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Annual Report to the Discharge Authority on Internal Audits Carried out in 2003

(Article 86(4) of the Financial Regulation)

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1. INTRODUCTION

The aim of this summary report is to inform the Discharge Authority, in line with the requirements of the Financial Regulation under Article 86.4, of Internal Audit findings and recommendations in 2003 from the Internal Audit Service (IAS) and to report on the follow-up.

The report focuses on the number and type of findings and recommendations, which arise from the audits carried out by the IAS in 2003. The Commission Services Working Document submitted alongside with this report is structured by broad sector of activity and contains short descriptions and follow-up information on the individual audit engagements completed by the IAS in 2003. It also gives follow-up information for previous audits, mainly based on information provided by the audited departments.

2. OVERVIEW OF IAS AUDIT WORK IN 2003

Based on Action 87 of the Reform White Paper, the IAS planned to carry out by 2003 a complete cycle of in-depth audits of all DGs. The objective was to allocate enough resources to ‘high risk profile’ DGs to be able to carry out system audits, including substantive testing, and to limit the scope for the other DGs to the identification of their major risk areas.

Some of the implementation of the 2003 audit programme was postponed into 2004 with the special request to the IAS concerning the review of contracts and grants managed by or with the involvement of ESTAT. In the resolution accompanying its decision of 8 April 2003 to grant discharge to the Commission for the year 2001, the European Parliament requested that “*the Commission’s Internal Audit Service examines by summer 2003 the legality and the regularity of all contracts concluded by Eurostat since 1999, and to include in its investigation those contracts concluded by other Commission services*”. Consequently, the Commission decided on 11 June 2003 to instruct the IAS to undertake an examination, on an agreed upon procedures basis, of the legality and regularity of contracts and grants completed by ESTAT or by other DGs following ESTAT’s advice from 1999 to 2002.

The IAS was able to finalise in 2003 nine Action 87 DG-specific audits, two thematic audits, two follow-up audits and the review of ESTAT contracts and grants at the request of the Commission. It has also included in this report one Action 87 audit for which the final report was issued early in 2004.

The following table gives an overview of IAS audit engagements completed in 2003:

Overview of IAS Audit engagements completed in 2003:

Audit	Audit Planning Memorandum	Draft Report	Final Report (Transmission Date)	APC Discussion
<i>Cross-cutting Budgetary Management, Accounting and Internal Control Systems</i>				
BUDG – Accounting system	05-Apr-01	15-Oct-02	15-Apr-03	15-Sep-03
BUDG – SINCOM2	23-Sep-02	10-Feb-03	21-May-03	15-Sep-03
BUDG – Treasury management	30-Sep-02	10-Apr-03	22-May-03	15-Sep-03
<i>Internal Policies including Research</i>				
RTD	21-May-03	31-Oct-03	02-Dec-03	16-Feb-04
ESTAT contracts and grants	11-Jun-03	10-Oct-03	22-Oct-03	Discussed by Commission (APC 7-May-04)
<i>Structural Measures and Common Agricultural Policy</i>				
REGIO	30-Sep-02	24-Jan-03	26-Feb-03	28-Apr-03
AGRI	20-Nov-02	06-Jun-03	13-Oct-03	10-Nov-03 8-Dec-03 19-Jan-04
<i>External Policies including Pre-accession Aid</i>				
ELARG	18-Mar-03	13-Nov-03	22-Dec-03	15-Mar-04
DEV	14-Feb-03	21-Nov-03	02-Feb-04	10-May-04
EDF counterpart funds (Follow-up)	23-Mar-03	23-May-03	12-Jun-03	13-Oct-03
RELEX	28-Feb-03	08-Sep-03	16-Oct-03	16-Feb-04
Governance review in the RELEX field (Follow-up)	18-Mar-03	08-Apr-03	15-Apr-03	16-Jun-03
<i>Administrative and other Support Systems</i>				
IT governance	15-Mar-02	21-Jan-03	23-May-03	15-Sep-03
Training Update	24-Feb-03	19-Mar-03	22-Jul-03	13-Oct-03
PRESS	17-Feb-03	08-Jul-03	12-Sep-03	13-Oct-03

Recommendations made by the IAS have been widely accepted by auditees and are to a large extent, according to information from auditees, either already implemented or in the course of being implemented.

The following table gives an overview over the degree of acceptance of recommendations for the audits covered in the present report:

Acceptance of IAS audit recommendations:

	Accepted	Accepted with comments	Partly rejected	Rejected	Outdated	Total	%
Critical	33	27	11	3	3	77	12,16%
Very imp.	152	70	16	23	1	262	41,39%
Important	161	42	12	17	0	232	36,65%
Desirable	31	16	4	11	0	62	9,79%
Total	377	155	43	54	4	633	100,0%
%	59,6%	24,5%	6,8%	8,5%	0,6%	100,0%	

Following the completion of its cycle of DG audits in 2004, the IAS will be able to present a consolidated picture of findings later this year, which should assist in gauging the relative importance of each of these.

Little progress, other than general planning, has been made with the IAS new remit to audit 14 Agencies, a task required by Article 185 of the Financial Regulation and the Implementing Rules, which lead to a reservation in the 2003 Annual Activity Report of the IAS.

The IAS also carries out from time to time specific consultancy engagements and is frequently asked to contribute to or volunteers its professional advice on internal control issues, resource management and operations. The IAS undertakes such consulting activities in line with normal internal auditing practice and with its mandate under the Financial Regulation and the IAS Charter.

3. SUMMARY OF CROSS-CUTTING FINDINGS AND RECOMMENDATIONS

The following five chapters discuss the recommendations made by the IAS on cross-cutting issues, derived from the findings of the audits presented in the attached Commission Services Working Paper and reinforcing in many cases similar findings made in earlier Annual Reports from the IAS.

Delegation of responsibility, accountability and supervision, which are core objectives of the Reform, are at the heart of many of the findings and recommendations emerging in IAS reports and underlie most of the systemic issues raised.

3.1. Accounting and Management Information Systems

The IAS considers that, parallel to financial management and accounting reform, the accounting function within DGs needs to be strengthened and professionalised so that within and across DGs the Commission and its management can have systemic assurance that the accounts are complete, accurate and relevant. Systems must ensure that the accounts capture all relevant information and staff must be aware of the dangers of not

recording it. Management and external stakeholders need to have assurance that the numbers represent reality, otherwise decisions will be ill-founded. For this reason, the IAS considers it preferable that the monitoring/recording function should have not only professionalism but also not fully depend on the authorising function.

Based on these considerations, the IAS proposes that functional reporting be formalised between those responsible for the accounting/monitoring function in the DGs and the Accounting Officer. It is the view of the Commission, that the existing contacts in the network of financial units (RUF), the group of resources directors, the group of the DG internal control co-ordinators and the creation of the accounting correspondent and accounting system user network, together with the need to keep clear and unambiguous reporting lines to the Director-General means that it does not intend to formalise further relations between the accounting and the monitoring function at DG and at central levels.

In order to comply with the provisions of the Financial Regulation regarding the role and function of the Accounting Officer (Art. 61), the IAS considers that it is necessary for the Accounting Officer to assume, beyond a consolidation function relying exclusively on the assurance given by delegated Authorising Officers as provided in Article 61(2), also systemic and overall product responsibility for the integrity of the accounts for the Institution as a whole. The IAS proposes to confirm or clarify, if necessary through a change to the Financial Regulation. Based on the provisions of the Financial Regulation, according to which it is the Authorising Officers by delegation, and not the accountant, who is responsible for the underlying assurance of legality and regularity of the transactions and for the reliability of the related information, the Commission has confirmed the systemic responsibility of the Accounting Officer. In application of Article 61(1e) of the Financial Regulation, the Accounting Officer has launched in 2004 a survey to validate the DGs' information systems and accounting procedures.

Given the impossibility to attribute major categories of overheads to activities, the IAS proposes an evaluation of the tools necessary for the pursuit of the implementation of ABM, with particular reference to the need for cost accounting of key overheads. The Commission will consider this recommendation in the event that further development of the existing SPP/ABM structure stemming from the administrative reform undertaken by the present Commission is deemed appropriate.

3.2. Delegation Risk

Progress has been made in acknowledging the delegation risk, which results from the Commission having final budget responsibility for all its expenditure but having to meet that responsibility also when EU funds are implemented in shared management with Member States. The IAS report renews the suggestion that this crucial issue be solved through a clear protocol as to the exact responsibility of Member States on the one hand and the Commission on the other, reinforced by a country disclosure and assurance statement.

Accordingly, the IAS suggests that concrete steps be taken now to ensure that the Structural Funds legislative framework for the next programming period include 'ex ante'

Disclosure Statements by managing authorities with a clear legal authority for penalties affecting the overall funding of the Member State concerned, in case of inadequate disclosure. The Commission, in its recent proposals for the legal framework of the next Structural Funds programming period has introduced the requirement to present audit assurance statements by Member State audit bodies together with reinforced provisions on financial corrections. As far as agriculture is concerned, the legislative framework for the next programming period includes an assurance statement for the Paying Agencies which are in charge of the management and control in the Member States. This proposal concerns all agricultural expenditure (2 funds: FEAGA and FEADER).

The IAS proposes that a joint approach be developed with the ECA on the way forward towards agreed acceptably qualified assurance. The Commission welcomes the Court's new DAS approach and sees in that the basis for working towards an agreed statement, based on solid financial management information presented in the DG's Annual Activity Reports and the Commission's synthesis report.

3.3. Activity Based Management – ABM Tools

Audit findings have led the IAS to raise a number of issues in this area: Firstly and most basically, the definition of objectives can be too global, which reveals itself in difficulties with resource allocation and risk analysis. Secondly, there is understandable difficulty in developing meaningful performance indicators. The IAS has proposed no recommendation on these observations at this stage since they may just be teething problems with the new ABM mechanisms. Thirdly, in some cases there is no clear link between the Annual Management Plan (AMP) for a DG and a comparable plan at the level of Directorates or Units. This would, however, lead to a clear and integrated single planning structure for a DG, the DG level AMP having more chance of being implemented if underpinned by Unit level plans. Accordingly, the IAS advises to clarify the instructions to DGs regarding the necessary coherence of AMPs at all levels of the organisation.

The Commission recognises the need for Annual Management Plans at unit level, but does not want to introduce mandatory standards, as units' responsibilities widely vary and decentralisation of management responsibilities towards DGs implies that they are best placed to organise their internal management, reporting locally and according to their own circumstances.

3.4. Legacy Risks, Resource Allocation and Risk Management

The Commission has inherited a number of serious legacy risks, some created by earlier under-resourcing, which, in the view of the IAS, are either not gaining adequate recognition or are being managed at the expense of sound management of current programmes. The IAS considers that there should be explicit recognition of these situations and they should feature in an Institution-wide management-led risk analysis. This should be the basis for resource allocation decisions, including as appropriate the use of executive agencies, and the 'under-managed' risks should be made known to the Budgetary Authority.

The IAS recommends that the Commission and its departments ensure that resources are made available for audit work to be carried out early enough in the lifetime of programmes to prevent the creation of future legacy problems. Such audits would be more effective in preventing the build up of new legacy exposures if they were combined with disclosure statements, as suggested. It also recommends that the correction of past errors should be carried out promptly on discovery and that corrective action be properly recorded and documented. The Commission agrees with the recommendations from the IAS and will pay proper attention to these considerations, in the limits of what is possible, in resource allocation and planning. In particular, for the Structural Funds, for the current programming period, there will be increased cooperation with national authorities concerning system audits and ex post controls. The new ex-post controls network, a sub-group of the network of the DG internal control co-ordinators provides a forum for exchanging best practice and harmonising methodology and strategies. It will start its work in autumn, drawing up an inventory of ex-post control activities and methods existing in DGs.

The IAS repeats its recommendation of last year, accepted by the Commission, that an institution-wide risk management be developed and that specifically the DGs' management risk self-assessments be further shared and centrally analysed to complement the CFS overview of the state of internal controls. This consolidated picture should be completed by such material as the results of audits, the Court of Auditors' reports and the Discharge resolution to provide a risk picture for the Institution as a whole, with a view to the establishment of a management-led central capacity. The growth and potential of executive agencies as a means to deal with staff shortage in programme management could usefully be directed and monitored through this same central capacity.

The Commission had accepted this recommendation in its synthesis report for 2002 and confirmed in its 2003 synthesis report that "risk analysis should help in orienting resource allocation, alongside other elements such as policy priorities"¹.

3.5. Management Assurance and Control Activities

The DG assurance statement has gained recognition for its importance as a transparency and accountability tool and has gone through a second year. Since the February 2004 decisions², the DGs' Resource Directors co-ordinate internal control issues and sign off the relevant annexes to the Annual Activity Report, thereby strengthening the checks and balances at DG level. It remains Reform's major change instrument, and, in the IAS' view, the Commission's AAR Synthesis report and related Overview on Internal Control from the Central Financial Service (CFS) should continue to be reinforced.

¹ "Synthesis of Annual Activity Reports 2003 of DGs and Services", point 4.

² "Completing the Reform Mandate", COM(2004) 93 of 10 February 2004.

The IAS recommends that future Synthesis reports should focus on the AOD declarations which relate to the effectiveness of controls and that the CFS position statement should progressively give more prominence to the evaluation of effectiveness than to the degree of formal compliance with the internal control standards. The Commission agrees, stressing in its 2003 synthesis report the "need for enhanced attention by DGs and services on the *effectiveness of their internal control systems*, also to ensure that they adequately support the assurance to be given yearly by them as authorising officers by delegation"³.

Controls on-the-spot are, in the opinion of the IAS, not frequent enough to provide a disincentive to over-claiming and/or do not form part of an overall control and audit strategy. In cases where internal management is fully decentralised, the managing unit should be carrying out all necessary controls under its own responsibility; this should include those on-the-spot checks designed to prevent over-claiming where grants are linked to real expenditure. Managing units often do not have the necessary skills to do this and, if it is done at all, it is done by central control units in the DGs.

Clarity is needed conceptually that, in such cases, the specialised units are providing assistance to the managing units and not assuming its responsibilities; staff of managing units should participate in drawing up the audit strategy and risk analysis and should participate in the controls on-the-spot. There needs to be a clear distinction between this activity and internal audit (IAC) work intended to verify the effectiveness of management systems as a whole. Against this background, the IAS proposes that the CFS assist in clarifying conceptually the activity of on-the-spot control in relation to the responsibilities of AODs and AOSDs and issue appropriate instructions or amended internal control standards in order to ensure its proper implementation. The above-mentioned ex-post control network, set up within the network of the DG's Control Coordinators and chaired by the CFS, has, among others, the mandate of exchanging best practice and harmonising control activities and methods, taking into account international standards.

³ "Synthesis of Annual Activity Reports 2003 of DGs and Services", point 7.