

## **Annex 5.A - Supporting note for auditing**

### **1 Financial audit**

Financial audits are intended to provide reasonable assurance that the financial statements are presented fairly, in all material respects, in accordance with the financial reporting framework.

#### **1.1. Objective of the financial audit**

The overall objective of the financial audit is to obtain reasonable assurance about whether financial statements regarding the funds granted through the MFA are free from material misstatement. Based on the audit evidence obtained, the objective is thereby to express an opinion on whether the financial information comprising the funds granted through the MFA are free from material misstatement.

In the case of an audit prepared based on stand-alone reporting, the financial statements only comprise the specific activities/engagement, to which the amount granted contributes.

Since the financial statements do not cover other activities, the sole objective of the audit is to provide assurance to the MFA as to whether financial statements are free from material misstatement. The auditor must therefore design the audit to meet this purpose. This includes identification of risks and procedures directly related to the funds granted, assessing the internal controls in relation to preparing financial statements for the engagement, evaluating the applied accounting practices against those set by the MFA and evaluating whether the structure of the financial statements complies with the reporting requirements set by the MFA.

#### *Special considerations regarding the objective of financial audit of organisational reporting*

In the case of organisational reporting, the financial statements will most likely be prepared to meet requirements other than those established as a result of including funds granted through the Danish MFA. The ability to determine reporting format, as well as audit scope and procedures, will therefore be limited. This results in the following considerations:

Since the financial statements do not specify the particular income or expenditure pertaining to specific activities, it is not possible to perform specific audit procedures for each grant based on the financial statements. The objective of the audit is therefore to provide assurance regarding the consolidated financial statements, thereby indirectly providing assurance regarding funds granted through the MFA. The MFA must determine whether such assurance regarding a set of consolidated financial statements provides sufficient guarantee, regarding funds granted through the MFA. If further assurance is deemed necessary, additional audit procedures must be specifically planned and performed to provide assurance on the individual engagement level including the funds granted through the MFA. These additional procedures must be described in detail in the relevant Terms of Reference for the audit.

#### *Special considerations regarding the objective of financial audit of appendix reporting*

In the case of appendix reporting, income and expenditure are specified for each individual engagement. It is therefore possible to specifically identify the income and expenditure pertaining to the

MFA. The objective of the audit is therefore to provide assurance regarding the consolidated financial statements, including appendices or notes containing individual grants, thereby providing assurance regarding activities funded through the MFA.

The proportional share of income and costs pertaining to the MFA, compared to the total income and costs, will vary. In some instances, the MFA portion will be highly significant compared to the total amount of income and costs, and in other instances the MFA share will be insignificant. The MFA must take this into consideration when determining whether assurance provided from the audit of the consolidated financial statement, including appendices or notes, is sufficient.

If further assurance is deemed necessary, this must be reflected in the Terms of Reference for the audit, as described in the next section below (7.1.2.).

### **1.2. Scope of the financial audit**

The financial audit must be carried out in accordance with International Standards on Auditing (ISAs).

As part of an audit conducted in accordance with the ISAs, and in order to meet the requirements applicable to audits of funds granted through the MFA, as regulated by the office of the Danish Auditor General, the work is expected to cover:

- The auditor must identify and assess risks of material misstatement of the financial statements, whether due to fraud or error. Based on the risks identified, the auditor must design and perform relevant audit procedures to obtain sufficient and appropriate audit evidence to serve as the basis for the auditor's opinion.
- The auditor must obtain an understanding of the internal controls relevant to the audit, in order to design appropriate audit procedures. The purpose is not to express an opinion on the effectiveness of the internal controls. In relation to activities funded through the MFA, these controls pertain in particular to costs, including costs related to projects, recognised in the financial statements.
- The auditor must evaluate the appropriateness of the accounting policies used in the financial statements, including the reasonableness of estimates and related disclosures. In relation to funds granted through the MFA, this is particularly relevant for accounting policies regarding project costs.
- The auditor must conclude on the appropriateness of Management's use of the going concern basis of accounting in preparing the financial statements. Based on the audit evidence obtained, the auditor must also conclude on whether a material uncertainty exists, which may cast significant doubt on the partner's ability to continue as a going concern.
- The auditor must evaluate the overall presentation, structure and content in the financial statements.

The audit should be performed on an annual basis, however, , under special circumstances, it may be extended by a couple of months with the explicit consent of the MFA.

*Special considerations regarding the scope of financial audits of organisational and appendix reporting*

As described, frameworks of auditing other than the ISAs may be applied in the case of organisational and appendix reporting. This can result in discrepancies in methodology and therefore discrepancies in planned and performed procedures. In these cases, the responsible case officer must ensure that the scope of the audit performed is equivalent to that of an audit performed according to the ISAs. Any discrepancies in methodology should be identified by the performing auditor. Subsequently, it must be determined whether further specific audit procedures are necessary to meet the requirements of an audit performed according to ISAs. This assessment must be based on a number of criteria, including but not limited to:

- The amount in question
- The capacity and competence of the organisation preparing the financial statements, including:
  - Accounting systems applied
  - Capacity in the finance section
  - Processes and implemented controls regarding costs
  - Processes and implemented controls regarding preparation of financial statements
- The scope of the audit performed
- Cost incurred as a result of further procedures
- Prior experience with the partner in question

The scope of further procedures may range from an actual audit being performed for the specific engagement to specific agreed upon procedures agreed with the partner. In all cases, discrepancies and further procedures, if necessary, must be described thoroughly in the Terms of Reference for the audit.

Since the objective of the audit is to provide assurance regarding the consolidated financial statements and not individual activities or engagements, the scope of the audit will be based on this. As a result, it is not likely that risks relating to specific activities will be identified and addressed. The responsible case officer must therefore evaluate the need for audit procedures on the individual engagement level.

The appropriateness of the applied accounting policies will similarly be assessed in relation to the reporting purpose of the consolidated financial statements for the organisation as a whole and not for the purpose of reporting on engagements funded by the MFA. The MFA must therefore assess whether the described principles for accounting in chapter 5 of these guidelines have been complied with.

## **2. Performance and compliance audit**

This chapter brings together both performance and compliance audit, even though it refers to two individual types of audit.

Performance audits examine the economy, efficiency and effectiveness of the audited activities. Compliance audits examine whether the activities are compliant with applicable rules, policies, and regulations.

### **2.1. Objective of performance and compliance audits**

The overall objective of a compliance audit is to obtain reasonable assurance that transactions covered by the financial statements comply with the appropriations granted, statutes, other regulations,

agreements, and usual practice. Similarly, the objective of a performance audit is to make an assessment to obtain reasonable assurance that the systems, processes or transactions examined support the exercise of sound financial management in the administration of the funds granted through the MFA. Sound financial management includes adhering to principles of economy, efficiency and effectiveness in the management of available resources.

Often financial audits will be carried out as an assurance service, and performance and compliance audits as reporting services. For performance and compliance audits the auditor is still expected to obtain a high degree of certainty for the conclusions reported, but typically does not declare him-/herself on the entirety of the financial statements.

*Special considerations regarding the objective of performance and compliance audits of organisational and appendix reporting*

Due to the limited influence on the terms of an audit in the case of organisational and appendix reporting, the objective of the audit will most likely not include assurance regarding compliance and performance for the engagement. The responsible case officer must consider whether specific procedures regarding compliance and performance audit are necessary. These additional procedures must be described in detail in the relevant Terms of Reference for the audit.

These procedures will vary according to the engagement in question and to the implementing partner. The planned and performed procedures must therefore be carefully designed to address individually identified performance and compliance audit criteria.

Please refer to annex 5 (Model ToR for engaging audit services) for guidance on relevant compliance and performance audit procedures.

## **2.2. Scope of performance and compliance audits**

As Danish provisions require the audit to be performed according to public sector auditing standards based on the International Standards of Supreme Audit Institutions (ISSAIs), the audit is required to cover not only financial aspects, but must also include compliance and performance elements.

The performance and compliance audit must be carried out in accordance with the ISSAIs. Specifically, the ISSAI 3000-series is used for performance audit and the ISSAI 4000-series is used for compliance audit.

As part of an audit conducted in accordance with ISSAIs, and in order to meet requirements applicable to audits of funds granted through the MFA, as regulated by the office of the Danish Auditor General, the work is expected to cover:

- The auditor must examine and evaluate the functioning of management systems and business processes with special consideration to compliance and performance audit. Based on the obtained knowledge, the auditor must determine relevant audit objectives and audit approach.
- The auditor must gain an understanding of the audited entity and its environment to identify relevant regulation and legislation; this includes tax legislation, company legislation, labour legislation, etc.

- The auditor must consider the necessity and relevance to perform test of details regarding compliance and the principles of economy, effectiveness and efficiency.

For further guidance on relevant compliance and performance audit procedures, please refer to annex 5 (Model ToR for engaging audit service).

The audit plan for a multi-year engagement should include considerations about what performance and compliance audit procedures to include and when to include these. Based on an understanding of risk and importance, the auditor can rotate the compliance and performance related audit procedures, as long as relevant performance and compliance are tested during the grant period.

*Special considerations regarding the scope of performance and compliance audits of organisational and appendix reporting*

As described, the scope of the audit will most likely not include assurance regarding compliance and performance for the engagement. Similar to the situation in relation to the financial audit, the MFA must determine whether procedures are required and the scope of these. The criteria, which must be considered, are similar to those regarding the financial audit, but also include:

- The complexity of the activity/engagement
- Capacity and competence in the organisation specifically regarding project implementation
  - Processes and controls related to procurement
  - Processes and controls related to project monitoring and evaluation
  - Processes and controls related to project reporting.

The scope of further procedures may range from an actual compliance and performance audit being performed on the specific engagement, to specific agreed-upon procedures agreed with the partner. In all cases, additional procedures, if necessary, must be described thoroughly in the Terms of Reference for the audit.

It is the responsibility of the MFA to determine, if separate compliance and performance audit procedures are needed. This determination should be based on a.o:

- An assessment of the risk and materiality of the activities funded. The higher the risk and materiality, the more important it will be to add compliance and performance audit procedures if these are not included in the organisational audit or if they are not considered to target the activities funded by the MFA, to a sufficient degree (see annex 1.A for an illustration of risk and materiality considerations)
- The extent to which other elements in the overall monitoring plan for the engagement covers compliance and performance elements (see guidance note on the monitoring plan). If other oversight activities address compliance and performance, it will be less important to add additional compliance and performance audit procedures.

### **3. Deliverables – audit report**

Conclusions of the audit, including relevant emphases or qualifications, must be reported in the independent auditor's opinion, which must be included in the financial statements. The auditor's

opinion should be prepared in accordance with the ISAs depending on the type of financial statements. The auditor's opinion must be provided together with the audited set of financial statements no later than six months after the end of the financial year.

The methodology of the audit must be described and provided, either in an audit report included in the financial statements, or via an audit summary memorandum submitted after the audit. In either case, the purpose of providing a description of the methodology of the audit is to provide the MFA with the basis to assess the scope of the performed audit. The methodology must therefore be as detailed and elaborate as possible and, as a minimum, is expected to contain:

- Identification of the accounting period
- A detailed description of the scope of the audit, including
  - Material account balance and classes of transactions
  - Identified risks
  - Procedures performed to address identified risks
- A description of the applied audit strategy and the basis therefore
- The number of samples allocated on physical locations, offices, etc.
- A description of the applied materiality, including
  - The basis for setting the materiality level
  - Any special considerations made regarding the materiality
  - The materiality level specified in the currency of the financial statements
- A description of planned and performed on-site visits.

The exact scope of the description of the methodology should be determined in the Terms of Reference of the audit.

In conjunction with the audit, the auditor is required to prepare and submit a management letter. The management letter must contain observations and findings identified during the audit, which must be communicated to management. These observations can pertain to deficiencies in internal controls, non-compliance with local legislation, specific issues discussed with management, etc. The observations and findings included may be immaterial for the financial statements as a whole, but relevant for management or relevant stakeholders, including the MFA. For each observation or finding, the auditor must provide a description of the related risk, the auditor's recommendation, as well as management's response to the observation or finding.

### **3.1. Audit of organisational reporting**

If the audit is performed in accordance with an audit framework other than the ISAs, the auditor's opinion should be prepared accordingly. However, to meet requirements set by Danish legislation for the audit of funds granted through the MFA, the opinion must provide information similar to that of an opinion according to the ISAs. This includes any qualifications, emphases, or whether the financial statements as a whole are free from material misstatements. Further, the opinion must state the basis for the opinion, including applied framework for the audit.

The purpose of providing a description of the methodology of the audit is to provide the MFA with the basis to assess the scope of the performed audit. If the financial statements are made public to a broader audience, the auditor may be reluctant to disclose detailed information regarding the audit. In these cases, the responsible case officer must obtain an understanding of the methodology through other means. The methodology may be communicated through a memorandum, not to be disclosed to third parties or at a closing meeting between the auditor and representatives from the MFA.

If any specific procedures have been planned and performed as supplement to audit of the consolidated financial statement, a description of the applied methodology regarding these procedures must be provided.

Since the audit includes the entire organisation, and not in particular the funds granted through the MFA, the management letter will cover observations and finding possibly not relevant for the granted funds. However, the management letter will still provide an assessment of any deficiencies in internal controls, etc. that may affect the handling of funds granted through the MFA. If further audit procedures are planned and performed as a supplement to the audit of the consolidated financial statements, a management letter should also be prepared to cover observations and findings identified as a result of these procedures.

### **3.2. Audit of appendix reporting**

If income and expenditure for each grant are specified in appendices or notes, the auditor is expected to have planned and performed procedures regarding these. These specific procedures regarding income and expenditure pertaining to the grant must be described as part of the methodology of the audit.

### **3.3. Audit of stand-alone reporting (special purpose audit)**

The independent auditor's opinion should be prepared in accordance with ISA 800 or ISSAI 1800 and must refer to the Terms of Reference for the audit.

Since the financial statements only pertain to the specific amount granted through the MFA or a specific engagement, the planned and performed procedures are expected to be directly aimed at obtaining assurance regarding these amounts or engagements. The scope of the description of the methodology is therefore expected to be in accordance with the specific requirements established in the Terms of Reference for the audit.

The purpose of the provided management letter will be to identify findings and observations relating specifically to the funds granted through the MFA, but also to the organisation as a whole. The management letter is therefore expected to contain detailed findings regarding the granted funds as well as observations and findings regarding more general areas, including key internal controls.