

Are International Audit Standards useful for First Level Control?

Some lessons learnt from the INTERACT workshop on International Audit Standards and First Level Control

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Much has been said by the European Commission and by Member States on requirements for the work of the Audit Authority in the programming period 2007-2013. Compared to this, **it has been remarkably quiet when it came to the requirements of First Level Control** to be fulfilled by Member States, Managing Authorities and First Level Controllers. By and large responsible bodies are free to choose their own solution for structure, reporting lines and control provisions, provided they stay within the flexible boundaries of the Regulations such as those of *Article 16 of Regulation (EC) No 1080/2006* and *Article 13 of Regulation (EC) No 1828/2006*. As there is a high variety of management and control systems throughout the EU-27, flexibility is important. However, many important questions remain unanswered, even though a *Guidance Note on Management Verifications* was released in June 2008.¹ The *Guidance Note on Management Verifications* clarifies some of the legal requirements in such a way that the enormous control requirements are somewhat downsized. The specific nature, timing and extent of the verification work to be performed is, however, largely left to the individual programmes putting much pressure on Member States and Managing Authorities to find reliable answers. Adding to this pressure, according to *Regulation (EC) No 1828/2006*², Certifying Authorities have to certify in particular the correctness of **all** expenditure and the lawfulness of **all** operations, including the underlying transactions and procedures as well as the accounting systems of operations.

Keeping in mind the *Commission Action Plan*³ to significantly bring down error rates in the Structural Funds, not least by improving the primary controls at management level in the Member States, **one of the most pressing issues is to ensure effective and efficient First Level Controls** in line with EU Regulations in order to avoid financial corrections.

International Audit Standards provide guidance and solutions for questions on audit work, documentation and audit design - at least for Second Level Control.⁴ Do they provide some answers for First Level Control as well? This question was addressed by INTERACT Point Vienna at a workshop for First Level Controllers of cross-border ETC Programmes on 25-26 September 2008 in Bregenz, Austria. In order to simplify the matter a little, the workshop focused on the IFAC International Standards on Auditing (ISA) rather than other existing standards⁵. The main outcomes of the workshop are summarised in this article.

¹ COCOF 08/0020/04-EN, 5.6.2008: Guidance documents on management verifications to be carried out by Member States on operations co-financed by the Structural Funds and the Cohesion Fund for the 2007-2013 programming period.

² Reg. (EC) No 1828/2006 Annex X; Certificate and Statement of Expenditure and Application for Interim Payment.

³ COM (2008)97final, 19.2.2008: Communication from the Commission to the European Parliament, the Council and the Court of Auditors. An Action Plan to strengthen the Commission's supervisory role under shared management of structural actions.

⁴ In the 2007 – 2013 programming period, the use of internationally accepted audit standards is compulsory for Second Level Control (see Article 62 (2) of Regulation (EC) No 1083/2006). The Regulations do not explicitly refer to the use of International Audit Standards for the purpose of First Level Control.

⁵ More information on ISA Standards can be found at: www.ifac.org. Other existing standards include EUROSAI and INTOSAI standards.

ISA comprise a set of tools some of which are already applied to First Level Control

Experience from the last programming period showed that, even though requirements for controllers were similar throughout Europe, **the type of work performed as well as its extent and quality could vary substantially from one First Level Controller to the next** even within one country. The weak performance of First Level Control in the previous Structural Funds period is among the top systemic effects found in the assessment of the financial management of Structural Funds programmes. The situation in cooperation programmes was rendered worse by the fact that operations were to be implemented and controlled in several Member States.

ISA define how audit work should be carried out by standardising and categorising audit procedures. As such they include also control procedures typically used in First Level Control.⁶ This comprises, for instance, substantive procedures such as the *test of details* of invoices, *risk assessment procedures* that can be applied at the beginning of an on-the-spot verification with the purpose of getting to know the beneficiary, *tests of control* that can be applied to verify the proper functioning of the beneficiary's crucial processes such as public procurement and *analytical audit procedures* to check if budget lines have been respected. In setting the standards, quality norms for audit procedures are set as well. ISA therefore could help defining standardised First Level Control procedures and could thus help ensure a basic quality level of the First Level Control carried out throughout the EU-27.

By reviewing the ISA it also became clear that **they contain more procedures than are usually employed by First Level Controllers**. For example, *tests of control* are usually not among First Level Control procedures. For this reason, it is absolutely necessary to selectively focus on those procedures that are most relevant to First Level Control. However, considering the wide scope of certification required by *Regulation (EC) No 1828/2006*, Member States could wish to assess whether additional procedures should be included in the standard management verifications or if some procedures would be more appropriate than the ones currently in use. For instance, the above mentioned *tests of control* - although currently not frequently used in First Level Control - could in fact be appropriate when it comes to the verification of transactions of accounting systems.

ISA could help improve communication between First and Second Level Controllers

Each First Level Controller documents his or her work by using checklists, copies of controlled documents, by signing off controlled invoices, and/or by writing control reports including a summary of findings. Here as well, in the past programming period, **the scope and quality of the documentation work varied considerably** among First Level Controllers. Specifically, documentation sometimes lacked important information with regards to the objective, nature, extent and result of checks undertaken. This in turn made effective communication of the work done and conclusions reached towards Second Level or Third Level Controllers very difficult and - in many cases - impossible. For instance, in many cases tick marks were used in checklists without a clear definition of the actual meaning of the tick marks.⁷ In such cases, for Second Level Controllers, sometimes

⁶ For this reason, in this article, the term 'audit' is understood as including also First Level Control checks (normally referred to as 'control' rather than 'audit' in a Structural Funds context).

⁷ The meaning of tick marks can vary substantially reaching from a general 'controlled' or 'expenditure is eligible' to more specific aspects of general eligibility such as 'expenditure has actually been paid', 'expenditure belongs to the project' or 'the correct cost accounting number has been used'.

the only way of assessing First Level Control work was to do a re-performance of the First Level Control checks. The purpose of these re-performances was to obtain substantial information missing in the First Level Control documentation such as extent of audit work, sample sizes, conclusions made for the individual documents controlled, and others.

In addition, a **certain lack of understanding of the meaning of the templates and terminology** used for certifications of financial project reports on the side of the First Level Controllers turned out to be an issue for some programmes. Put in simple terms, First Level Controllers were not always aware of the control work necessary to obtain appropriate evidence in order to be able to sign the certification template. This led to certificates lacking appropriate supporting control work, which in turn raised questions about the reliability of the First Level Control System as such.

ISA set rules for efficient documentation. ISA documentation provides comprehensive information on the work done, including references to documents constituting the audit file (e.g., application form, application for reimbursement, expenditure list, checklists, contracts), as well as results of the work, conclusions drawn and decisions taken. They also give guidance on effective working paper preparation, for instance, by requiring the use of defined tick marks and checklists. Finally, they also provide guidance on the documentation of professional judgement as well as the documentation of potential follow-ups. By establishing common standards for the documentation of First Level Control work - complementing the already well established and successful use of checklists - much pressure could be taken off from the First Level Controllers as the control work done could be made more transparent and choices and judgements made could more easily be communicated towards auditors of other levels.

In addition, a **common understanding of a limited set of key terminology and phrases** as defined by ISA and also employed by the Structural Funds Regulations⁸, could ensure that everyone has the same understanding of specific issues. It could thus facilitate communication between First Level Controllers, Managing Authorities, Certifying Authorities, Audit Authorities and others and effectively avoid misunderstandings. The resulting gain in transparency could also significantly improve the demonstrable quality of First Level Control systems and reduce overall programme error rates.

However, as it is the case for the procedures discussed above, a standard documentation of the work done complementing checklists based on ISA standards **would need to be developed specifically for the purpose of cooperation programmes**. The workshop provided an example of how this could be achieved for a participating cross-border programme. Individual solutions would need to be developed for individual programmes.

Likewise, it would certainly be necessary to **identify the terminology defined in ISA that is most relevant to First Level Control**. As the words and phrases defined in ISA cover a very large ground, downsizing to the most appropriate terms would be key in order to avoid swamping First Level Control with nice but not applicable terminology.

⁸ For example, Article 13 III Reg. (EC) No 1828/2006 requires the Managing Authority to determine the size of the sample for on-the-spot verifications in such a way that **reasonable assurance** about the legality and regularity of the underlying transactions is achieved. *Reasonable assurance* is defined by ISA as a high, but not absolute, level of assurance. It is expressed positively in the auditor's report as *reasonable assurance* that the information subject to audit is free of material misstatement. The ISA provide a clear concept of materiality (or material misstatement) as well. As a consequence, by using the term *reasonable assurance*, the Regulation seems to introduce the concept of *materiality* and the *audit risk model* (audit risk being the opposite of reasonable assurance) to the First Level Control systems. Clarifying the consequences of this particular phrase for First Level Control systems requires some thought by all levels of control and might need a clear positioning of the European Commission as well. In any case, it influences the decision on the size of the sample for on-the-spot verifications.

ISA could help focus and downsize First Level Control workload

Currently, it appears to be **common sense amongst First Level Controllers that a full control of all supporting documents is the best approach**. As already pointed out above, for certain verification objectives, a full control in the sense of substantive procedures (e.g. *test of details* of all invoices) might not always be appropriate. This could especially be the case when it comes to controlling underlying transactions and procedures of the beneficiaries such as procurement procedures, project accounting and the process of establishing applications for reimbursements. Furthermore, discussion amongst workshop participants showed that there is no common understanding of what a 100 % control really implies, for instance with regards to public procurement.

Presently, First Level Control approaches tend to rely much on template checklists. The use of checklists, if not complemented by more general documentation, can lead First Level Controllers to the erroneous conclusion that a check is complete if the checklist is completed. As a consequence, non-typical material eligibility issues specific to an operation or beneficiary but not covered by the checklist might slip the First Level Controllers' attention. Equally important, control based on checklists only can focus too much on formal and/or minor issues and consequently drain much needed resources from First Level Control.

Given the already very substantial workload for First Level Controllers, it appears appropriate to re-think current approaches to First Level Control and more specifically the practice of full control of documents. One option would be to establish more effective **risk-based approaches for both administrative checks and on-the spot checks**. Introducing a more risk-based approach, guided by the main risk that ineligible expenditure is declared to the European Commission could render the First Level Control approaches more flexible and more efficient with regards to material error sources. At the same time, First Level Controllers would gain more freedom to exercise professional judgement with regards to minor deviations from the norms.

Based on an Audit Risk Model, ISA could help Member States, Managing Authorities and Certifying Authorities analyse the risks of their programmes and management and control systems. Through this process, the relevant risks could be identified and methodological reasoning for focusing control efforts on the material risks identified could be established. Based on EU legislation as well as ISA and identified risks, Member States and Managing Authorities could make informed decisions and answer questions like:

- Which risks are material in view of the overall objective of the management verifications⁹ and must therefore be controlled?
- Which risks could be accepted (as being of minor importance) in view of the overall objective of the management verifications and thus downsize control work?
- What is the relevant procedure for which management verification objective and which relevant risk?

However, the workshop also made clear that the scope of the Audit Risk Model is clearly more appropriate for Second Level Control and that an **un-reflected application of the Audit Risk Model to First Level Control might also cause unintended control gaps** in the

⁹ In addition to the main risk mentioned above namely that ineligible expenditure is declared to the European Commission, additional risks of key importance are that operations are not lawful and are not based on legal and regular transactions and correct accounting systems. See as well Reg. (EC) No 1828/2006, Article 13 and Annex X.

First Level Control systems. There are very important restrictions which need further methodological considerations from Member States and Managing Authorities¹⁰. The applicability of the Audit Risk Model to First Level Control of specific programmes would therefore need to be assessed on a case-by-case basis for each Operational Programme by each Managing Authority/Member State.

Conclusion and Next Steps

To conclude, specific aspects of ISA such as standardised audit procedures and documentation **could be used as a means to professionalise First Level Control and to facilitate communication with Second Level Control** and other control bodies. Potential benefits are substantial, with the most prominent one being the improvement of the First Level Control system in terms of effectiveness and efficiency. Considering limited guidance on running Structural Funds programmes as well as limited resources available to First Level Control and Programme management bodies, any promising chance to improve effectiveness, efficiency and certainty should be worth further exploration.

However, First Level Controllers rarely are certified auditors and International Audit Standards are new to many. As information provided by ISA or other international Audit Standards is typically only partially relevant to First Level Control, any further step would require further specification of those aspects that are relevant to First Level Control based on a set of practical examples. This was also confirmed by the concluding workshop discussion where **participants raised concerns with regards to additional documentation requirements** and potential control procedures that seem to be overdone in certain cases. For example, further discussion is needed as regards the approach for on-the-spot verifications and the usefulness of *risk assessment procedures* and *tests of control*, especially for very simple or very small operations.

It remains the impression that **we are only at the beginning of a discussion** on quality, scope, nature and objectives of First Level Control. The workshop in Bregenz provided very important insights and new thoughts. It is important that this beginning will soon lead to results that can be used by the people actually doing the work: the First Level Controllers, on whom the control system relies. As the discussion among programmes has just begun, there appears to be no 'pilot case' of a First Level Control system based partially on ISA or any other standard. INTERACT Point Vienna thus correctly pointed out that supporting Member States, Managing Authorities and First Level Controllers in making relevant ISA usable and useful for First Level Control requires a very pragmatic approach far away from academic discussions.

About the Author: Susanne Volz has more than eight years experience in Second Level Control of national and ETC Programmes. Working for an international audit company, she became familiar with ISA by using ISA in her day-to-day work. Due to her high specialisation on EU financial control she is not a certified auditor. She has a degree in Public Administration from the University of Konstanz, Germany and a Masters degree of Advanced European Political Studies from the College of Europe in Bruges, Belgium. Currently, she works as a freelance expert in the field of Financial Control.

¹⁰ The first and most important restriction being that International Audit Standards are made for external audits of entities, which use internal controls in order to establish their financial statements. Transferring this analogy to Structural Funds programmes and their management and control systems, the First Level Control system represents the internal control of the entity, the Second Level Control system represents the external audit. In consequence, some methodological concepts of ISA, especially the ones that refer to the *audit risk model* and the achievement of reasonable assurance, need to be assessed with special consideration of the concept of (internal) control and control risk, if one intends to make the *audit risk model* fully usable for the First Level Control.