MINISTRY OF FOREIGN AFFAIRS
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Danida

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FINANCIAL MANAGEMENT GUIDELINES

FOR DEVELOPMENT COOPERATION

Version 1.0

CHAPTER 1 Introduction to the Financial Management Guidelines

This guideline describes the general requirements for the financial management of programmes and projects with development assistance from the Danish Ministry of Foreign Affairs (MFA).

Financial management is a means to monitor and ensure that the funds appropriated are used in accordance with the agreement, in compliance with relevant regulations, and in an efficient and cost effective manner. Sound financial management is essential in order to achieve the results and outcomes intended.

The guideline elaborates on the overall requirements and procedures set out in the MFA Guidelines for Programmes and Projects and should be understood in this context. The scope covers all MFA funded contributions, programmes and projects with exception of multilateral contributions[1].

Although exemption from specific requirements for certain types of organisations and institutions may be accepted, the general principles as set forth in this guideline are expected to be adhered to by all partners. If exceptions apply, these must be described in the development engagement document (DED), which is the contract between the MFA and the partner[2]. The financial management guideline should be used as a tool and reference for all aspects of the programming cycle including the preparation, implementation, and closure of a contract or agreement between the MFA and the partner. During the preparation stages the guideline can be consulted for guidance on e.g. financial capacity assessment of the partner(s) and for ensuring that the budget meets the requirements in relation to continuous monitoring of activities and spending. They should also be used for reference when concluding an activity and exiting a partnership.

The most recent version of this document and related guidelines can be found at the Aid Management Guidelines website, www.amg.um.dk.

1.1. Purpose, application and scope

The purpose of the guideline is to provide guidance and support on the financial management of Danish funds appropriated for the implementation of development cooperation activities.

The target audience is the partner's implementing development projects with Danish funding, audit companies auditing the partner projects, as well as the responsible MFA units preparing and monitoring the use of the Danish funds.

The guideline covers a wide variety of funding modalities and partner types. This means that the requirements and conditions in some instances will have to be adopted to the particular condition and purpose of the development engagement. The development engagement document (DED) between the partner and the MFA defines the specific objectives and planned results, requirements and conditions for the spending of a grant, as well as the time period. Where the requirements or conditions differ from

[1] Multilateral contributions are covered in Guidelines for Management of Danish Multilateral Development Cooperation.
[2] The signed agreement between the partner and the MFA is the basis for the grant and the activities agreed. Agreements include DEDs (Development Engagement Document), PSED (Peace and Stability Engagement Document) and other types of written agreements as relevant.

the procedures in the MFA guidelines, the reasons and arguments for the use of alternative procedures must be described in the DED. Aspects not covered in the DED may be referred to the guidelines for resolution. If a specific issue is not covered by the DED or these guidelines, partners are referred to the MFA for guidance.

Financial management should be understood in the larger context of the programme or project. The guidelines and the principles therein constitute an integrated and essential part of the overall supervision and management of the development funds. The aim of the guideline is to ensure a clear link between the results framework for the development engagement and the financial management and reporting activities throughout all phases of the programme or project cycle.

In pursuit of long-term results, it is the priority to support the development of the partner's financial management capacity and avoid parallel procedures, by using the partner's own plans, procedures, budgets, monitoring frameworks and organisational set-ups. This means that supported activities, to the extent possible[3], should be integrated into the partner's own plan and results framework and incorporated into the partner's own budget, accounting, reporting, and auditing structures. If the partner's procedures differ substantially from the procedures described in these guidelines, it should be underlined that the procedures in these guidelines prevail.

1.2. The partners and their obligations

It is the obligation of the partner to adhere to the requirements for financial management of Danish development assistance, as set forth in these guidelines.

The Danish grant must be spent solely on activities leading to the expected outputs and outcomes as agreed in the DED. The partner is responsible for ensuring that the funds are spent in compliance with the agreement and with due consideration to economy, efficiency and effectiveness in achieving the results intended. To achieve this, the partner is expected to ensure that a system is in place for day-to-day monitoring of the implementation of the activities and for overseeing the progress as compared to the agreed results framework, budgets and work plan.

If part of the project activities are to be carried out by organisations other than the partner institution, the MFA and the main partner should consider how to assess the financial management capacity of these "sub-partners". As signatory of the DED, it is the responsibility of the main partner to ensure that the financial management of sub-partners follows the principles set forth in the guidelines, and that the sub-partners' financial management capacity is sufficient). This includes regular financial monitoring of any sub-partner under the grant (see Annex 1.A and 1.B for guidance).

It is the responsibility of the partner to approach the MFA in response to significant changes in the activities not envisaged by the provisions of the engagement agreement and other agreements. The MFA has the right to request all information from the partner deemed relevant to assess the implementation and progress of activities.

Furthermore, the MFA has the right to carry out inspection, monitoring visits, reviews, etc. at any time during the period covered by the DED, unless otherwise specified in the engagement agreement. The

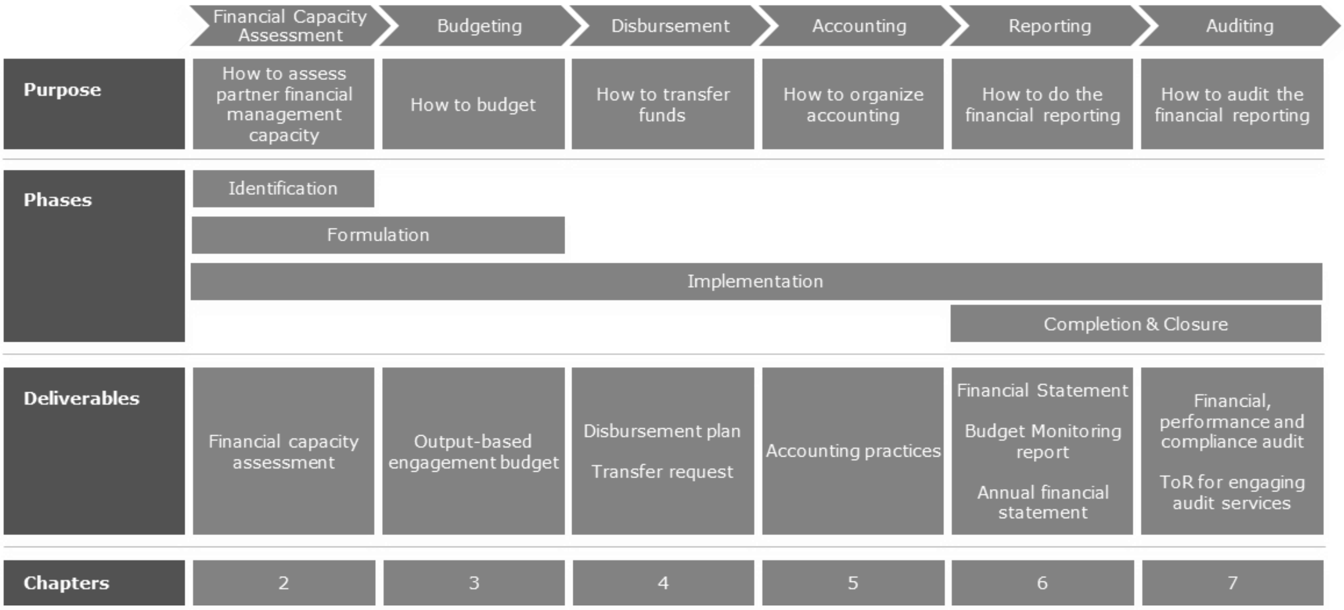
[3] etc. while at the same time adhering to the requirements of the engagement agreement and these guidelines

partner is obliged to report any suspicion of irregularities, fraud, corruption, or financial mismanagement immediately to the MFA. The MFA reserves the right to claim full reimbursement of expenditure regarded ineligible according to the agreement between the parties.

1.3. How to use these guidelines

The guideline is structured in accordance with the main elements of financial management: financial management capacity, budgeting, disbursement, accounting, reporting, and auditing. For each element, the relevant chapters provide an introduction and outline; what are the mandatory requirements and the products to be delivered, followed by guidance on how to deliver as required. In addition to the guideline, various tools, templates and guiding notes to provide additional technical detail and best practice examples are provided in the annexes. It is the idea that these can be used as they are, or used as reference to ensure that the partner's formats meet the requirements set forth in the guidelines.

Figure 1 presents a schematic overview of the guidelines.



CHAPTER 2 Assessing Financial Management Capacity

The purpose of a financial management capacity assessment is to ensure that the partner can provide a trustworthy, timely, and efficient handling of financial information to support the successful implementation of project/programme activities. Furthermore, the aim is to minimize the risk of financial irregularities in project implementation.

Financial management capacity is the ability of the partner to properly apply and manage procedures relating to budgeting, accounting, internal controls, governance, financial reporting, and auditing. Adequate financial management capacity is a prerequisite for efficient and effective grant management and the achievement of the agreed results.

During the preparation of a development engagement with a new partner, the partner's financial management capacity must be assessed. An assessment should also be performed, if the proposed engagement with a known partner differs significantly from prior agreements, if there have been significant changes to the partner's organisation, or if the MFA for any other reason considers an assessment relevant.

The financial management capacity assessment may be done during the identification process or prior to the appraisal of the project documentation. It is the responsibility of the MFA that the assessment is done, but its execution may be led by the MFA or by the partner, or as a collaboration. If the assessment requires external assistance, this must be concluded and documented before the projects can be approved and funds are appropriated to the partner. The financial management assessment is further elaborated in Annex 1.A and 1.B.

2.1. General requirements for the partner's financial management capacity

The objective of a financial management capacity assessment is to identify whether minimum requirements for the financial management capacity of the organisation are met. The assessment should be used to identify any shortcomings in the capacity of a partner institution to meet the financial management requirements of these guidelines. If these are not met, the assessment can provide recommendations for which aspects the partner needs to improve and thereby mitigate the identified risks or recommend that MFA should not enter into a development engagement with the organisation.

Disbursements of the grant to the partner should not be initiated before minimum requirements as specified in Annex 1.A are met by the partner and confirmed by MFA, or a plan has been made to mitigate any deviations from the minimum requirements.

2.2. Scope

The scope of the assessment will depend on several factors, including the complexity and size of the engagement, the nature of the partner and their history of prior cooperation with MFA or other donors.

An assessment can be made based on existing knowledge gained through regular financial monitoring visits to the partner, or as a more comprehensive exercise such as a systems-based audit or other assessment. These can be performed by an external consultant. If information on the financial management capacity of the partner is already available, the assessment can be carried out as a desk study.

Relevant materials include e.g. appraisals by other donors, partner's own assessment, existing audit reports, etc.

2.3. Deliverables

The financial capacity assessment is the MFA's tool to provide MFA and the partner with relevant recommendations to mitigate risks and build the capacity of the implementing partner(s). The assessment is documented and shared with the partner and a process action plan is developed for follow-up.

CHAPTER 3 Budgeting

The budget is a presentation of the financial resources needed to implement the planned and agreed activities. The purpose of the budget is to determine the estimated cost of the engagement, control expenditures, measure performance through the comparison of actual cost against budget and enforce financial accountability. Hence, the budget and work plan provide the combined overview of how the project management plans to utilize the resources for the agreed activities within the time frame of the project.

Budgeting processes are an important part of the financial management of the partner organisation. The following sections provide some guiding principles for budgeting for grants from the MFA.

3.1. General requirements for budgeting

As a rule of thumb, the budget must be designed to:

1. Reflect all sources of income pertaining to the programme or project
2. Reflect all costs and composition of costs related to the achievement of the results
3. Reflect the timing of costs during the implementation period.

In other words the budget should be comprehensive, itemized and periodized. A grant is always provided in DKK and cannot deviate from the amount expressed in DKK. The expenditures, however, are usually in a local currency, or one used by the partner organization to implement the activities. It is thus often necessary to calculate the budget in DKK and local currency, using a standard exchange rate.

3.2 Developing the budget

It is the responsibility of the partner as the project implementer to develop the detailed budget. The partner's own budget formats can be used directly or adapted to meet the requirements of the MFA.

The budget should be designed to reflect the structure and corresponding level of the outputs of the results framework. It should be detailed enough to show the different categories of inputs and budget items necessary for achieving the planned results.

The budget should be output-based. This means that all inputs and budget items should be directly linked to the expected results. Output-based budgeting is achieved by linking all budget items (cost) to the output/result they contribute to achieve. If a budget item is linked to two or more expected outputs, it should be divided between outputs through cost allocation (see Annex 2.A for guidance).

The budget should include all costs associated with the activities necessary for the delivery of the outputs funded under the development engagement for the period covered. For multi-year engagements, the budget should be presented at least at the level of the financial year of the partner. For shorter engagements, the budget could be divided into shorter time frames.

The budget items included in the budget presentation will depend on the type of project. Normally budget items include: salary and related staff costs, external consultant cost, rent of office premises, travel expenses, cost of services, goods, equipment, rent, and expenses related to the audit of accounts.

The budget may contain a contingency to cover unforeseen expenses such as currency fluctuations. The contingency should not exceed 5% of the budget for total direct cost, excluding contingency, for smaller projects (less than 10 million DKK). For engagements above 10 million DKK which are implemented over more than two years, the contingency may be up to 10% of the budget for total direct cost, excluding contingency.

It can be difficult to allocate all costs to a specific output. Therefore, the budget may also include an administrative cost to cover unspecified administrative costs such as rents, office expenses, etc. The administrative cost should cover non-activity specific cost and should not surpass 7% of the direct costs of the activities, unless explicitly agreed in the DED (see Annex 7 for further guidance on administrative costs).

3.3 Managing the budget

It is the responsibility of the partner to ensure that procedures to continuously monitor the implementation of the budget against actual expenditure and results achieved are in place. If changes occur during project implementation, which change the assumptions on which the budget is based or changes in the expected outputs, the partner should inform the MFA.

The partner should forward semiannual budget monitoring reports to the MFA in order to ensure a regular monitoring of the project implementation against the planned budget. The reporting can be used to follow the progress of the project. Depending on the project and capacity of the partner, the frequency of reporting can be agreed upon, and more frequent budget monitoring can be applied, if deemed necessary. See Chapter 6 regarding budget monitoring reports.

The DED between the partner and the MFA should describe the mechanisms for budget revision. The partner may have the discretion to re-allocate within the budget to a certain limit, if stated in the DED. Normally, changes exceeding 10 % will be presented to and approved by the steering committee or other relevant decision-making body. Spending in excess of the allocated budget (in DKK) cannot be covered by the Danish grant. Any reallocations to budget items for salaries and staff costs must be approved by the MFA.

The contingency may only be used for activities already included in the approved budget and with the explicit approval of the MFA.

3.4. Deliverables – the output-based budget

The partner presents an output-based budget for the entire engagement to the MFA. The partner may choose to apply the template for output-based engagement budgets which is presented in Annex 2.B.

The approved budget is the basis for budget monitoring. The partner presents the budget monitoring report to the MFA at the frequency agreed. See chapter 6 (section 6.3.) for guidance on budget monitoring reports.

CHAPTER 4 Disbursement

A disbursement or transfer of funds from the MFA to the partner is provided to cover costs as per the agreed budget. Depending on the size of the grant, the MFA usually transfers funds to partners twice a year, to cover foreseen expenditures for up to six months.

4.1. General requirements for disbursement of funds

The partner should produce an indicative disbursement schedule that covers the duration of the project. This should be aligned with the budget in such a way that funds are available in time for planned activities so that disbursements cover the liquidity needs for the coming six month period. This is also to avoid the accumulation of funds at the partner level.

The partner can only spend the funds on activities approved within the agreed budget. The funds received from MFA are to be kept in a designated bank account or alternatively the designated ledger account must be established unless otherwise agreed in the DED.

Disbursements are based on a written request from the partner indicating the detailed information on recipient bank account. The request should take into account the balance of funds previously received in order to avoid accumulation of funds for more than the coming six months.

The partner must confirm receipt of funds as soon as possible and no later than 14 days after receipt of funds from MFA.

If it is agreed that Danish funds are kept in a separate bank account, a copy of the bank statement with a reconciliation of the bank account must be attached to the request.

The disbursement of funds is subject to a number of conditions, see inserted box.

Conditions for transfer of funds

- There is an approved work plan and budget for the period to be financed.
- Copy of bank statement with balance of accounts.
- Satisfactory technical and financial reporting has been submitted for previous periods.
- Confirmed reception of prior transfers.
- Satisfactory use of prior transfers.
- There is an approved work plan and budget for the period to be financed.

Interests accrued from bank holdings should be returned to the MFA on an annual basis, unless explicitly stated in the DED. Negative interests are to be accounted for as expenditures and may be covered by the grant.

Unused funds and any interest shall be returned to the MFA after approval of final accounts for the engagement.

4.2. Deliverables – disbursement plan and request

Partner obligations in relation to disbursement:

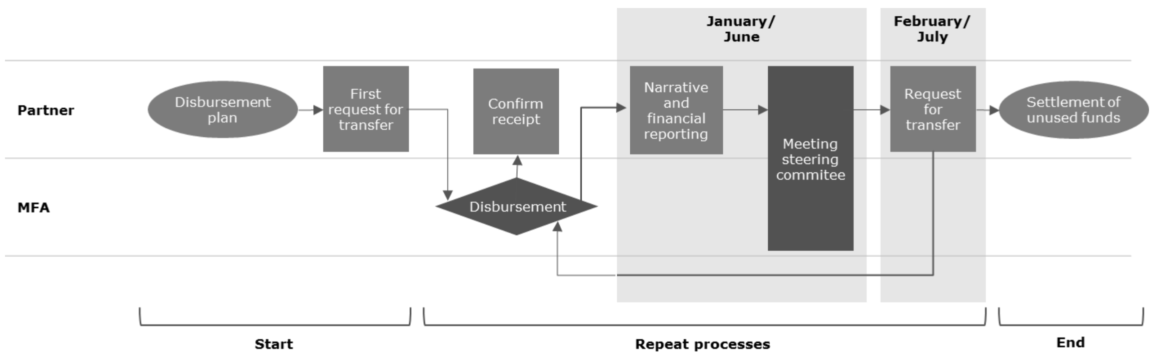
1. Create bank account for funds, if applicable
2. Create indicative disbursement budget based on approved budget

3. Prepare request for disbursement of funds for upcoming six months
4. Prepare new disbursement budget, if request differs from indicative disbursement budget
5. Request transfer of funds semi-annually. See insert for requirements for request for disbursement of funds. A template is available in Annex 3
6. Confirm receipt of funds within 14 days after receipt
7. Prepare statement on interest accrued annually
8. Repay interest (annually)

Requirements for request for disbursements

• Funds previously received
• Funds previously spent
• Bank statement or bank reconciliation. Balance, if applicable
• Budget for the next period
• Amount requested for transfer/disbursement
• Bank details (IBAN account number, recipient bank name and address)
• Two authorised signatures

Flow chart illustration of the disbursement process.



CHAPTER 5 Accounting procedures

Good and well-described procedures for accounting and a digitised dedicated accounting system is the basis for creating the conditions for a sound financial management of the project funds. A well-designed accounting system is the basis for controlling, reporting and auditing of the financial performance of the project/programme.

The following principles and requirements apply for partner-level accounting when receiving Danish development funds from the MFA.

The general principles as set forth in this chapter are expected to be adhered to by all partners.

5.1. Recording of costs (chart of accounts, cost-center and use of dimensions)

The accounting setup of the partner should ensure a recording of cost in such a way that, where Danish funds are used, the individual transaction can be clearly linked to the budget of the engagement. An alignment between the budget and the chart of accounts is necessary in order for the partner to deliver audited annual financial statements, as well as budget monitoring reports, aligned to the budget.

Annex 4 provides guidance on how to analyze and if necessary adjust the accounting setup in relation to integrating the output-based budget with the chart of accounts by use of cost-centers or by tagging the transactions using multiple dimensions in the accounting system.

5.2. Accounting records and internal controls

The partner is required to maintain accurate records of all financial transactions and fully account for the resources provided for operations using appropriate accounting and double-entry-bookkeeping bookkeeping systems. Partners are required to establish and maintain accounting records and documents on all activities funded by the MFA. Records must be systematic, easily traceable, identifiable and verifiable. The partner must ensure safe and up-to-date back-up systems to eliminate the risk of losing accounting data.

As part of the financial capacity assessment in the appraisal phase, the MFA unit will evaluate the partner's accounting system and internal controls (see chapter 2). The partner organisation should therefore meet the minimum requirements as listed in 1.A regarding financial capacity. The partner's organisation manual or manual for accounting policies and procedures must as a minimum include the specifications below in relation to the programme/project.

- Accounting principles applied for registration of income and expenditures
- Segregation of duties between executing, registering, authorizing, and controlling roles
- Purchasing procedures defining who can authorize purchases on which budget lines and up to certain ceiling amounts, if relevant. Description of tender procedures and roles, including determination of minimum amounts that require tendering and at what organisational level tenders are approved
- Procedures on reconciliation of accounts, salaries and cash and bank accounts balances
- Asset register. Description of information on assets and procedures for asset management, including frequency of register updating

- Procedures and roles for approval of paychecks and salary calculations on a monthly basis
- Description of salary management, including procedures for maintaining staff and payroll records such as contracts, salary statements and time sheets. For local staff recruited on fixed-term contracts, details of remuneration paid, duly substantiated by the person in charge locally, broken down into gross salary, social security charges, insurance and net salary should be applied.

It is noted that it is best practice to expand the accounting policy into a financial management policy, which, in addition to the above mentioned sections, also includes sections on policies, procedures and roles in relation to budgeting, reporting and governance.

The Danish funds and funds from other sources should not necessarily be registered in separate bank accounts, but must be easily distinguishable in the accounts set-up of the organisation.

Accounting records should be kept for a period of ten years after completion of the engagement.

The partner shall allow accounting verifications to be carried out by the MFA and external audit companies and for them to conduct any verifications, review or other exercise deemed necessary by the MFA.

5.3. Accounting standards and criteria for recognition of cost and income

Accounting practices should be aligned to local legislation, and the MFA encourages partners to use internationally accepted accounting standards as the basis for their accounting practices. However, MFA recognises that accounting practices may differ from country to country. As a minimum the accounting standards and policies applied must comply with the accounting legislation in the country concerned.

The following is considered good practice for recognition of expenditure and income and must be applied in the accounting procedures of the partner organisation:

- For recognition of income, a cash-based accounting principle should be applied
- For the partner to maintain the overview of commitments on expenditure, the accrual basis of accounting should be applied. This method ensures that expenditure are recorded in the accounts when the expenditure has been agreed with the supplier. Registration of accrued expenditure should be at least yearly and preferably quarterly to align with quarterly budget monitoring reports.
- Costs are recognised in yearly financial statements for specific activities when the cost is:
  - Incurred in the implementation period of the engagement
  - Pertaining to the engagement
  - Necessary for the engagement
  - Supported by verifiable documentation
- Funds transferred from the partner to the sub-partners should only be recorded as expensed once an audit has verified the expenditure at sub-partner level.
- Costs in currencies other than that of the accounts are translated using the exchange rate at time of the transaction

- A weighted average of currency rates can be applied for costs incurred by partners based on transfers
- Expenditures for assets exceeding a value of 500 EUR, such as vehicles, computers, mobile phones, satellites/GPS devices must be included in the asset list and included in reporting. Other transferrable items should also be included in the asset list and included in reporting
- Grants received must be recognised as income or accrued income when received in the bank or when a letter of commitment is received depending on the accounting policy of the partner
- Interests must be recognised as income when recorded by the bank

CHAPTER 6 Reporting

The purpose of the financial reporting is to ensure proper administration and monitoring of funds and to allow for timely allocation and adjustment of project/programme activities and resources when necessary.

6.1. General requirements for reporting

Reporting consists of several elements such as technical and financial progress and results of the engagement. The financial reports should, where feasible, be submitted together with technical/narrative reports to ensure that progress is monitored consistently across resources, results and activities.

The financial reports can be divided into two types of reports – the audited annual financial statements and budget monitoring reports, which are regular unaudited financial reports comparing actual expenditures to the approved budget.

Characteristics	**Audited annual financial statements**	**Budget monitoring reports**
Reporting frequency	Yearly	Preferably bi-annual or quarterly
Reporting period covered	Yearly	Preferably six months or quarter
Prepared by	Audit company or partner	Partner
Is audited by an external audit company	Yes	No
Responsible for validity of figures	Partner management, quality assurance by audit company	Partner management
Includes budget	Preferably	Yes
Includes budget variance	Preferably	Yes
Includes comments on individual variances	Maybe on overall variance	Yes
Responsible for follow up on variances and recommendations	Partner management	Project management
Includes result indicators	No	Preferably

Budget monitoring reports are required for projects/programmes and earmarked contributions across all types of partnering organisations. The frequency, format and content can vary on the partner profile, capacity and size of the engagement. This should be described in the engagement agreement prior to implementation. In addition to the regular reporting, the MFA may request additional information and details.

6.2. Reporting frequency

The frequency of reporting shall be described in the engagement agreement. As far as possible, reporting should be aligned with, or fully integrated into, the reporting cycles of the partner.

The minimum requirement for reporting frequency on development engagements and earmarked contributions is <u>an audited annual financial statement and a budget monitoring report</u>. The reporting frequency may be different throughout the activity period, with more frequent reporting being used during the inception and closure phases. The exact requirements should be agreed with partners and stated in the engagement agreement.

An illustrative example of a financial reporting set-up covering a multi-annual project engagement is shown below. The table illustrates the different reporting requirements and best practices for the types of financial reporting over a three-year period, where the engagement activities are completed after three years and final report is received in the fourth year. (Q2 Year 4) The reporting frequency must always be adopted to the specific needs and the identified risks of the individual engagement.

■ Proces	Year 0				Year 1				Year 2				Year 3				Year 4			
• Deliverable	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Financial management capacity																				
Assessment	■	•																		
Financial monitoring visit by MFA												•								
Budget and budget revisions																				
Initial budget developed as part of programme development		■																		
Budget revision based on budget monitoring and results reporting							•				•				•					
Budget monitoring reports																				
Format developed and aligned with MFA guidelines				■																
Quarterly budget monitoring reports					•	•	•	•	•	•	•	•	•	•	•	•				
Disbursement plan																				
Initial disbursement plan developed on the basis of budgeted expenditures				■																
Requests for transfer of funds					•		•		•		•		•		•					
Audited financial statements																				
ToR for engagement of audit services					■															
Annual audited financial statement										•				•						
Final audited financial statement for entire project/programme																		•		
Completion report																				
Final report / completion report																			•	

6.3. Budget monitoring reports

The purpose of the budget monitoring reports is to monitor and report on progress against agreed plan and budget for a specific period of time. As such, the budget monitoring reports are the primary tool to keep track of resources and compare expenditures to results.

The budget monitoring reports should be drawn up to the same level of detail as the detailed output-based budget and include budget figures, actual expenditures and variance for both the accounting period in question and accumulated for the entire engagement period.

The information presented in the budget monitoring reports should be:

- Funds received during the period and accumulated
- Budget for the period and accumulated
- Actual expenditure for the period and accumulated
- Variance between budget and expenditure

- Explanation of significant deviations between budget and expenditure and description of mitigating measures

Best practice is to include a column reporting on output progress and results for the period, as well as columns comparing total accumulated expenditure over the total programme period to the total programme budget. A template budget monitoring report that can be adjusted to the specific engagement and partner is provided in Annex 2.B, which partners may use as it is, or as a guidance.

Partners can use own formats, provided the minimum required information as stated above is included. The budget monitoring report must be endorsed by management and presented to the MFA, as well as other relevant authorities, such as the steering committee, other donors etc.

6.4. Audited annual financial statements

Aligning to partner reporting cycles and procedures also means considering whether it is relevant to use the existing financial reporting of the partner. Audited annual financial statements can be in different forms. Below are three main categories:

- Organisational statement: Financial statements cover the financial situation of the entire organisation, including all income and expenditure for the organisation specified in the financial statements. Organisational statements should be used, when the Danish contribution is given as core funding or similar. It can also be used as supplement to stand-alone reporting.
- Appendix statement: Financial statements cover the financial situation of the entire organisation, but detailed income and expenditure information pertaining to particular grants/engagements is specified in notes or appendices to the financial statement. Appendix statements should be used, when the Danish support is for a specific activity or engagement, but where it is considered sufficient, that the activity/engagement is audited as part of the general audit of that organisation.
- Stand alone or special purpose statement: Financial statements, which only cover income and expenditure for the particular activities funded through MFA. Stand alone or special purpose statements should be used, when the Danish support is for a specific engagement, and it is considered useful or necessary with a more comprehensive audit of the specific engagement.

A comparison of advantages and disadvantages across the three types of audited annual financial statements is shown below.

	Advantages	Disadvantages	Typical scenario
Organisational	Alignment with the reporting set-up of the partner. No double reporting.	Difficult or no possibilities for accommodating special/MFA reporting requirements.	Often relevant for large partners with a substantial financial management capacity and grants from many sources/donors. Typically applicable to multilateral organisations and core funding arrangements.
Appendix	Alignment with the reporting set-up of the partner with the option of more detailed information on the MFA contribution.	Limited possibility for accommodating special/MFA reporting requirements. No information on output level expenditures.	As above, but relevant where it is possible or necessary to impose special/MFA reporting requirements. Situations where grants are material (significant amounts in a MFA context or as a percentage of partner turnover or of high political importance) Typically applicable to international organisations, and governmental/parastatal organisations
Stand-alone	Detailed reporting with the possibility of fully accommodating MFA reporting requirements in terms of specificity.	Reporting only covers the grant – not the entire financial management of the partner. Risk of double reporting.	The preferred type of reporting from a donor perspective for programmes and earmarked funds as it gives the full picture of expenditures on output level, whereby it is comparable to the budget.

The relevant type of audited annual financial statement category will be described in the engagement agreement. The type will depend on the modality, capacity of partner, budget size, and complexity of the activities.

6.4.1. Format and content of the audited annual financial statement

The audited annual financial statement must, regardless of the category as stated above, include

- **Frontpage**: with information about the period which the financial statement covers, the name of partner organisation, the identification of the activity/engagement, including the MFA file number
- **Statement by management**: with management's endorsement of the financial statement. Should include signature by management as agreed
- **Auditor's opinion**: See chapter 7 for the specific requirements for the audit
- **Income & expenditure:** including income during the period, budget for the period, actual expenditure, variance between budget and expenditure, and explanation of significant deviations between budget and expenditure
- **Notes**: including
    - income received (from all sources). The Danish contribution must be identified explicitly
    - a list of fixed assets
    - statement on accounting principles applied

- **Statement on liabilities**: should disclose amounts owed to or by the partner
- **Statement on repayment of bank interest**: statement on bank interest accrued from the Danish funds and information about repayment, where applicable
- **Management letter**: signed by the auditor and elaborating on tasks performed, risks identified with a classification of severity and recommendations for risk minimizing actions. The management letter may be submitted as a separate report.

If the partner provides grants for other partners as part of the activity, the statement shall also contain a financial statement on all subgrants, including: funds granted, funds transferred, funds accounted for.

The audited annual financial statement should be submitted together with the technical/narrative reporting covering progress and results of the engagement.

If reporting is done in a stand-alone financial statement format, the expenditure lines should be structured according to the output-based budget, thus providing information about the linkage between output and expenditure.

The audited annual financial statements must be submitted to MFA no later than six months following the end of the financial year.

6.4.2. Final financial statement

Upon completion of an engagement, the partner is required to present a final financial statement along with the completion report covering the entire project/programme/activity. The final financial statements must be submitted no later than six months following the end of the project/programme period and be signed by the auditor as audited.

As part of the final audited financial statement, a specification of any remaining unspent funds and interest earned, but not yet transferred to the MFA, is presented and these funds are repaid to the MFA.

6.4.3 Handover or liquidation of assets

Where the agreement, at its expiry, provides for a transfer of equipment, fixtures or buildings funded through the Danish grant, the partner is required to prepare a list of the items concerned indicating current value and acquisition prices. This list shall be included in a handover note for transfer of assets as part of the final reporting. The handover note must have two authorized signatures (see Annex 6 for format for an example of a handover note).

The intention of handing over assets to the partner, should be considered already during the formulation phase and then advanced during the implementation of the engagement. (Ref. P&P and the guidance note on exiting from bilateral development cooperation)

Ensuring an early discussion on the relevance of a handover of assets allows for a better strategic planning for both partner and the MFA. An important element when considering the handover of assets is the partner's capacity to maintain and operate them. Furthermore, it is relevant to consider whether the partner would still have actual use of the asset as part of its operations, also beyond the engagement, and whether this usage would be within the initial objective of the grant. MFA should insist on full transparency regarding the handover of assets both in the local community, within the organisation, towards local authorities (vehicle registry or other), and also in regards to any existing donor group or to potential donors. The assets should be formally registered as assets in the accounts.

Where there is no basis for handing over assets, these must be liquidated and the income is to be returned to the MFA.

Chapter 7 Auditing

All funds granted through the MFA should be subject to audit from an independent, certified audit company if not otherwise agreed[4]. The audit requirements and provisions for grants are established by Danish law and regulations. The Danish principles applicable to audits of funds granted through the MFA are found in the Standards for Public Audit (known as SOR) published by *Rigsrevisionen* - the Danish National Audit Office.

The purpose of this chapter is to elaborate on these provisions in the context of Danish development cooperation and establish concrete requirements applicable for different types of engagements. The requirements are further specified in the Annex 5.A and Annex 5.B.

The audit arrangement applicable to each engagement shall be explicitly stated in the engagement agreement between the MFA and the partner, including but not limited to provisions on the procurement of the audit, approval of the terms of reference and choice of audit company, as well as the timing of the audit and reporting.

The Danish National Audit Office and the MFA reserve the right to conduct any audit deemed necessary. The partner must grant access to the Danish National Audit Office, the MFA or any of its representatives.

> These guidelines and the provisions stated herein will apply to all funds originating from the MFA. This implies that in situations where funds are transferred from the grantee to a third party, it is the responsibility of the grantee to ensure that all regulations, including provisions regarding audit, are complied with.

7. 1 General requirements for auditing

Financial statements for grants received from the MFA must be audited on an annual basis, and the audited financial statement should be submitted to the MFA no later than six months following the end of the period audited. Please see Annex 5.B for Terms of Reference template.

The audit shall comprise of a financial audit, including elements of compliance and performance audits.

Therefore, an audit is required to cover both financial information as well as compliance, economy, efficiency and effectiveness aspects of the activities. The basis for the audit must be the International Standards for Auditing (ISAs) in regard to the financial audit. The basis for the compliance and performance audit must follow relevant International Standards of Supreme Audit Institutions (ISSAIs).

When supporting Government institutions audited by a local National Audit Office, other frameworks of auditing will be applied by the auditor. Other frameworks of auditing than ISAs are accepted as a basis for the audit, provided these frameworks result in an audit equivalent to an audit planned and performed according to the ISAs and ISSAIs.

[4] Danish public institutions are audited by the National Audit Office, unless the engagement agreement states otherwise.

The audit must be carried out by an audit company with the appropriate professional qualifications and competencies required as per the standards. The assessment of the adequacy of the audit company must be based on the complexity of the accounts to be audited and criteria such as:

- the audit company's general experience
- the audit company's specific experience with audits of donor funded activities
- the audit company's internal quality assurance systems
- that auditors proposed by the audit company has the necessary capacity

In addition to the assessment above, the auditor must be a registered auditor or the national equivalent.

It is advised that the partner conducts a tender process on the audit assignment relating to the engagement agreement every three-five years. To support the principle of independence by rotation, an audit company currently holding the assignment should not participate in the tender process for the following period.

7.2. Financial audit

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

Based on the audit evidence obtained, it is the objective of the auditor to express an opinion on whether the financial information, presented in the financial statement covering the funds granted from the MFA, is free from material misstatement.

7.3. Performance audit

Sound financial management includes adhering to principles of economy, efficiency and effectiveness in the management of available resources.

The objective of a performance audit is to make an assessment to obtain reasonable assurance that the systems, processes and transactions examined support the exercise of sound financial management in the administration of the funds granted through the MFA. Thus, performance audits examine the economy, efficiency or effectiveness of the audited activities.

7.4 Compliance audit

Compliance audits examine whether the activities are compliant with applicable rules, policies, and regulations.

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. This includes compliance with terms stated in the engagement agreement.

7.5. 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, which subsequently must be signed by the project/programme management. The auditor's opinion should be prepared in accordance with the ISAs and ISSAIs, depending on the type of audit, i.e. financial, compliance, and performance audit.

The methodology of the audit must be described either in the audit report or as an audit summary memorandum, in order to provide the MFA and the partner with the basis to assess the scope of the performed audit.

The auditor is also required to issue a management letter. The management letter communicates observations and findings identified during the audit. These observations can pertain to deficiencies in internal controls, non-compliance with 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 findings. Further, the management letter should include a description of how compliance audit and performance audit tasks have been performed in relation to the relevant ISSAI standards. Compliance- and performance audits can also be addressed in a separate management letter.