

**HIGH LEVEL GROUP REFLECTING ON FUTURE OF COHESION POLICY**

**MEETING NO. 4 - 25<sup>TH</sup> + 26<sup>TH</sup> MARCH 2010**

**VENUE: EUROPEAN COMMISSION, CHARLEMAGNE (MANSHOLT ROOM)**

**170 RUE DE LA LOI, B-1049-BRUSSELS**

**ASSURANCE MODEL AND FINANCIAL MANAGEMENT**

## **1. THE BASIC PRINCIPLES OF THE ASSURANCE SYSTEM**

The discharge procedure represents the political aspect of the external control of budgetary implementation and may be defined as the decision by which the European Parliament, on the Council's recommendation, accepts the correctness of the accounts and the Commission's management of the budget for the financial year in question. In order to take its decision, the Parliaments' assessment of the accounts is supported by:

- A synthesis report from the Commission which draws on the results of the annual activity reports and the assurance declarations signed by Directors-General. This report seeks to provide reasonable assurance that the accounts present a true and fair view of the financial position of the European Communities in all material aspects and that the underlying transactions are legal and regular.
- A statement of assurance by the European Court of Auditors which provides the European Parliament and the Council each year an assessment of the reliability of the accounts of all revenue and expenditure of the Community and the legality and regularity of the underlying transactions.

The central measure of assurance by the Court is the annual error rate within expenditure reimbursed by the Commission for the different policy areas, which should remain below 2% to be considered below the level of materiality.

Cohesion Policy is implemented in the context of shared management. Implementation tasks are thus delegated to the Member States along with the obligations to take measures to ensure the legality and regularity of the expenditure and to protect the financial interests of the Community (in particular through the establishment of an effective control system). However the final responsibility for the EU budget remains with the Commission, which must fulfil its supervisory role and implement financial corrections where necessary.

The "single audit principle" is part of the development towards an integrated internal control framework in the EU. The single audit principle foresees a control system, where the control and audit functions are based on common methods enabling auditors at one level in the control chain to draw assurance from controls at a lower level and auditors of one institution to rely on the work of auditors from another institution instead of re-performing the audit themselves. In the context of shared management the single audit approach should ensure that in most cases Commission can rely on audits performed at national or regional level.

The Commission's "Roadmap to an Integrated Internal Control Framework" of June 2005 identified "exploring the scope for greater simplification of the management of EC

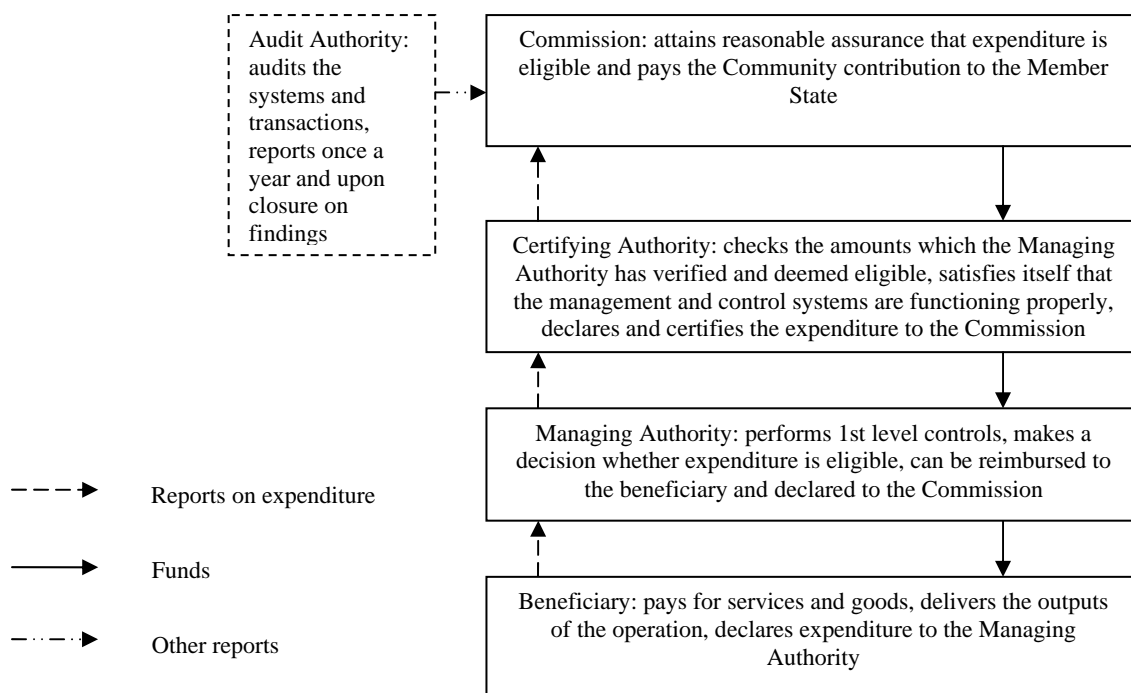
funds, and ensuring that the control requirements are proportionate to the risks”. The Council reinforced this approach in its ECOFIN conclusions: “The regulations to be adopted for the programming period 2007-13 should include simplification of the control requirements while providing reasonable assurance”. The 2007-2013 regulatory framework for Cohesion Policy put these principles into practice.

## 2. MAIN FINANCIAL FLOWS AND TRIGGERS IN THE AREA OF COHESION POLICY IN 2007-2013

Payments to Member States are made in three stages. Advance payments are released once programmes have been approved by the Commission.

Interim payments are conditional on a positive compliance assessment. After this however they are made continuously (several times a year) throughout the programming period as described below. Payments by the Commission to the Member States are based on eligible expenditure paid and declared by the beneficiaries and certified by the Certifying Authority with each statement of expenditure. The amount to be paid is determined by applying the priority axis co-financing rate to the eligible expenditure.

The final balance for each programme is settled at closure when the programme authorities submit the final statement of expenditure, final implementation report and audit declaration. The final 5% of the funds which Member States are entitled to are withheld until the Commission has attained assurance from these reports submitted and its own controls that expenditure co-financed by the EU within the programmes subject to closure has been legal and regular. The final payment (or recovery) constitutes the closure of the programme.



At any stage the Commission has the possibility to interrupt and suspend payments to Member States in the case of serious deficiencies or irregularities, as well as to make

financial corrections, which creates incentives for Member States to address problems without delay and contributes to assurance.

Payments to Member States are made on the basis of expenditure paid by the beneficiaries (not by Member States) and can be calculated from total public expenditure (excluding private contribution) or total eligible expenditure (including private contributions).

In the current system, there are a number of factors that may increase the error rate. Payments by the Commission on the basis of expenditure paid by beneficiaries, which has not always been reimbursed by the national administration, increase the risk that expenditure is not checked adequately. Furthermore, the "n+2/3" rule, while encouraging a smooth uptake of funds, can create further incentives to spend funds quickly without the necessary checks before declaration to the Commission. The possibility to include private expenditure as co-financing means that in some cases Member States interventions contain no co-financing from national public sources.

#### Questions

- Would it strengthen the system to have a requirement for the programme authorities to keep annual accounts related to the financial year for the Funds (payments, recoveries, unrecovered amounts etc.)?
- Are there advantages to a system of annual advances to the Member State which are cleared at the end of each year with a definitive reimbursement determined on the basis of the annual accounts?
- Are there advantages in terms of simplifying management, clarifying accountability and strengthening assurance in a system where reimbursement by the Commission is made on the basis of payments to beneficiaries rather than expenditure paid by beneficiaries, taking into account the public contribution only?
- Are there alternatives to the present decommitment rules which would ensure financial discipline and encourage sound financial management?

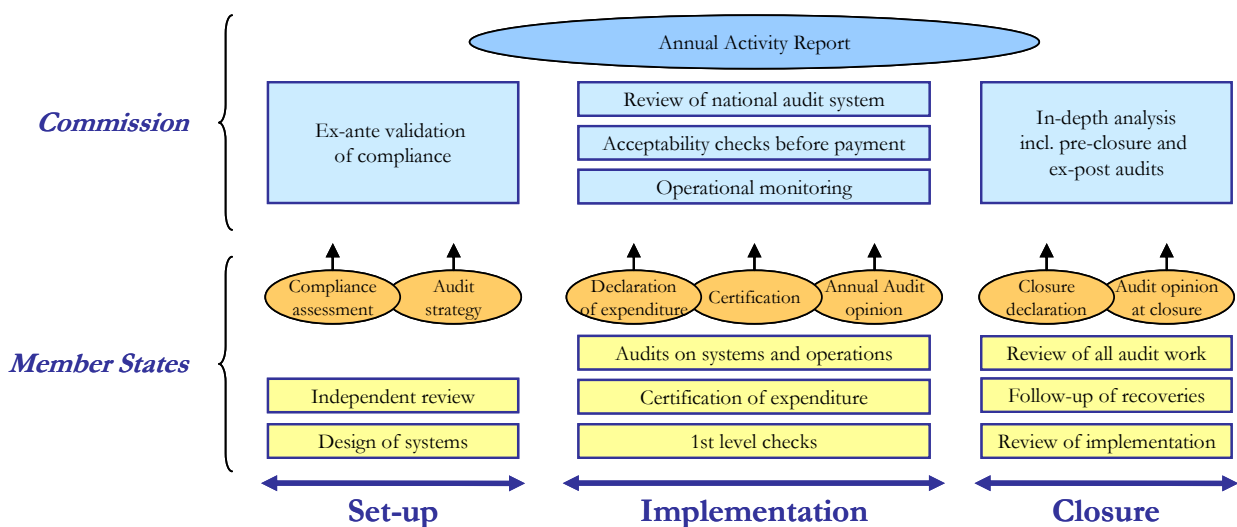
### 3. THE ASSURANCE PROCESS IN THE PROGRAMMING PERIOD 2007-2013

The assurance model in Cohesion Policy has a number of strengths. It has evolved over time, in particular through the introduction of elements to reinforce the assurance process. It is familiar to Member States. It ensures a clear division of functions and responsibilities and contains preventive elements.

The most visible weakness related to assurance in the area of Cohesion Policy has been the annual error rate which for the past programming period has significantly exceeded the 2% threshold used by the Court of Auditors as a measure of materiality. Thus the capacity of this system to deliver reasonable assurance for the European Parliament discharge on the appropriate use of EU funds has been problematic. There is preliminary evidence that in 2007-2013 the error rate is lower than in 2000-06 and hence the introduction of ex-ante elements like the compliance assessment have led to greater assurance. However the error rate is still likely to remain above the level of materiality

on a yearly basis during programme implementation. The assurance system consists of elements which fall into three categories:

1. Ex-ante elements (compliance assessment and the approval of the audit strategy) which provide assurance both to Member States and the Commission that the set up of systems is sound and that Audit Authorities will review the system methodically throughout the period.
2. Controls performed during implementation. In 2007-2013 there are three layers of national controls: 1<sup>st</sup> level controls by the Managing Authority, controls preceding certification of expenditure (by the Certifying Authority) and independent audit of systems and transactions (by the Audit Authority). In ideal cases the Commission can rely on these controls and in particular on the work of Audit Authorities, as their work has been standardized to a great extent. The Commission's assurance is based on regular reports on audit activities. It also receives annual implementation reports and participates in Monitoring Committees that can provide additional information.
3. Closure, which signifies the end of the assurance process at Member State level – final settling of all accounts, final controls and final conclusions drawn on the legality and regularity of expenditure declared.



### Assurance at National Level

The main controls on the beneficiaries are performed by the Managing Authorities. These controls can be arranged in a flexible manner and they are adjusted to risks involved. The standardisation of these controls is low, with only guidelines issued by the Commission, and there is no regular reporting on them directly to the Commission. The Certifying Authority, however, needs to be satisfied that these controls are sufficient for expenditure to be certified and the Audit Authority makes a similar assessment before issuing an opinion on whether the management and control systems function effectively.

The most important source of assurance is the annual opinion of the Audit Authority. However this is ex post and cannot in itself prevent the Commission from reimbursing irregular expenditure in a given budget year. The Court of Auditors may still therefore find a material level of error in claims audited. The assurance which the Commission

attains is heavily reliant on the work of Audit Authorities and the quality of their work. If the Audit Authority does not function well, the Commission's source of assurance is substantially weakened and the single audit concept in danger as the Commission needs to compensate for its assurance gap.

Expenditure is certified with each payment claim to the Commission, hence several times per year. There is a separate body which is responsible for certification – this means that costs are not certified only on the basis of the 1<sup>st</sup> level controls performed by the Managing Authority, but also on the basis of additional controls performed by an independent body.

However, no information on the activity of the Certifying Authority accompanies the statement of expenditure. As there are also no specific detailed requirements defined in the regulations, the Commission has very limited information on controls performed before certification to make sure that the declaration contains only eligible expenditure. Thus the added value of this layer of control in terms of additional assurance can be variable.

The high error rate detected by the Court of Auditors in the past signals that in some countries many errors are not detected by the Managing and Certifying Authorities. The Commission receives very little information on 1<sup>st</sup> level controls by Managing Authorities which are a key element in achieving a low error rate. This is partly the case because there is a very low level of standardisation – organisation of 1<sup>st</sup> level controls is flexible, content and coverage of controls can vary significantly.

### Questions

- Would it provide stronger assurance to have an annual management declaration (signed by the head of the body responsible for 1<sup>st</sup> level controls) accompanied by an audit opinion (on systems, transactions and expenditure declared) rather than a certification of each payment claim?
- Could national authorities complete the work necessary to provide reasonable assurance in relation to the transactions of a certain financial year within 3 months from the end of that year – in time for the budget discharge process at EU level?
- Shifting to a system of annual management declarations linked to audit opinions would reduce the need for control authorities to two instead of three – a body responsible for 1<sup>st</sup> level controls and the independent audit body. It could also mean that annual summaries are no longer required as a separate process. Would these changes constitute desirable simplification?
  - Would clearer minimum requirements for 1<sup>st</sup> level controls be desirable? Would regular reporting on these controls (in the context of annual management declarations for example) contribute to the assurance of the Commission?
  - What could be done further in Cohesion Policy (apart from issues such as public procurement and state aid) to ensure an error rate which is considered acceptable by the budget authority (changes in eligibility rules, applying sanctions etc.)?

## **Assurance at EU Level**

Cohesion Policy has a flexible management and control system, which allows adaptation of interventions to particular circumstances and tailor made controls of those interventions. However, this flexibility can generate uncertainty as regards requirements in relation to reporting, application of rules, and audit methodology.

The regulations for 2007-2013 foresee an ex-ante assessment of the compliance of national systems where the assessment itself is undertaken by the national administration, but the Commission has to take a position in regard to the adequacy of the assessment. Interim payments are not made before a positive approval has been given by the Commission, which encourages Member States to set up appropriate systems at the beginning of the period.

The system has a number of clear strengths. In particular, it gives greater assurance to the Commission at the start of the programming period as regards the functioning of the whole system including intermediate bodies. Furthermore, it reduces legal uncertainty for Member States as regards Commission expectations. However, the role of the Commission in the compliance assessment can be seen to dilute the full responsibility of the Member States as they need not to make fully independent decisions on the compliance of systems. Compliance assessment itself is resource intensive and time consuming - it can delay implementation. At the same time, there is always a risk that systems will not actually function as described during the assessment.

Closure takes place at the end of the programming period. It entails final reporting to the Commission on implementation, compiling a final statement of expenditure and providing a final audit report/opinion. Partial closure before the end of the period is also possible, but not mandatory. Closing the entire programme at the end of the programming period means that many supporting documents have to be kept for 10-15 years. This contributes to the error rate as some documents are inevitably lost. The more time passes from actual implementation, the more difficult and time consuming the closure process becomes, as information is forgotten or lost (due to staff turnover etc.).

During implementation and at closure the Commission relies mainly on the Audit Authorities, which submit annual control reports and an annual audit opinion on the effective functioning of systems. Audit work at national level is standardised. Audit strategies are subject to approval by the Commission which focuses its audit efforts on the quality of work of the Audit Authorities, but also undertakes additional audit work to reinforce its assurance. This should ensure that audit resources are used efficiently.

### **Questions**

- Is it necessary to provide greater clarity as regards requirements in relation to reporting, application of rules, and audit methodology?
- Should the current compliance assessment be maintained or would there be an advantage in a purely national accreditation system in which the Commission's intervention would mainly be limited to ex-post corrections?
- Would a more regular (obligatory) closure of finalised operations, or an annual clearance of accounts procedure be beneficial in strengthening assurance?

#### 4. PROPORTIONALITY AND DIFFERENTIATION IN COHESION POLICY

In the context of sound financial management it is necessary to encourage an optimal allocation of resources within the assurance system to manage risks. This implies ensuring that the administrative burden imposed by EU legislation for the management and control of Cohesion Policy interventions is proportionate to the risks involved. It also entails avoiding circumstances where achieving an optimal management result (e.g. a very low error rate) requires a disproportionate management effort. Given the diversity of situations in Member States in relation to volume of funds allocated, size of programmes, types of investment and administrative capacity, a “one size fits all” approach may lead to excessive requirements for some programmes.

##### **Existing arrangements for differentiation in 2007-2013**

Adjustment of management effort to risk in the area of Cohesion Policy is provided for in the current regulatory framework both at the level of the Commission (towards Member States, Operational Programmes) and at the level of Member States (towards operations). In the 2007-2013 period a proportionate management effort is explicitly foreseen in the following areas.

1. **Audit work at the level of the Commission.** In the case of positive compliance assessment (indication of lower risk) the Commission may rely mainly on the Audit Authorities and does not have to audit Member States itself. Present differentiation allows adjustment to risk. Risk assessment by the Commission is based also on other sources of regular information.
2. **Audit work at Member State level.** There are special provisions for programmes where the Community contribution is small: there is no requirement to submit an audit strategy and there is an exception for small programmes in sampling rules (which allow the use of non-statistical samples to reduce work load). System audits are not strictly regulated; there is flexibility to arrange them in a proportional manner (frequency, intensity etc).
3. **Establishment of management and control systems.** Member States have the freedom to organise the work of the Certifying Authority and the Audit Authority as well as some of the functions of the Managing Authority according to national rules if the Community contribution to the Operational Programme is small.
4. **Evaluation and annual reporting.** Resources contributed towards these functions should be proportional to the overall volume of EU funds managed; therefore less can be done for small programmes.

##### **Possibilities for further differentiation**

**Tolerable risk:** At the moment there is no differentiation across different types of interventions. Any error above 2% is considered material (by the Court of Auditors). In high risk areas keeping the error rate below 2% may require a disproportional control effort. **Option:** Establishing a higher rate of tolerable error for areas which are by default of higher risk but instrumental in the achievement of EU objectives. Such areas could

include innovative measures, territorial cooperation and certain types of local development operations.

**Compliance Assessment.** In 2007-2013 there is no differentiation. The process is the same for all Operational Programmes. Interim payments are released only upon positive compliance assessment. **Option:** Relying on national accreditation only in countries/regions/sectors which have demonstrated solid systems in 2007-2013 through consistently low error rates, where there will be no significant change in the systems for post 2014.

**General audit requirements** The area of audit is already subject to differentiation; however there are further possibilities to adjust management effort. **Option:** waiving the requirement for annual (statistical) sampling by the Audit Authority where there is consistent evidence of low error rates.

**Reimbursement principles** The regulations already provide for several alternatives for reimbursement. Flat rates for indirect costs, standardized scales of unit costs and lump sum payments require a different audit trail and different controls compared to the regular expenditure-based reimbursement. **Option:** to further develop the option of simplified costs, possibly by differentiating reimbursement principles by type of operation or by area of intervention.

#### Questions

- Are the options outlined above feasible and would they ensure clearer proportionality based on administrative capacities?
- Are the other areas where differentiation would be beneficial?