better the accuracy of the planning will be. However, for reasons of effectiveness and efficiency the detailed collection and assessment of information is subject to the preparation and examination phase.

For the planning stage it is therefore recommended to focus on such information which is essential and required for the planning. This usually includes the following:

- General information on the project(s) to be audited (grant agreement, amounts, …);
- General information on the organisation to be audited (legal form, contact details, …);
- Information on eventual previous audits on the organisation to be audited by the (External) Audit Services of the EC.
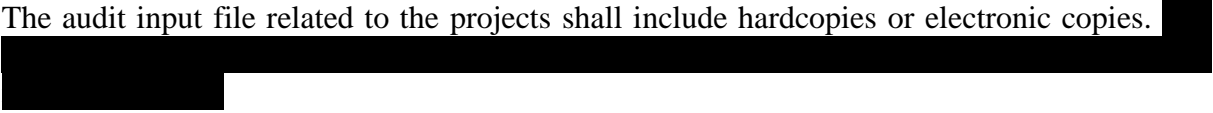
4.2.2.2.2 Audit Input File

An Audit File is required to be created for every audit assignment. This file consists of copies of documents held by the operational service for each of the projects to be reviewed within the scope of the audit assignment.

While some of the documents could be compiled by the External Audit Service with the assistance of the administrative support function of the External Audit Service centrally, for other documentation the auditor is advised to directly approach the operational service concerned. The detailed procedures for obtaining information may differ for individual audit engagements.

The nature of the Audit Assignment determines who should request the compilation of the Audit Input File by the operational services. For internal selections a centralised request may be chosen whereas for Audits on Requests a decentralised request by the assigned auditor may be considered. For each case, the assigned (principal) auditor needs to assess what information and documentation has already been requested centrally and which (additional) information/ documentation (s)he needs or wants to obtain directly from the operational services.

The audit input file related to the projects shall include hardcopies or electronic copies. ████████
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4.2.2.2.3 *Information on previous audits*

If an audit has previously been performed on the beneficiary, useful information for the audit work may be found in the audit documentation.

Following an internal selection or a (positive) Audit Decision the Management of the External Audit Service or delegated person should request the respective information from the administrative support function of the External Audit Service and forward this information with the Audit Assignment. However, the assigned (principle) auditor also has to check that respective information (or indication that no prior audit has been noted) has been provided and needs to obtain the specific information on the audits carried out previously as considered relevant (Audit Report, DASS, access to Working Papers).

Further guidance on relevant information to be obtained is to be found under section 5.2.2.2

4.2.2.3 Informal contact with the beneficiary (timing of the field work)

The auditor may consider to informally agreeing with the audited organisation on the arrangements of the audit prior to the sending of the 'Letter of announcement'.

In the Grant Agreement Preparation Forms or in similar forms for other framework programmes, it is stated who is responsible for preparing the Financial Statements (Form C). Normally this is the person to contact to set up a tentative appointment.

The contact with the beneficiary may be made by phone or email. The Auditor may agree on a preliminary date and location for the initial meeting and the audit on site. Further (s)he should inform the beneficiary about the scope and the necessary preparation and make clear that the presence of the project manager and of the financial officer who is familiar with the financial management of the EU project(s), is desirable during the audit.

Where such informal telephone/ email arrangements have been undertaken they shall be confirmed by the letter of announcement, after the formal approval for the audit has been received.

4.2.2.4 General Audit Risk Assessment

Audit risk is defined as the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.[4]

Audit risk is a function of the risk of a material misstatement and the risk that the auditor will not detect such misstatement ("detection risk"). The risk of material misstatement has two components: inherent risk and control risk. Inherent risk is the susceptibility of an assertion to a material misstatement assuming there were no internal controls. Control risk is the risk that a material misstatement will not be prevented, detected and corrected on a timely basis by the entity's internal control.

Within the framework of audits performed by the External Audit Service, the auditor will be requested to estimate the inherent risk and the control risk. The assessment of risks is expressed in terms of low, medium or high. Medium risk represents the normal situation.

4.2.2.5 Audit Plan and Audit Program

The <u>Audit Plan</u> is the formulation of the general strategy for the audit, which sets the direction for the audit, describes the expected scope and conduct of the audit and provides guidance for the development of the Audit Program.

An <u>Audit Program</u> ███████████████████████████████ sets out the audit procedures the auditors intend to adopt and may include references to other matters such as the audit objectives, timing, sample size and basis for selection of each audited area. ████████████ █████████████████████████████████████

It is important to know how the Audit Plan is translated in detail in the form of the Audit Program. The Audit Program is the result of the planned Audit Plan (see below). Indeed, the outcome of the preliminary analysis of the Audit Engagement, i.e. indications of where the auditing resources should be concentrated, is to be reflected in the further audit process. Moreover, during the course of the audit process, the Audit Plan may again be the subject of modification. After the Audit Preparation phase, the preliminary Audit Plan should be reconsidered and possibly modified. During the substantive tests, the auditor may find evidence that differs significantly from that on which the Audit Plan was originally based. In such a case, the planned procedures foreseen in the Audit Program may again be altered.

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[4] IFAC International Standards on Auditing and Related Services no. 6

[redacted]

The Audit Program is designed to assist the auditor(s) in the implementation of the audit examination procedures and can also be used for the documentation of the audit. It outlines the specific audit procedures to be carried out for an audit in accordance with the respective requirements of the assignment (i.e. the scope). The program includes the audit approach (implicitly), the audit risk assessment and the testing procedures during the examination [redacted].

Within the Planning phase [redacted] the auditor has to give an indication on the planned Audit Program to be executed. [redacted]

[redacted]

4.2.2.6 Potential Impact of the Audit

[redacted]

[redacted]

4.2.2.7 Ethical considerations

The assigned (principal) auditor and the members of the audit team <u>must</u> formally declare for their assignment the respect with the [redacted] ethical considerations to avoid conflict of interests.

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[redacted]

[redacted]

[redacted]

4.2.2.8 Letter of Announcement

The audit and the arrangements of the audit are to be formally communicated and confirmed (announced) to the beneficiary in writing.

A draft of the letter is ███████████████████████████████████████ ██ transferred into a final letter by the back-office and the administrative support of the External Audit Service (provision of a (final) Audit Reference Number, registration and formal aspects) to be signed by the Head of the external Audit Service and sent to the beneficiary by email and registered post.

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███████████████████ references are made to articles in the underlying grant agreement. The assigned (principal) auditor needs to ensure that the relevant articles are mentioned depending on under which (Framework) Program the grant agreement is signed.

Annex to the Letter of Announcement:

The auditor is suggested to annex to the letter a specification of documentation that should be made available prior to and during the audit. This annex shall ensure that the relevant information and documentation is provided timely and in an appropriate form.

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4.3 Summary: Mandatory procedures and documents

The use of the following procedures █████████████████ are mandatory for the planning phase:

Mandatory Procedure/ Action	███████████████
Audit Planning ████████	<█████████████████
Letter of Announcement	████████████████
Ethical Considerations ██████████████ ████	<██████████████████████>

4.4 Summary: Further guidance on procedures and documents

The following documents ████████████████████████ are available:

Suggested Procedure/ Guidance	████████████████
Audit Input File	<████████████████████████████ ████>
Annex to Letter of Announcement (to be customised)	<████████████████████████████ ████>

5 Process Phase 2: Audit Examination

5.1 Overview of the examination phase

The Audit Examination Phase includes three sub-phases:

- The Audit Preparation Phase:

  In the Audit Preparation Phase the auditor collects and assesses detailed information on the organisation and projects to be audited, amends the Audit Program and performs analytical audit procedures to prepare the substantive testing.

- The Audit Testing Phase:

  In the testing phase the auditor usually verifies the information received and collects further audit evidence by performing substantive testing on the site of the audited organisation.

- The Audit Conclusion Phase:

  In the Audit Conclusion Phase the auditor analyses the audit evidence and draws conclusions to determine the audit results to be reported

Typically, preparation can already be performed prior to the audit field work, whereas the testing and the conclusion phase will be respectively on site and/ or after the audit field work.

However, this distinction between actions prior to the field work and on site shall only be taken as indicative. Depending on the respective needs and planning of the engagement (e.g. availability of information, timing and resources, …), the preparation can partially be performed on the site of the audited organisation and certain procedures related to the testing phase may be performed after the audit field work based on audit evidence collected or additional information received at the end or even after the audit field work.

Due to the interference of the phases, the following section does not strictly differentiate between the 3 Phases mentioned above. Moreover, it follows a division between the usual functional steps of the audit process during the examination:

- The information collection (prior to the testing phase)
- The analysis of the information collected
- The Assessment of the Audit Risk
- The Amendment of the Audit Program and Audit Work Plan
- The Audit Testing following the Audit Program (collection and analysis of Audit Evidence)

The flowing figure summarises the Audit Examination Phase:
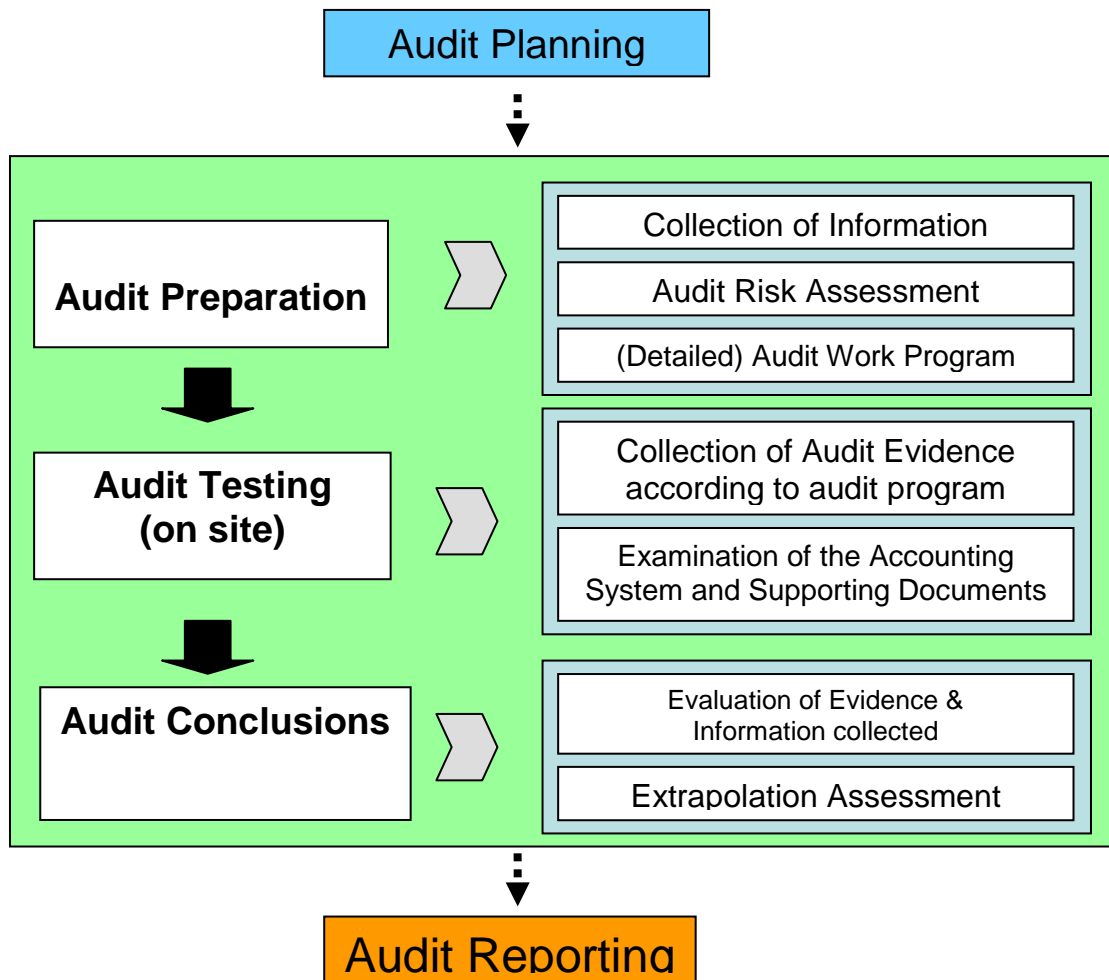
Figure AUDIT EXAMINATION PHASE

5.2 The procedural steps during the Examination Phase

5.2.1 Audit preparation

The objective of the audit preparation is to identify and assess the risks of material misstatement, whether due to fraud or error, within the financial statement, through understanding the entity and its environment, including the entities internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

The auditor's responsibility to identify the risks of material misstatements in the financial statements is governed by the International Standard on Auditing ("ISA") 315 "Identifying and assessing the risks of material misstatement through understanding the entity and its environment".

The auditor's responsibility is today even expanded in consideration of the recent development of ISA 240 dealing with the auditor's responsibility relating to fraud in an audit of financial statements.

5.2.2 Information to be collected prior to the audit fieldwork

In order to identify and assess the risks of material misstatement, whether due to fraud or error, within the financial statement, the auditor shall collect and analyse information prior to the audit fieldwork.

The information to be collected and analysed is detailed here after.

5.2.2.1 Audit Input File

The Audit Input File consists of copies of documentation related to the projects included in the audit scope.

This documentation shall be requested by the External Audit Service to the operational services during the planning phase and include the following:
- Signed grant agreement including amendment(s);
- Annexes to the grant agreement and in particular the Description of Work/Technical Annex and the General Conditions;
- Grant Agreement Preparation Forms;
- Periodic Management Reports;
- Periodic Review Reports;
- Financial Statements;
- Certificates on financial statements;
- Certificates of methodology (CoM, CoMAv)
- Conclusions of the acceptance/disallowance by the Operational Services of the costs claimed so far by the audited beneficiary;
- Report from the co-ordinator on the distribution of EC financial contribution.
- In particular, specific attention should be dedicated to the Description of Work/Technical Annex which usually includes a presentation of the beneficiary, its role in the indirect research action as well as its key staff deployed on the implementation of the indirect research action.

This list is only indicative and may be completed by any information that the operational services consider as valuable for the performance of the audit.

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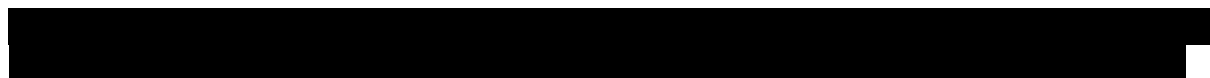
5.2.2.2 Previous Audits

If an audit has previously been carried at the Beneficiary, the auditor shall collect the related Audit Report in order to go through the audit conclusions and identify any associated risks. Where appropriate, additional audit documentation shall be consulted.

General information on previous audits (including the reports) should already be obtained and considered in the planning stage.

Where the previous audit(s) identified systematic financial errors and/or presented recommendations to the systems improvement, the auditor must follow up these issues in the

course of the normal work under the current audit. The result of this follow up shall be described in the audit report.

5.2.2.3 List of projects with the audited organisation

The auditor shall obtain, eventually with the help of the Back office of the external audit unit, the list of all grant agreements in which the beneficiary has participated within the Research DG/agency carrying out the audit and if possible with other (Research) DG's.

5.2.2.4 Open source information related to the audited organisation

The auditor shall obtain information regarding the audited beneficiary in order to understand the organization and its role in the audited indirect research action.

5.2.2.5 Open-source information related to the key staff

The auditor shall obtain information regarding the key staff brought forward in the project related documentation in order to understand their competences and links with the audited beneficiary.

[black redacted block]

5.2.2.6 Internal Contacts with the operational services

A discussion with the operational services may be recommended in consideration of the information collected so far. Operation services can provide the most recent information as well as informal information concerning the overall impression about the project, the participants, the scientific result, risk factors and potential problem areas. They can also present copies of correspondence with the Beneficiary concerning for example amendments to the costs claimed, etc.

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5.2.2.7 Information obtained from the audited organisation prior to the audit fieldwork

A list of information requested from the audited beneficiary is usually attached to the Letter of Announcement. This list may include documents that need to be sent to the external audit service in priority before the audit fieldwork takes place.

These documents may contain valuable information regarding the identification of risks of material misstatement prior to the audit fieldwork.

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• [redacted]

In addition the following document may be very useful: *Audit Manual FP7*

5.2.3 Analysis of the information collected prior to the audit fieldwork

The auditor shall carefully analyse the information collected prior to the audit fieldwork in order to identify and assess the risks of material misstatement, whether due to fraud or error, within the financial statement

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The identification of risks of material misstatement will impact the audit risk assessment covered in the next section of the APH, and in particular the inherent risk.

Appropriate responses should be designed and implemented by tailoring the audit program to the specific risks identified.

5.2.4 Audit Risk Assessment

Audit risk is defined as the risk that the auditor gives an inappropriate audit opinion when the financial statement is materially misstated.[5] The Audit Risk needs to be considered when (re-)designing the Audit Plan and the Audit Program (see also sections 4.2.2.4 and 4.2.2.5).

Audit Risk is made up of three components;

1.   INHERENT RISK - the risk that a material misstatement occurs. A highly complex accounting system increases the inherent risk. The estimation of the level of the inherent risk implies that the auditor should attempt to predict where misstatements are most and least likely in the financial records.

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[5] IFAC International Standards on Auditing and Related Services no. 6

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2.   CONTROL RISK - the risk that a misstatement will not be prevented or detected and corrected by the internal control system. To be able to estimate the control risk, the auditor must obtain an understanding of the internal control system and preferably also test it, to prove its effectiveness.

3.   DETECTION RISK - the risk that the auditor will not detect a material misstatement. The level of the detection risk depends on the amount of substantive testing the auditor carries out.

Within the framework of audits performed by the External Audit Service, the auditor will be requested to estimate the inherent risk and the control risk. The assessment of risks is expressed in terms of low, medium or high. ▮▮▮▮▮▮▮▮▮▮▮▮▮▮▮▮▮▮▮

Concerning the control risk, the following is a list of controls that the auditor will find in many organisations, private as well as governmental. Based on a combination of these, the auditor may assess the degree of reliance of the internal control system.

Organisation

The beneficiary should have a plan of its organisation that shows how responsibilities are defined and allocated. Reporting procedures and delegation of authority should be specified.

Segregation of Duties

Duties, which may enable one person to record and process a complete transaction, should be separated. Due to the risk of employee fraud, duties concerning the custody of assets should be separated from the accounting of these assets. The separation of duties will reduce the risk of intentional manipulation.

Authorisation of Transactions

Every transaction should be properly authorised. Authorisation can be general or specific. General authorisation is established by the management, and can cover a class of transactions, or specific transactions.

Adequate Documents and Records

These include items such as system manuals, chart of accounts, subsidiary ledgers, project accounts, invoices, employee time records, purchase orders, and payment orders.

System Manuals (also called Accounting System Handbooks) describe the record keeping procedures and facilitate consistent application. Universities and larger companies, with computerised accounting systems, will normally have appropriate instruction manuals.

The chart of accounts classifies accounts into individual balance sheet and income statement account, whilst the detailed ledger exhibits the posting of the transaction in the accounting records of the beneficiary. From the Audit Service point of view, the chart of accounts and its detailed ledger can provide useful information about how e.g. a purchase has been recognised (equipment /consumables) and subsequently measured in the general ledger.

Records and supporting documents perform the function of transmitting information. They must therefore be adequate to provide reasonable assurance that all assets are properly controlled and all transactions are properly recorded.

Records and supporting documents should be:

- Pre-numbered sequentially to facilitate control over missing documents
- Prepared at the time a transaction takes place, or as soon as possible thereafter. The longer the interval, the less credible is the record.
- Constructed in a manner that encourages correct preparation (e.g. time-records).
- Properly managed. From the Audit Service point of view, time records should be kept and verified in accordance with the contractual obligations.

The Control risk is considered low when the beneficiary is using control functions that go beyond the normal. The auditor should give a general description of the control functions used and justify his/ her assessment of the control risk. Factors that will increase the control risk are for example:

- Inadequate separation of duties;
- Insufficient authorisation procedures;
- Management override of controls;
- Use of internal documents as verifications;
- Incomplete evidence, e.g. lack of time records

Besides the preliminary Audit Risk Assessment in the planning phases (see section 4.2.2.4), an Audit Risk Assessment should be performed during the audit preparation phase and shall be finalised by the end of the examination phase. ▮▮▮

5.2.5 Audit Program

5.2.5.1 Definition and Characteristics

The Audit Program is designed to assist the auditor(s) in the preparation and in the implementation of the audit examination procedures and can also be used for the documentation of the audit. It outlines the specific audit procedures to be carried out during an audit in accordance with the respective requirements of the assignment (i.e. the scope, objectives and audit plan). The program i.e. includes the audit approach (implicitly), the audit risk assessment and the testing procedures during the examination. ▮▮▮

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5.2.6 Planning materiality

When making an audit risk analysis and performing audit sampling procedures, one factor that has to be considered is materiality. IFAC defines materiality as follows:

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statement. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality

provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful".[6]

Transferred to the operational environment of the External Audit Service, the auditor's responsibility is to determine whether the cost claims (the Financial Statements submitted to the European Commission) are materially misstated. Considering the analysis result, the auditor may identify – during the audit preparation – the areas of potential audit risk. The auditor should target his resources in areas with the most risk. With this understanding the auditor can identify the controls that are relevant, in relation to the objectives of the audit.

In principle the setting of the planning materiality threshold is within the responsibility of the auditor.

5.2.7 Audit Testing on site

5.2.7.1 Initial Meeting with the beneficiary on site

The initial meeting with the beneficiary at the beginning of the audit field work is an important opportunity to compile information and audit evidence concerning all relevant aspects of the beneficiary's relation with the Commission, that is, information concerning the accounting system, internal control, project financial management, different categories of cost etc.

The presence of staff, such as the scientific project manager, financial manager and internal auditor of the beneficiary, who can be expected to possess valuable information, is therefore essential.

It is necessary that the auditor prepares the meeting and, based on previous analyses, tries to foresee possible problems.

5.2.7.2 Collection of Audit Evidence

5.2.7.2.1 Types of Audit Evidence

Audit evidence is the information obtained by the auditor based on which (s)he will be able to draw his/her conclusions. Audit evidence will comprise source documents and accounting records underlying the financial statement (*cost claims, in audits performed by the External Audit Service)* and corroborating information from other sources.[7]

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[6] International Federation of Accountants (IFAC), Glossary of Terms, June 1994
[7] IFAC, International Standards on Auditing and Related Services no. 8

Auditors obtain evidence by one or more of the following procedures:

INQUIRIES - Seeking information from client staff or external sources. These can be in writing or oral and may involve the beneficiary's personnel as well as external sources such as officers within the Commission. The reliability of evidence from inquiries depends on, *inter alia,* the informant's competence, experience, independence and integrity.

INSPECTION OF DOCUMENTATION – Confirmation to documentation of items recorded in accounting records confirms that an asset exists or a transaction occurred. Inspection also provides evidence of valuation/measurement, rights and obligations and the nature of the items (presentation). It can also be used to confirm authorisation. In this sense, documentation means the auditor's examination of the *Beneficiary's* documents and records. Each transaction in the accounts should be supported by at least one document.

PHYSICAL EXAMINATION - is an inspection or count of a tangible asset that is recorded in the accounting records. This type of evidence can be used to verify the existence of equipment charged to the project.

OBSERVATIONS – Involves watching a procedure being performed. Compared to physical examination, an observation test does not require *detailed* physical inspection or examination of documentation, and hence a person other than the auditor may perform the observation test. However, this doesn't mean that the auditor should not make observations. A*u contraire*, observations are a natural element in any audit.

INSPECTION - is a review, without or with a very brief analysis. E.g. an inspection of the internal control system would result in a description, but without an analysis of its proper operation or effectiveness. An inspection of a supporting document would be a control of its existence, but without an analysis of its reliability in terms of the existence of the underlying action, completeness, occurrence etc.

CONFIRMATION – Seeking information from another source of details in Beneficiary's accounting records for example, confirmation from bank of bank balances.

COMPUTATIONS – Checking arithmetic of beneficiary's records for example adding up detailed ledger accounts and confirming them with the general ledger.

ANALYTICAL PROCEDURES - are evaluations of the relationship (ratio) between financial data, or financial versus non-financial data, to identify areas requiring additional audit attention. The reasons for using analytical procedures are generally to understand the Beneficiary's business, his ability to finance his part of the project, and to identify possible misstatements in the financial data.

5.2.7.2.2 Reliability of Audit Evidence

The reliability of the audit evidence is influenced by its source. Physical examination is generally regarded as the most reliable way of compiling audit evidence. █████████████ ██ ██ ██ █████████████████████

Documents can be classified as internal and external, whereby the Beneficiary creates internal documents. An example of internal documentation is time records. ████████████ ██ ████████████████████████████████████

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5.2.7.3 Examination of the Accounting System and Supporting Documents

This part of the audit procedure consists of the execution of the Audit Plan and the Audit Program. However, it is important to stress that the Audit Plan and the Audit Program are not a once and for all fixed strategy. The auditor must always be flexible and ready to modify the plan in accordance with new circumstances.

This is the stage in which the main part of the audit evidence is normally collected and analysed. The focus is on the quality of the evidence, to determine the cause and quantify the effect of the conditions identified. The audit work should be focused on collecting and analysing data needed to support the findings, conclusions and recommendations.

5.2.7.4 The Control of the Accounting System

The objective of the control of the Accounting System is to verify the formal status of the accounting system, including the existence and effectiveness of an internal control system.

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[8] IFAC, International Standards on Auditing and Related Services no. 8

The internal control system is defined as all the policies and procedures adopted by the management, to assist in achieving management's objectives of ensuring the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.[9]

This definition given to the Internal Control System includes not only those matters which are directly related to the accounting system, but also the control environment, being the management's awareness and concern about the control system, and the actual control procedures in place.

THE ACCOUNTING SYSTEM

THE INTERNAL CONTROL SYSTEM

Control Procedures

The Control Environment
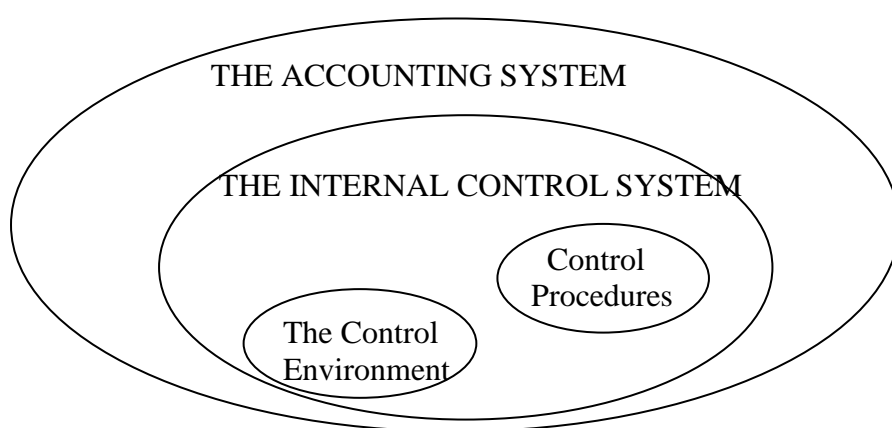
Figure X: The Internal Control System

The audit of the accounting system will provide the auditor with evidence to assess whether it is suitably designed to prevent material misstatements. The audit of the control system is aiming at assessing the system's effectiveness, in terms of its capacity to detect and correct misstatements.

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[9] IFAC, International Standards on Auditing and Related Services no. 6

5.2.7.5 Up-dating of the Audit Risk Assessment and the Audit Program

After the initial meeting with the Beneficiary and the assessment (and testing) of the control system, but before the testing of transactions and their supporting documents, it has to be evaluated if the preliminary Audit Risk Assessment and Audit Program can be maintained or need to be amended. E.g. the results of the assessment of the internal control system may determine areas to be audited more thoroughly or other areas where less testing procedures are necessary.
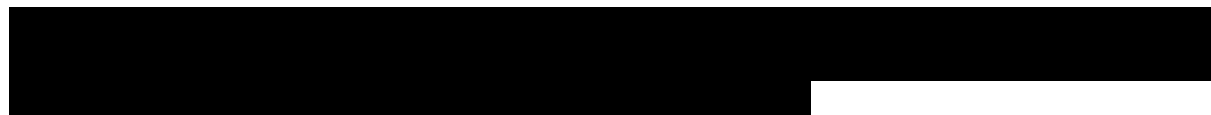
5.2.7.6 Audit Sampling

Sampling is a method to reach a conclusion about a population by selecting part of the items within the population. In the audits performed by the External Audit Service, a population would ordinarily consist of the records/transactions within an account or a cost category.

Audit sampling methods can be divided in two categories: statistical and non-statistical. Statistical sampling is based on the assumption that a randomly selected sample will reflect the same characteristics that occur in the population. The advantage of the statistical sampling method is that it enables quantification of the sampling risk[10]. In non-statistical sampling, the auditor will select those items he thinks will provide the most useful information in relation to the audit objective.

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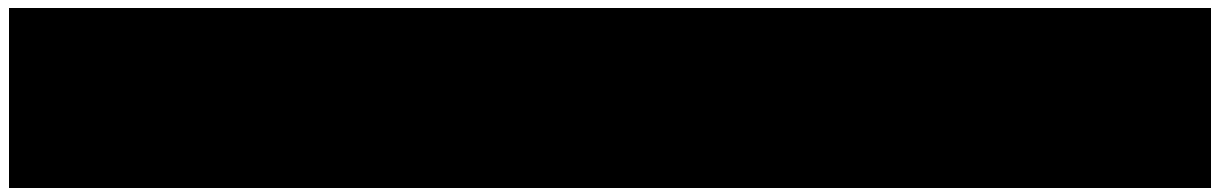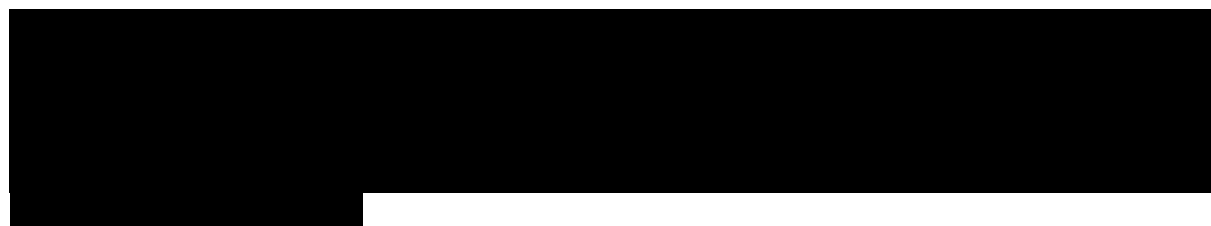
[10] Sampling risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

5.2.8 Audit Conclusions

After the completing the preparation and the testing on site the auditor has to analyse the information and evidence obtained and draw the audit conclusions for the reporting.

5.2.8.1 Extrapolation Assessment

After the auditor has analysed the audit evidence and concluded on the findings as to the audited projects, an additional assessment on the overall or partial participation of the beneficiary in EC funded research projects may be required by the individual audit assignment (scope and objectives of the audit).

The auditor needs to assess to what extent individual findings of the audit can be extrapolated on other projects by indicating whether these findings are of a systematic nature. Systematic errors are repetitive and recurring; the implication of this type of error is that the beneficiary is not complying with his contractual obligation in a systematic way. In this context it is essential that the audit finding is extrapolated to non-audited areas.

5.2.8.2 Exit Meeting

After the audit work on the spot is concluded, a meeting is generally held with the Beneficiary's representatives. At this stage it is normally not possible to indicate or quantify precisely the final outcome of the audit. Hence, the intention is to give a summary of the observations made and to agree these with the beneficiary as far as possible.

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6 Process Phase 3: Audit Reporting

6.1 Overview of the reporting phase

Within the Audit Process, the Audit Reporting includes two sub-phases:

- The **Drafting of the Audit Report**. This includes i.e. the assessment and formulation of the Audit Findings.

- The **Finalisation of the Audit Report**: This includes i.e. the consultation of the draft report with the relevant parties, the audit conclusion and where necessary the application of specific procedures

The flowing figure summarises the Audit Reporting Phase:
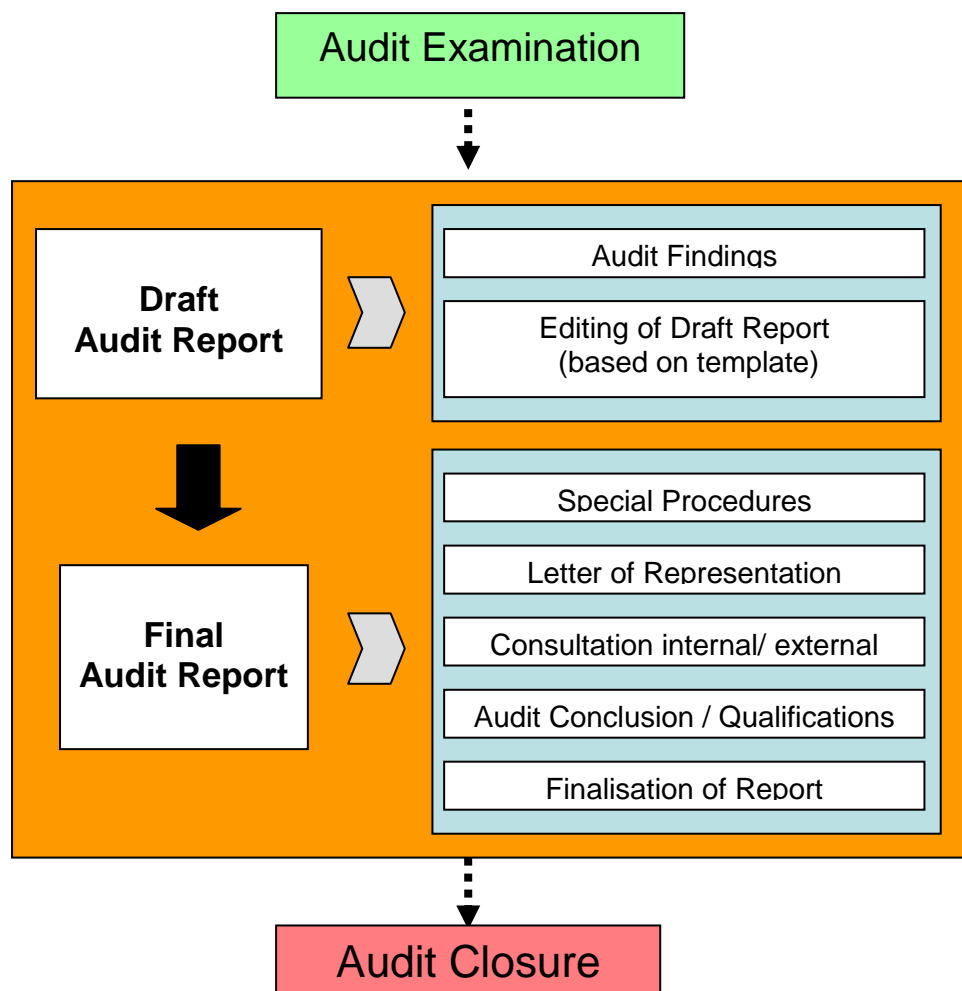
Figure AUDIT REPORTING PHASE

6.2 The procedural steps during the Reporting Phase

6.2.1 Draft Audit Report

In a first step the Auditor should prepare a draft report presenting the audit findings obtained.

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6.2.1.2 Presentation of the Audit Findings

The structure of the presentation of the audit findings should organise the audit result into a logical and coherent document. To obtain a formalised structure in the presentation of the audit findings, it is desirable that each section follows the finding's attributes.
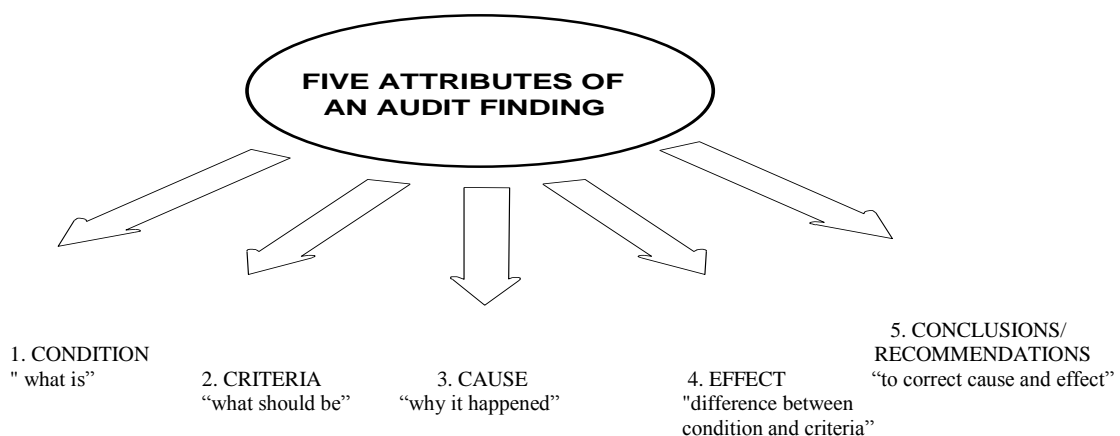
 Figure: Audit Finding Attributes

The attributes guide the auditor in organising and analysing relevant evidence and help ensure that all necessary information for a finding is identified, developed and adequately documented. In audits where the attributes are unclear, the result can be a collection of facts that provides little or no direction for writing, reviewing and reading the audit report. On the other hand, if the integrity of the audit attributes is maintained, the reader of the audit report can be led through the evidence, clearly establishing the credibility of the auditor's position.

The CONDITION is a factual statement describing what was found during the audit, or what the auditee did or is doing.

The CRITERIA are the standards against which the auditor measures the activity or performance of the auditee. In audits performed by the external Audit Service, the standards are, apart from

the pertinent grant agreement, the generally accepted accounting principles and normal accounting conventions in the state where the beneficiary is established.

The CAUSE is a description of why and how a condition occurred. Knowing the cause is essential to developing meaningful recommendations. The auditor needs to have a clear understanding of the cause to be able to develop recommendations that will correct the problem and will be accepted by the Beneficiary.

The EFFECT is the identified difference between conditions and criteria. The auditor needs to determine the impact on the audited project and on other EC research-programmes, as well as whether the impact is ongoing or represents a one-time occurrence. Such considerations will enable the reader of the audit report to grasp the relevance of the incorrect action and understand the need for implementing the recommendations.

A CONCLUSION/RECOMMENDATION is a statement of the action that must be taken to correct the findings identified by the audit. Recommendations should ideally address the underlying cause and be specific, feasible and cost effective.

6.2.1.3 Nature of Audit Findings

The nature of the audit findings is a classification that has to be reported on the final audit assessment and may impact further (specific) procedures. There are three categories: Irregularities, Error and Qualitative. The words have been given the following definitions [11]:

Irregularities - refers to ▮▮▮▮▮▮ distortions by an individual of the Beneficiary's management, employees, or third parties, which results in a misrepresentation in the Financial Statement. Irregularities may involve *inter alia* manipulation or falsification of documents, recording of transactions without substance and misappropriation of assets.

Error - This term refers to unintentional mistakes or oversights in the Financial Statement, such as mathematical or clerical mistakes in the underlying records, misinterpretation of facts or misapplication of accounting policies. This is the situation when, for example, misstatements are due to the Beneficiary's lack of awareness or understanding of the contractual obligations.

Qualitative - Audit findings that are not giving reasons for a financial adjustment, are categorised as qualitative. An audit to verify the correct cost basis would normally be classified as qualitative.

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6.2.1.4 Seriousness of Audit Findings

The nature of the audit finding has to be distinguished from the seriousness of the audit finding. The seriousness of the audit findings is an additional classification that has to be reported on the final audit assessment and may also impact further (specific) procedures.

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[11] Reference is made to IFAC International Standards on Auditing and Related Services no. 11, "Fraud and Error"

There are four categories: *None, Small, Medium, High.* █████████████████

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6.2.1.6 Currency of adjustments to cost in the report

The adjustment of costs is to be expressed in national currency and EURO. The conversion rate to be used depends on the Framework Programme under which the grant agreement is agreed.
Usually relevant information to determine the exchange rate to be used should be included in the Audit Work Program (to also verify the exchange rate used by the beneficiary).

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6.2.2 Finalisation of the Audit Report

6.2.2.1 Special Procedures before finalisation of the Audit Report

Special procedures may apply to the audit findings before finalisation of the audit report. The auditors need to check if such procedures have to be followed and assess whether the report can be finalised.

6.2.2.2 Consultation of the draft audit report

When the draft report is completed the related parties may be consulted on the audit findings and conclusions by transmission of the draft report and request for comments.

The consultation should not lead to a significant delay in the closure of the audit engagement.

The following consultation procedures are foreseen and are **recommended** for use:

6.2.2.2.1 Consultation of internal parties (i.e. operational service)

The internal parties may be asked for comments on the draft report in writing.

6.2.2.2.2 Consultation of the Quality Control officer

Before sending the draft audit report to the auditee, the auditor should consult the Quality Control officer. ███
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6.2.2.2.3 Consultation of the audited organisation (beneficiary)

The audit organisation should be asked for comments on the draft report in writing. ███
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The audited organisation should be given a fixed deadline for comments within the judgement of the auditor(s).

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6.2.2.3 Letter of Representation

With the finalisation of the collection of audit evidence (usually at the end of the audit field-work and testing) the auditor has to obtain a letter of representation from the representatives of the beneficiary responsible for the financial and scientific management of the EC grant.

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6.2.2.4 Adaptation of the draft audit report

After analysis and eventual incorporation of the comments received during the consultation phase the auditor(s) will complete and finalise the draft audit report. Special attention shall be applied to ensure that all notions to the draft status of the report are removed.

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7 Process Phase 4: Audit Closure

7.1 Overview of the closing phase

Within the Audit Process, the Audit Closure Phase includes the following sub-phases:

- The **Communication of the Audit Results** for the further implementation of the Audit Results ███ ██

- ███ The **Completion of the Audit File** to be archived including all documentation related to the audit engagement ████████████████████████████████████ ████████████████████████

- The **Archiving of the Audit File** by the administrative support (secretariat)
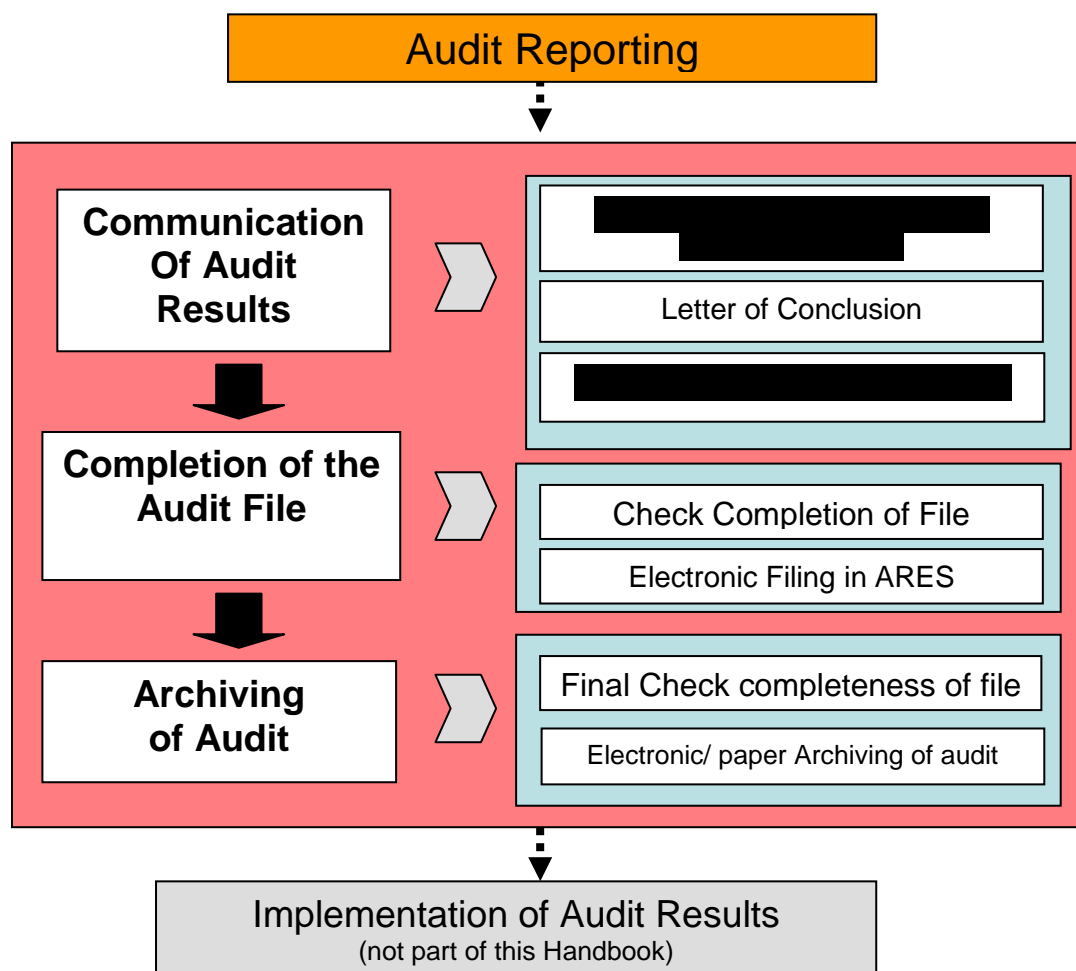
Figure AUDIT CLOSURE PHASE

7.2 The procedural steps during the Closure Phase

█████ Communication of the Audit Results and the Audit Closure ████████████

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Audit Closure ████████████████

Letter of Conclusion	✚	Final Audit Report	✚	Any annexes and Supporting Documents

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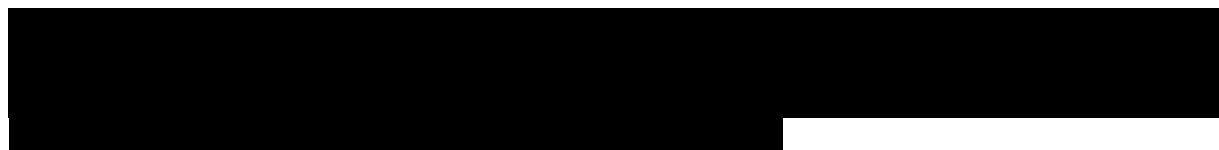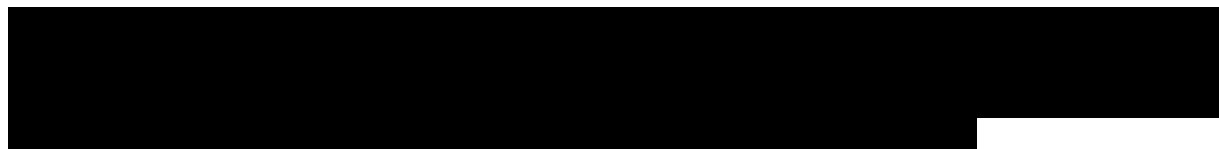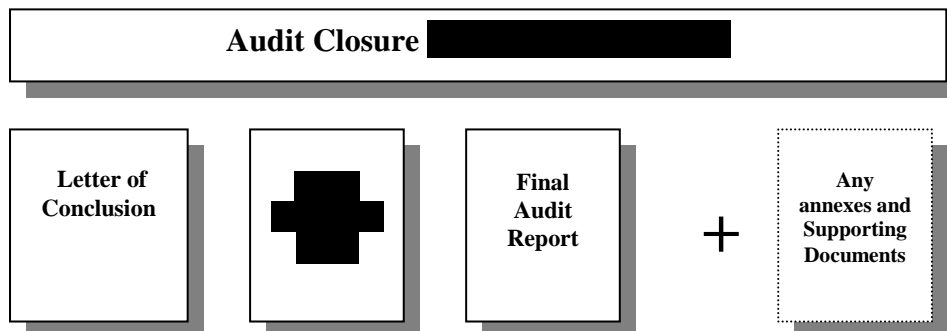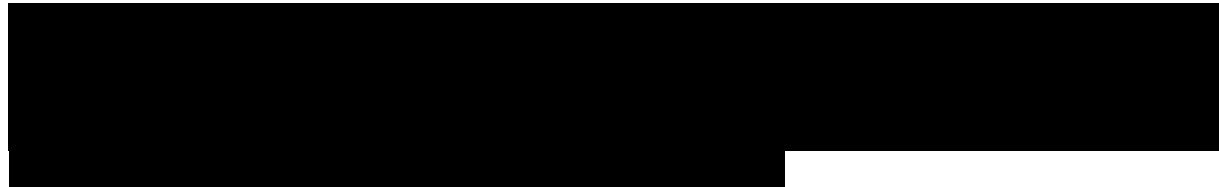
7.2.1.1.1 Letter of Conclusion (LoC)

The Letter of Conclusion is the document in which the audit results are communicated to the Beneficiary, and it contains remarks, conclusions and recommendations concerning the audit findings.

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The Letter of Conclusion prepared by the assigned (principal) Auditor is considered a draft version. The letter is finalised by signature of the authorised representative of the External Audit Service (Head of the external Audit Service or Director of the Directorate under which the service operates).

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7.2.1.1.3 The Final Audit Report

The finalised Audit Report should be re-checked by the auditor and signed by all members of the audit team.

The final Audit Report becomes valid with the approval by the authorised representative of the External Audit Service (Head of the external Audit Service), i.e. the signed Letter of Conclusion.

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[REDACTED]

List of grant agreements with the audited organisation

[REDACTED]

7.2.1.2 Audit Closure [REDACTED]

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7.2.1.3 The practical procedure for the communication of results

[REDACTED]

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7.2.2 The Completion of the Audit File

The Audit File is the complete set of documentation related to the audit engagement performed. ██
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Electronic Audit File

An audit file can be archived in a hardcopy and/ or electronic format.

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7.2.3 The Archiving of the Audit File

The administrative support function performs a (**mandatory**) final check of the completeness of the Audit File ████████████████████

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8.5 Sensitive Cases and Suspicion of Fraud

'Sensitive Cases' are characterised as audit cases which lead to indication or suspicion of fraudulent behaviour towards EC interests and assets.

[redacted]