Annex 2 – Financial and Compliance Audit Procedures

2

2.1 Planning and Fieldwork

The Audit procedures should, in accordance with ISAs, include:

Obtaining an understanding of the engagement context (ISA 300)

The Auditor should obtain sufficient understanding of the engagement context and establish an overall audit strategy. This will entail confirming the Auditor's understanding of the scope of the engagement, and understanding the laws and regulations which apply to the Programme and projects, including the Contractual Conditions which are set out in Section 3 of the ToR (Scope).

Specifically, the Auditor should focus on:

- understanding how the EEA and Norway Grants function and are disbursed and accounted for. The auditor should understand how the PIA, Manual and Management Control Systems (MCS) Description of the FO fit into the overall context of the EEA and Norway Grants. In addition, the auditor should understand the nature of activities managed by the FO;
- being familiar with the contents of the PIA and Manual. Familiarity of the PIA should extend to its annexes, which are integral to the PIA and therefore part of the Programme's legal framework; and
- understanding the objectives of the financial and compliance audit, the process to be followed e.g. for reporting and the outputs required.

The Auditor should pay specific attention to the Contractual Conditions related to:

- Eligibility of expenditure, particularly as set out in Chapters 4 and 5 of the PIA, and Chapter 9.2 of the Manual;
- Public Procurement rules set out in Chapter 7 of the PIA;
- Co-financing requirement at project level, including in-kind contribution in the form of voluntary work set out in Article 4.5 of the PIA, Point 4.3 of Annex II and Chapter 9.1of the Manual
- Cash and bank management;
- Documentation, accounting and financial reporting;
- Audits, monitoring, and reporting / remedying irregularities; and
- Information and communication rules set out in Chapters 3 of the PIA and Chapter 3 of the Manual.

Performing risk assessment (ISAs 315 and 330)

The Auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatements at the Financial Report and assertion levels, whether caused by error or fraud.

These procedures shall include inquiries of management and of others within the respective entities, analytical procedures (i.e. based on the financial reports submitted by the FO and PPs), and observation and inspection.

The risk assessment shall be based on the Auditor's understanding of the FO and PPs, the Programme (and projects) objectives and activities, as well as the relevant implementation context (i.e. sector / country / region), including the internal controls applied by the respective entities.

The Auditor shall design and implement responses to address the assessed risks of material misstatements, through substantive procedures designed to address such risks, as well as tests of controls, as appropriate (*see detailed sections below*).

Obtaining an understanding of the Entity and its environment, including internal control (ISA 315)

The Auditor should obtain an understanding of the nature of the Entity(ies) and its environment, including:

- the organisation's status (i.e. public / private, non-profit, NGO, etc.);

- the relevant / sector it operates in;
- the regulations relevant to its operations;
- ownership and governance structures (including related entities, if relevant);
- operations; and
- sources of financing.

The Auditor should also obtain an understanding of the Entity(ies)'s internal control relevant to the Audit, focusing on the key controls, and specifically those relating to the Programme / project, which are designed to prevent and detect material errors, irregularities, or fraud with regard to the Programme and the funds received under the EEA and Norway Grants.

In particular, the Auditor should obtain an understanding of the Entity(ies)'s:

- control environment;
- risk assessment processes; and
- control activities (relevant to expenditure control and financial reporting),

and assess how the FO ensured that all activities implemented, and costs incurred, under the Programme comply with the applicable Contractual Conditions.

The Auditor should consider qualitative as well as quantitative factors but since this audit is not a performance or operational audit, the Auditor should concentrate on financial internal controls rather than operational controls. The Auditor should use professional judgment to determine the extent of the understanding required.

When obtaining an understanding of relevant controls, the auditor should evaluate the design of the controls and determine whether they have been implemented effectively. Evaluating the design of an internal control involves considering whether, individually or in combination with other controls, it is capable of effectively preventing, or detecting and correcting weaknesses and deficiencies.

Procedures to obtain evidence regarding the design of internal controls can include:

- Discussions with relevant members of the Entity's staff;
- Evaluating whether descriptions of the various Entities' internal controls, if available, fairly present the internal controls that have been designed and implemented;
- Observing operations and inspecting documents, reports, printed and electronic records of transaction processing, accounting procedures (e.g. bank reconciliations) and other key approval and internal control procedures (e.g. periodical expenditure reports, budget – actual comparisons, review and approval of timesheets etc.); and
- Re-performing internal controls.

Performing tests of controls (if considered appropriate under ISA 330)

The Auditor should design and perform tests of (relevant) controls to obtain sufficient appropriate audit evidence if:

- The Auditor's assessment of risks of material misstatement includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the effective operation of controls in establishing the nature, timing, and extent of substantive procedures); OR
- Substantive procedures alone cannot provide sufficient appropriate audit evidence.

An internal control is operating effectively if, individually or in combination with other controls, it provides reasonable assurance that:

- The Entity's internal control objectives are achieved and in particular that risks to the achievement of the objectives of the Programme / Project are properly managed and controlled;
- The risks of error, irregularities and fraud with regard to the Programme / Project funding are properly prevented or detected in a timely manner.

When designing and performing tests of controls, the Auditor should:

- Perform other procedures in combination with inquiry to obtain evidence about:

  - How the internal control was applied;

  - The consistency with which the internal control was applied; and

- By whom or by what means the internal control was applied;

- Determine whether internal controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain evidence supporting the operating effectiveness of those indirect controls; and
- Determine the method for selecting items for testing that are effective in meeting the objectives of the procedure.

When determining the extent of tests of controls, the Auditor should consider matters including the characteristics of the population to be tested, which includes the nature of controls, the frequency of their application (for example, monthly, daily, a number of times per day) and the expected error rate.

Tests of controls may include, but are not limited to, inspection (of records, documents and assets), observation, inquiry of management and others within the Entity, confirmation, recalculation and re-performance.

Performing substantive procedures (ISAs 330 and 520)

Irrespective of the assessed risks of material misstatement, the Auditor should design and perform substantive procedures. This requirement reflects the facts that:

a) the Auditor's assessment of risk is judgemental and so may not identify all risks of material misstatement; and

b) there are inherent limitations to internal control, including management override.

Nevertheless, the results of tests of controls, if any, should be taken into account in determining the extent of substantive procedures.

Substantive procedures comprise:

- Establishing the audit trail (i.e. agreeing the financial reports to the underlying accounting records);
- Reviewing / establishing the cashflows within the Project and reconciling fund balances;
- Performing tests of details of transactions across the different budget lines; and
- Performing substantive analytical procedures.

The tests should be relevant to the nature of the transaction and the related assertions (i.e. completeness / occurrence, etc.), as well as its compliance with the eligibility criteria set out in the Contractual Conditions, and should include:

- Agreeing costs to invoices, receipts, contracts, and other relevant supporting documents;
- Reviewing evidence of actual payment;
- Reviewing compliance with procurement policies and applicable guidance (i.e. Contractual Conditions and national regulations); and
- Reviewing the calculation and reasonableness of costs charged / allocated to the project / programme.

ISA 520 defines substantive analytical procedures as evaluations of financial information through analysis of plausible relationships among both financial and non-financial data (e.g. assessing the reasonableness of total staff costs claimed based on contractual pay, timesheets, joining and leaving dates, etc.). Analytical procedures also include identifying fluctuations or relationships which are inconsistent with other relevant information or that differ from expected values by a significant amount (e.g. level of travel costs claimed compared to the nature of activities actually implemented).

Sampling methodology and selection (ISA 530)

In the context of the financial and compliance audit for the ACF Programme, the Auditor will need to perform audit sampling as a minimum, at two levels:

1) selection of the projects to be audited to meet the minimum criteria set out in Article 9.5 of the PIA (see also Section 3 of the ToR); and
2) selection of transactions from the expenditure reported under the projects selected for audit, as well as from the expenditure directly incurred by the FO.

ISA 530 states that audit sampling can be applied using either non-statistical or statistical approaches. The decision regarding which approach to use is a matter of the Auditor's professional judgement. However, it is important to note that the Regulation on the implementation of the EEA and Norwegian Financial Mechanisms for 2014-2021 considers statistical sampling as the preferred approach for national entities tasked with its implementation.

The ISA further states that the Auditor shall:

- consider the purpose of the audit procedure, and the characteristics of the population;
- determine a sample size sufficient to reduce sampling risk to an acceptably low level; and
- select items for the sample in such a way that each unit in the population has a chance of selection.

Article 6 of the 'Manual for the FOs of the Active Citizens Fund' states that the FO's description of its management and control systems (MCS) should include a section setting out its own sampling methodology and the Auditor should also take this into account, if available.

Nevertheless, the Auditor should adopt a risk-based approach in determining its sample (at both levels as above) and consider the following factors, amongst others:

- Results of the FO administrative verifications and/or any previous audits (in selecting projects to audit);
- Whether a project had been subject to previous monitoring controls (i.e. on-the-spot verifications) from the FO and the results thereof;
- Amount of actual vs. budgeted project expenditure;
- Length of implementation period; and
- Nature / amount of the underlying transaction.

In the event that the Auditor discovers errors of a systemic nature in the sample selected, the Auditor should assess if, and what, further procedures are appropriate to obtain reasonable assurance in relation to the remaining transactions in the population (e.g. extending the sample size, performing other substantive procedures, etc.).

In addition, the Auditor should assess the cause(s) of these systemic errors and consider if raising a management control finding is appropriate.

2.2 Audit Documentation and Evidence (ISAs 230 and 330)

The Auditor should prepare audit documentation and obtain sufficient appropriate audit evidence to support audit findings and to draw reasonable conclusions on which to base the audit opinion. The Auditor should use professional judgment to determine whether the audit evidence is sufficient and appropriate taking into account the Contractual Conditions.

Audit documentation or working papers means the record of audit procedures performed, relevant audit evidence obtained, judgements, and conclusions that the Auditor reached. An audit file should be prepared in one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation or working papers for each specific engagement.

Audit documentation should provide:

- Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the audit; and
- Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements (including the Contractual Conditions).

The following should be included in the audit documentation:

a) the overall responses to address the assessed risks of material misstatements, and the nature, and extent of audit procedures performed;
b) the linkage of the procedures with the assessed risks; and
c) the results of the audit procedures, including the conclusions.

In forming an opinion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial report.

If the Auditor has not obtained sufficient appropriate audit evidence, the auditor should attempt to obtain further audit evidence (see further guidance on *Reporting*, under Section 6 of the ToR) before issuing a conclusion (i.e. final audit opinion).