

Exploring milestones and rationales for the development of the audit methodology of the European Court of Auditors

Judit Fortvingler

Received 2012-05-27

Abstract

The key objective of the article is to explore the evolution of the audit methodology of the European Court of Auditors, the external auditor of EU finances. The author identifies significant landmarks of the process, by splitting the whole period into three parts from its foundation until recent progresses. The research method applied is the consultation of the documents available at the Historical Archives of the European Union in Florence and the European Court of Auditors in Luxembourg (within the framework of the Postgraduate Research Grant Programme), and interviews with auditors of the Court and professionals who have the knowledge of the overall external audit.

The article concludes that the Court's methodological framework reflects from all aspects the professional standards on auditing. Both the legal framework and the Court's institutional evolution highly influenced the development of the methodology. The outcome of the research later serves as a reference point to investigate whether a common methodology to EU funds across Member States is possible and of intention. This aspect is a fundamental prerequisite of the feasibility of the single audit concept in the context of the external audit function and internal control chain of EU funds.

Keywords

European Court of Auditors · substantive tests · European Auditing Guidelines · International Standards on Auditing

Acknowledgement

This work is connected to the scientific program of the 'Development of quality-oriented and harmonized R+D+I strategy and functional model at BME' project. This project is supported by the New Széchenyi Plan (Project ID: TÁMOP-4.2.1/B-09/1/KMR-2010-0002).

Judit Fortvingler

Department of Finance, BME, 1117 Budapest, Magyar tudósok krt 2, Hungary
e-mail: fortvingler@finance.bme.hu

1 Introduction

One of the most risky budgetary areas of the European Union is the cohesion policy under the heading of sustainable growth, which is run under shared management. It means that not only the European Commission but also the Member States bear responsibility of the implementation of the budget. For years, the European Court of Auditors (ECA) has revealed flaws and errors of which a significant proportion should have been detected by the Member States themselves. This raises the issue how the present internal control and external audit functions could work more effectively following the assumption that not more audits but better coordinated audits are required. The financial management of the EU funds could be further developed, notably by putting reliance on others' work at different levels of the control and audit chains. An important prerequisite to achieve confidence on others' work is the convergence in methodology. The article analyses the audit methodology and its evolution of a fundamental element of the EU finances: the ECA's methodology, which will later serve as a reference point for further research.

Inspired by a report, 'The Case for a European Audit Office', published by Heinrich Aigner, the European Court of Auditors was established in 1975 to transform the antecedent Audit Board into a more powerful external audit function of the European finances. Due to the Treaty on European Union, signed in Maastricht and with entry into force in 1993, the ECA became one of the institutions of the European Union. The Treaty on the Functioning of the European Union (TFEU¹) declares the tasks of the ECA. On the one hand, it is to examine the accounts of all revenue and expenditure of the Union and of all bodies, offices or agencies set up by the Union and to issue a statement of assurance (DAS - Declaration d' Assurance), for the European Parliament and the Council with respect to the reliability of the accounts and the legality and regularity of the underlying transactions. On the other hand, the Court examines whether all revenue has been received and all expenditure incurred in a lawful and regular manner, and whether the financial management has been sound. The ECA is authorised to perform administra-

¹ TFEU (Consolidated version of the Treaty on the functioning of the European Union), Article 287, *Official Journal C 83 of 30.3.2010*

tive audits of records and on the spot audits in any institution, which manages EU funds even in the Member States.

The ECA performs its audits according to internationally accepted standards: the International Standards on Auditing (ISA), the INTOSAI standards, and the European Implementing Guidelines for the INTOSAI Auditing Standards. The intention to harmonize its own approach and methodology with international standards has been beyond dispute and has influenced the evolution of ECA's methodology to a large extent. As a first step, the Contact Committee of the Presidents of the Supreme Audit Institutions of the European Union established an ad-hoc working group on auditing standards in 1991 in order to develop guidelines built on the INTOSAI Auditing Standards. In 1994, the working group issued eight guidelines and urged the examination of what the advantages of adopting the INTOSAI standards and European guidelines by the Court are, and if those are compatible with the ECA's audit manual. Moreover, the set of ISAs, issued in 1991, was also an important influencing factor with respect to the Court's methodology. An important framework from methodological aspect is considered to be when the Court approved the Court Audit Policy and Standards in 1997, which integrated three substantial references: the ISAs, the INTOSAI Auditing Standards and the ECA's audit policy. The compliance with professional international standards has been under review from time to time, by both internal and external quality controller. In 2008, the International Peer Review of the European ECA of Auditors declared that the Court meets the requirements of international auditing standards.

2 The development of the Court's audit methodology

The ECA's methodology has been strongly affected by internal and external factors. Internally, the institutional evolution of the Court had notable impact on its methodology. Moreover, the continuous pressure to comply with international standards and, on the other hand, the requirement to form an opinion (DAS) on the reliability of the EU accounts and on the regularity and the legality of the underlying transactions contributed to the development of a DAS methodology itself.

Based on interviews with professionals and on the internal documents of the Court, the author argues that the whole evolution can be split into three distinct periods.

The first period lasted from the establishment until 1993, the year when the Maastricht Treaty came to force. Starting its operation in 1977, the first challenge the Court had to face was to make an agreement on the mission and the philosophy. Based on the diversity of auditing practices across the Member States, the ECA had to find the appropriate approach to auditing EU funds. First, the ECA made an effort to define what the term "good financial management" means. The ECA interpreted its task as a value for money (VFM) type of audit. In those years, there was no formal written audit manual or even guidelines; the president of the ECA was responsible for uniform auditing procedures, and a separate department was set up to improve audit

procedures and develop reference audit materials, which can be taken as a basis for later guidelines.

A paper on the working methods included a list of audit methods, the application of which differed depending on whether the financial management was examined or the regularity and legality were evaluated. A fundamental distinction was made by sorting the methods into two categories: system or individual transaction examination. The necessity of using sampling methods instead of auditing every single item was also emphasized in the paper, which proves a shift towards the 'systems approach' for the examination of legality and regularity. By definition, it refers to the concept that 'the auditor seeks to rely, as far as possible, on the systems of management and internal control applying to the particular Community body or activity being audited' under the assumption that the auditee has an internal control function. As for the evaluation of financial management, the concept addressed the effectiveness and the efficiency of audits, so the questions of 'why', 'how', and 'how much' were arisen. Those years huge efforts were invested to analyse working methods and to bridge those with work programme, while there was no formal written methodology, and the common methodology remained still a desire. A working group on the audit of the financial management prepared an exhaustive study, which interpreted the sound financial management as a combination of three elements; the economy (resources are available at the right time, in the right place/quantity/quality, at the right price), the efficiency (the relationship between the output and the input), and the effectiveness (the degree of goal fulfilment in a cost-effective way). In addition, the study included a model for auditing the financial management. According to the model, to form an opinion on financial management distinctly comprises the antecedent examination of individual transactions and systems in operation. Under the assumption of the model, there is a strong inter-relationship between system- and transaction-based audits. If the auditor finds deficiencies in a transaction, the reasons have to be revealed in order that procedural weaknesses, stemming from the system, could be eliminated.

In 1980, a special unit, called ADAR (Audit Development and Reports) was set up, which accelerated the development of a common approach. Nevertheless, a progress report of financial management audit it was argued that there had still not been a consistent approach to that type of audit. In the path towards a common methodology, it was a substantial threshold when the ECA adopted the *Audit Guidelines* in 1983, which replaced the antecedent audit notices, and were expected to serve as a basis for an audit manual. The Guidelines made a sharp distinction between the examination of accounts, that of legality and regularity, and the examination of financial management, notwithstanding that there is a relationship among those tasks: in order to operate in a legal and regular manner, reliable accounts are necessary. Moreover, the audit of the accounts serves as a basis for the examination of regularity, legality, and financial management. Thus, the Guidelines introduced the term of 'integrated

audit', if there was an overlap between financial and financial management audits.

The ECA affirmed in the Guidelines that it adopts the system-based approach as applied earlier. The system-based approach suggests that the auditors seek to find, as far as possible, evidences of an effective and well-managed system, in order to be able to put reliance on these systems, which reduces the amount of substantive testing. It was emphasized that to achieve reasonable assurance on legality and regularity, a combination of three tools has to be applied; analytical review of trends, variances, compliance tests to evaluate controls, and substantive tests of transactions. The *analytical review procedures* (trend analysis, computation, and explanation of ratios and variances, and review of other internal or external bodies) assist the auditors to find the areas where detailed substantive testing is necessary. By performing *compliance tests*, the auditor examines whether reliance can be put on internal control systems, which has significant impact on the extent of substantive testing. In case of serious system weaknesses, the amount of substantive tests cannot be limited; consequently performing compliance tests is not worthwhile. Analytical review procedures and compliance tests are both indirect evidence with respect to the audit of accounts, legality, and regularity. On the contrary, *substantive testing*, a sort of direct audit evidence, means that a sample of transactions is selected and tested to obtain reasonable assurance as to whether the revenue and the expenditure are materially legal and regular, and the accounts are free from material misstatements. As can be seen, the Guidelines introduced a new term, the *materiality limit approach*, which is, by definition, the maximum value of errors, remained undetected, can be attached to an amount previously set by the auditor. The materiality limit is a quantifiable threshold of the maximum tolerable error. The Guidelines suggested that the materiality limit should lie between 0.5 and 2 percent, for the time being it is 2 percent.

To determine the extent of substantive testing, the Guidelines proposed a classification of transactions as follows. First, *error-prone items*, which are likely to be incorrect, should be examined separately to avoid misleading extrapolation, thus to keep away from incorrect opinion, from the sample. *Secondly, high-value items* having special importance have to be identified as those may result in significant or even material errors in total. *Thirdly, the remaining transactions* serve as the sample basis. Due to substantive testing, the most likely error anticipated, containing the results of the sample of the normal population and also that of error-prone and high value items, can be compared on an aggregated basis with the materiality limit.

As the substantive tests significantly relate to the overall audit assurance required (usually 95 percent), the higher the expected degree of assurance from substantive tests, the higher will be the number of high value and sample transactions to be examined.

The aforementioned approach can be judged as the predecessor of the assurance model, introduced in DAS audits in 2005, although it did not use the terms of inherent and control risks.

Inherent risk represents the auditor's assessment that there may be a material misstatement in the financial statements, regardless of the fact if there are internal controls. Control risk refers to the deficiencies of internal control systems as those fail to prevent a material misstatement from occurring.

In 1990, it was a considerable landmark in the evolution of the Court's methodology, when the first Audit Manual was published, which systematized the former audit notices, guidelines, and informal practices. Levy (1996) describes the Manual not as operational but says it "codified practice on systems audit which can be used for Value for Money (VFM) audits"[5]. The Manual introduced the term VFM audit to replace the term financial management audit.

The author argues that **second period** of the evolution of the methodology started in 1993, with the entry into force of the Maastricht Treaty. On the one hand, the ECA's power, ranked as one of the European institutions, increased. On the other hand, the provisions of Article 248 of TEU declared that "The European Court of Auditors shall provide the European Parliament and the Council with a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions," which expanded audit work and had strong impacts on audit methods. Undoubtedly, new requirements necessitated to find the appropriate sampling techniques to reach the required assurance for DAS. Moreover, more intensive audit presence became necessary in Member States, even down to the financial beneficiaries of EU funds. As for sampling techniques, the Court has applied the *monetary unit sampling* (MUS), the result of which can be extrapolated to the whole EU budget.

In addition to the challenge to meet DAS requirement, an important external factor also affected the Court's methodology. The European Auditing Guidelines, based on the INTOSAI Auditing Guidelines, were developed with the intention to harmonize audit approaches among national audit institutions of Member States. The Court's audit approach proved to be consistent with those guidelines. In 1998, the European Implementing Guidelines for the INTOSAI Auditing Standards were published, which used the expression of "performance audit" as a synonym for VFM audit and audit of sound financial management (SFM) with respect to the examination of economy, efficiency, and effectiveness. Both the Guidelines and the (revised) Manual of the Court contained the mathematical model of audit risk: $AR=IR \cdot CR \cdot DR$ where AR is audit risk, IR is inherent risk, CR is control risk, DR is detection risk. Detection risk is attached to the likelihood that the auditor will not detect a material misstatement. In addition, the materiality approach and the significance of professional judgement were strongly emphasized. In 2001, the Court adopted the first performance audit module of the manual, 'Planning SFM audits'.

In EU finances, the establishment of Activity Based Management (ABM) and Activity Based Budgeting, which allocate financial resources according to priorities based on pre-defined objectives, must have affected the ECA's work. A group of spe-

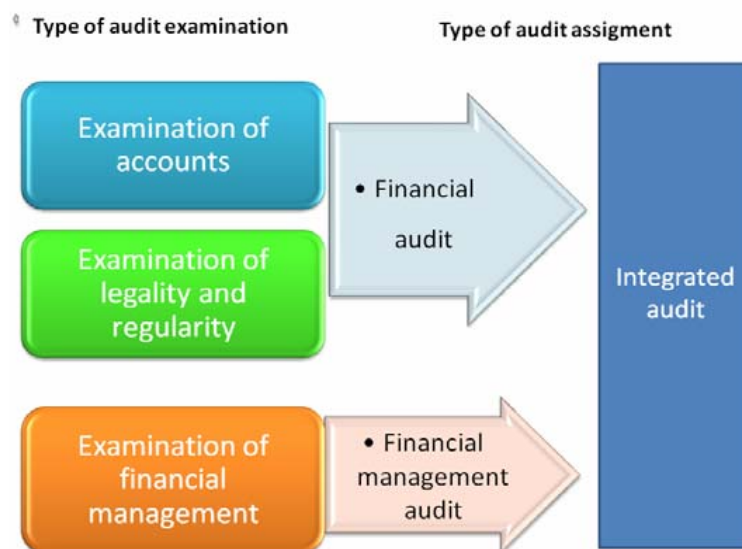


Fig. 1. The concept of integrated audit source: ECA (internal document)²

Tab. 1. The necessary degree of audit assurance deriving from substantive tests source: ECA (i.d.)

Verification situation	Internal control and analytical review satisfactory	Internal control satisfactory	Analytical review satisfactory	Neither internal control nor analytical review satisfactory
Overall audit assurance required	95%	95%	95%	95%
Overall audit risk tolerable	5%	5%	5%	5%
Risk of audit procedure failing to detect any evidence or error:				
<i>Evaluation of internal control</i>	37%	37%	100%	100%
<i>Analytical review for overall reasonableness</i>	37%	100%	37%	100%
<i>Substantive testing of accounts</i>	37%	14%	14%	5%
Audit assurance required from substantive test	63%	86%	86%	95%
Appropriate extent factor	1	2	2	3

cialists worked on a report to reveal the potential impacts. They found that it was not impossible to comply with ABB/ABM, but there were some important consequences. With respect to the impact on the organization, the report included that the Court should carry on financial audit within a single audit division and not according to policies. The audit approach itself was not changed due to the introduction of ABM, rather the examination of the ‘relevance of objectives, and the reliability of impact and output indicators’ was of priority. In a few months, a new module added to the Court’s manual, ‘Programming of the ECA’s work,’ indicated the needed changes. The module introduced the phrase of *Portfolio of Potential Audit Tasks*, which is an up-to-date set of potential audit tasks, ranked by priority on commonly accepted criteria (risk, materiality, relevance, and coverage). The module described the planning as a two-level

activity: a five-year *Audit Strategy*, which enumerates areas of special interest and sets up framework for the audits, and an *Annual Work Programme*, based on Portfolio of Potential Audit Tasks.

In 2005, another module of the manual, the framework for performance audits, was approved. This module was developed to promote the common understanding what is meant by performance audit, what the main differences between financial audits and performance audits are, and what the basic questions in performance audits are. Compared to previous manuals, the appearance of quality control of audits was a new element, which strongly related to the issuance of the International Standard on Quality Control 1 by International Federation of Accountants (IFAC), which has made it mandatory to establish and record

²internal document: referred to as ‘i.d.’ hereinafter

quality control policies and procedures embedded not only ex-post quality reviews to assess the quality of work done, but also quality controls built in the audit process and ongoing quality assurance reviews.

Also in 2005, the Court updated its DAS methodology and made some improvements, out of which the main fields of amendments were as follows:

- assurance model;
- hierarchy between sources;
- reliance on work of other auditors.

The Court introduced an *assurance model*, built upon the National Audit Office of the United Kingdom. It used of phrases inherent and control risks, which reflects the evolution of the interpretation of audit risk taken place in international standards on auditing and in the ECA's own methodology.

The assurance model suggests that if the auditor evaluates the supervisory and control system and finds that it fails to prevent or to detect and correct errors, *focussed substantive testing* has to be performed, with an expected confidence level over 90 percent. If the inherent risk is high and supervisory and control systems are excellent or good, or the inherent risk is not high and the supervisory and control systems are good, *standard substantive testing* has to be carried out. In such cases, assurance derives from substantive testing with a minimum confidence level between 67 and 80 percent. If the auditor assumes that the inherent risk is not high and supervisory and control systems are excellent, a large extent of the overall assurance can be gained from controls assurance, and confidence of the *minimum substantive testing* is decreased to 45 percent. In other words, the level of confidence to be obtained depends on the results of the assessment of inherent risk and evaluation of supervisory and control systems.

As for the hierarchy between sources of evidence, the main sources derive from the examination of the supervisory and control systems and substantive testing. Meanwhile, other sources, the work of other auditors and analysis of annual activity reports and declarations of the Director-General, can also be considered while forming an audit opinion.

The possibility to place reliance on other auditor's work is particularly dependant on if the auditor operates in the internal supervisory and control system or outside of it. For the time being, the elements of the internal system are not considered as audit evidence for the ECA. On the contrary, the work of auditors outside the internal control systems, which are basically supreme audit institutions of the Member States, can be evaluated as a sort of audit evidence for the ECA's audit. Taking the example of Annual Summaries, the issuance of which became mandatory under the provisions of the amendment Financial Regulation applicable to EU budget, the Member States shall produce it at the appropriate national level of the available audits and declarations, first submitted in 2008. The Annual Summary can be judged as a sort of summary, being unaudited in

general, instead of a source of conclusive audit evidence which the ECA could rely on for DAS. Instead, audited National Declarations, which is currently a voluntary initiative of some Member States³, is a valuable evidence for the ECA, for funds under shared management. The compulsory introduction of National Declarations would allow the Member States to bear responsibility for the funds managed by them. To place reliance on audited ND as audit evidence, the ECA must be convinced that the underlying audit work has been ISA compliant. Consequently, to gain this assurance, a common approach and methodology, in addition political intention is unavoidable between the ECA and Member States. The ECA has started a *Pilot Project on coordinated audits*, which aims at the examination of the legality and regularity with the DAS approach in some Member States⁴. The rationale for the project is that the ECA would take into account the outcomes audited by SAIs, such as audited national declarations, if those were more common and better structured.

To a large extent, the year 2005 can be judged as a milestone. The establishment and the continuous update of the ECA's Manual, with distinct modules for different types of audit, ended, and a complex framework was about to be set up.

The third period in the evolution of the methodology began when Vítor Caldeira, the present president of the ECA, handed in a proposal for a Performance Audit Manual in 2006. From some aspects, this movement can be judged as a paradigm shift, because a multi-level reference framework has been developed, which broke with the practice that the audit methodology for different types of audit methodology is embedded in different modules of a single audit manual. The former Manual included parts applicable to financial audits, performance audits, and general procedures, and CAPS also included audit procedures. The new reference framework was expected to remedy those overlaps.

Level 1 contains the legal framework for the ECA, its mission, and the Rules of Procedure.

Level 2 contains international standards relevant to auditing, and the CAPS based upon INTOSAI and IFAC standards.

Level 3 consists of three different manuals: the Performance Audit Manual (PAM); the Financial and Compliance Audit Manual (FCAM); and the Vademecum of General Audit Procedure (VGAP). With regard to the PAM, it consists of the modules of the previous manual, which were adopted a few years ago. The Court's intention was to provide guidance to understand the concept of performance audits rather than to lay down strict rules, based upon the experience of best practices of supreme audit institutions of the EU. The other element of level 3, the VGAP addresses subjects, which are common to compliance, financial and performance audits. Concerning financial audits, a 'stand-alone financial manual' has several rationales. On the one hand, the new reference framework was initiated to

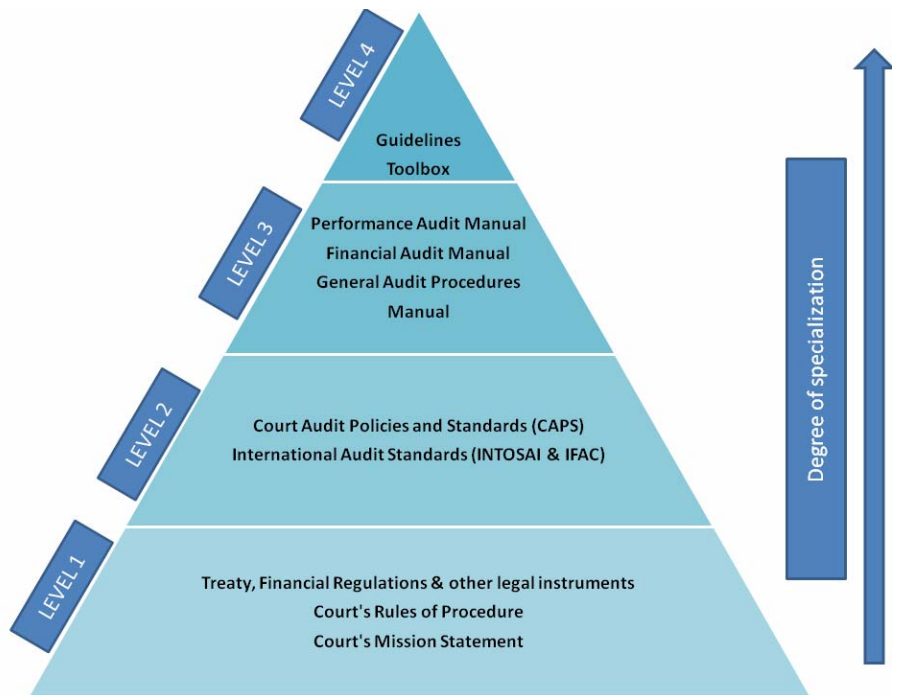
³e.g. Denmark, the UK, the Netherlands, Sweden.

⁴Denmark, the Netherlands, and the Czech Republic.

Tab. 2. The Assurance Model source: ECA (i.d.)

Assessment of inherent risk	Not high			High		
	excellent	good	poor	excellent	good	poor
Evaluation of supervisory and control systems	excellent	good	poor	excellent	good	poor
Residual level of substantive testing	Minimum	Standard	Focussed	Standard	Standard	Focussed
Minimum degree of confidence to be derived from substantive testing (%)	45	67	92	67	80	95

Fig. 2. The reference framework



build up a separate manual for financial and compliance audit, which is applicable to DAS (reliability of the accounts and the legality and regularity of the underlying transactions), and other financial and compliance audits. On the other hand, the previous manual had not been considerably amended to reflect the development in methodology, with respect to ISAs or even the revised DAS approach. Consequently, the basis for the FCAM was the revised DAS approach, in compliance with INTOSAI and IFAC standards. To be consistent, the structure of the FCAM was intended to follow that of PAM: the process of planning, execution, and reporting. To support the development of the FCAM, a ‘Think Tank’ was set up on the DAS methodology. In 2009, the Think Tank published an “Issue Analysis” paper, which included both internal and external expertise. Due to efforts, the FCAM was completed in 2011, and the revised DAS methodology can be taken into account afterwards.

Ultimately, *Level 4* includes guidelines, worked out by the

Court, to provide information on audit techniques and the toolbox, which serve as a reference point to external sources such as INTOSAI, supreme audit institutions etc.

3 Conclusions and further research

The most influencing factors on the evolution of the ECA’s methodology have been assessed in this article. Both the legal framework and the Court’s institutional evolution highly affected the development of the methodology, which were delineated by splitting the whole process into three phases. The evolution of the methodological framework reflects from all aspects the internationally excepted professional standards of auditing.

As stated earlier, to improve the financial management not more audits, but better coordinated audits are necessary, and thus the necessity of reliance on others’ work is indisputable. Consequently, the types of audits performed and the methodologies applied within the internal control system and by the

external auditors should be explored to which the initial step the understanding of the development of ECA's methodology was.

There is still room for the European Commission and the Member States to put more confidence on the work of others within and outside the internal control framework, if there is a political commitment. In addition, as long as the approaches and the standards are not common, the smoother and more effective financial management, applied through reliance on work at different levels, seems a bit far away.

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