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**COMMUNICATION FROM THE COMMISSION  
TO THE EUROPEAN PARLIAMENT, THE COUNCIL AND THE EUROPEAN  
COURT OF AUDITORS**

**Report on the Commission Action Plan towards an Integrated Internal Control  
Framework**

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**Report on the Commission Action Plan towards an Integrated Internal Control Framework**

**1. EXECUTIVE SUMMARY**

When it entered office, the current Commission fixed a strategic objective of aiming for a positive declaration of assurance from the European Court of Auditors. To support this, it adopted in January 2006 the "Action Plan towards an Integrated Internal Control Framework"<sup>1</sup>, drawing on recommendations by the Court of Auditors<sup>2</sup>, the European Parliament's discharge resolution 2003<sup>3</sup> and the ECOFIN conclusions of 8 November 2005. The Action Plan addressed 'gaps' in the Commission's then control structures and identified 16 areas for action by end-2007. In its interim progress report in March 2007<sup>4</sup>, the Commission outlined progress and announced some additional actions.

In the two years since the 16 actions were launched, 7 have been completed, 6 are substantially complete and 3 could not be implemented or are being taken forward in other ways. Figure 1 gives an overview of the status of each group of actions and a first impact evaluation. The action plan deadline was end-2007 for putting measures in place. Detailed progress on the actions is spelt out in the Annex to this report. A first assessment of the **impact** of the actions is given, but reduction of errors and increase in assurance will only build over time as the actions taken begin to have an impact on underlying control systems.

**Figure 1: Implementation and impact of the action plan**

Group of actions	Status March 2007	Status February 2008	Impact February 2008
<b>Simplification and common control principles (actions 1-4)</b>	■ ■ □ □ □	■ ■ ■ ■ ■	■ □ □ □ □
<b>Management declarations and audit assurance (actions 5-8)</b>	■ ■ □ □ □	■ ■ ■ ■ □	■ □ □ □ □
<b>Single audit approach: sharing results and prioritising cost-benefit (actions 9-11)</b>	■ ■ □ □ □	■ ■ ■ ■ □	■ □ □ □ □
<b>Sector-specific gaps (actions 12-16)</b>	■ ■ ■ □ □	■ ■ ■ ■ □	■ □ □ □ □

*Figure 1 shows that the Commission has met the ambitious Action Plan timetable, ending on 31 December 2007. The actual impact on error rates will only become perceptible at a later stage..*

<sup>1</sup> COM(2006) 9 and SEC(2006) 49.

<sup>2</sup> Opinion No 2/2004: OJ C107/1 of 30.4.2004 (the 'Single Audit' Opinion).

<sup>3</sup> OJ L196, 27.7.2005, p. 4.

<sup>4</sup> COM(2007) 86.

The Action Plan was designed to provide the foundations for a positive DAS. The completed actions have clarified and strengthened the internal control framework for Community programmes.

Actions not yet closed will be completed in 2008. The principal incomplete actions are:

- action 7, the development of "agreed upon procedures" in education and culture was postponed to 2008 due to updates of DG EAC's audit methodology. This work will be completed by December 2008;
- action 10, the collection of data on costs of control in agriculture and the structural funds has been completed and analysis is underway. The results will be reported in a Communication in October 2008 (see below);
- action 11N, modifications to ABAC in February 2008 will allow clear tracking of multi-annual recoveries from 2008 on; and
- action 16, a sampling guide for Commission services, as well as a specialist sampling guide for the Structural Funds, will be made available in Summer 2008. The revised structural funds audit manual will be completed during the year to take account of the new regulations.

Despite the actions already taken, the Court is still finding too many errors in some areas. In the 2006 DAS, structural actions delivered through Member States and external aid managed by implementing organisations received a "red" assessment from the Court. As the Court indicated in its "single audit opinion", a sound understanding of risk and the costs and benefits of control is vital in defining control strategies and evaluating their results. The Commission will prepare a Communication for October 2008 on the costs and benefits of control systems and the analysis of residual risk which DGs for whose policy areas the Court of Auditors' assessment is "red" are required to include in their . 2007 Annual Activity Reports.

The action plan was designed to address gaps in the internal control framework and to support the move towards a positive declaration of assurance. As the different actions begin to bite, the impact on control effectiveness will become progressively more visible. This report provides an overview of actions taken since the previous progress report in March 2007.

## **2. COMPLETION AND IMPACT OF THE ACTION PLAN**

Progress on each action is described in the sections below and in more detail in the annex.

### **2.1. Simplification and common control principles (actions 1-4)**

#### ***Action 1: Simplification of proposed 2007-13 legislation***

**Action completed:** the Court indicated in its "single audit" opinion that simple, clear and easily-applied rules are crucial to reduce the risk of error. When the action plan was adopted, a limited window of opportunity was left for further simplification of 2007-13 legislation beyond provisions already negotiated. Simplification - a responsibility the Commission shares with the Legislative Authority - has not therefore been as extensive as hoped, although, some elements intended to reduce errors were introduced in specific sectors, including rural development and structural actions. The internal control systems covering shared

management, for example, are set out more clearly in the new period legislation and respect the single audit principle<sup>5</sup>.

Complex rules remain however a significant cause of error. Since its March 2007 report, the Commission has clarified rules through guidelines<sup>6</sup> on the new Structural Funds legislation. It will continue to provide support and further guidance where necessary. The Commission will also ensure that future legislative proposals include clear and straightforward rules.

***Impact: Percentage of the budget spent using lump sums. ■□□□□***

***Probable evolution: little change expected under current legislation. Further simplification will be proposed for the next legislative round.***

***Action 2: Integrate common internal control principles in the proposal for the revised Financial Regulation***

**Action cancelled, but achieved in another way:** as indicated in the March 2007 progress report, this action was cancelled as the legislator declined a specific principle on internal control in the Financial Regulation. The objective of this action has been achieved through Article 28a, which provides that "the budget shall be implemented in compliance with effective and efficient internal control".

***Action 3: Establish and better harmonise the presentation of control strategies and evidence providing reasonable assurance***

**Action completed:** the annual activity reports form the basis upon which the College accepts its responsibility for management by its services. A clear presentation of the internal control system is therefore crucial to users' understanding of how assurance is built-up. During 2007, "internal control templates" were developed for each management mode, describing the internal control system on a consistent and concise basis and presenting a logical build-up to the Director General's assurance statement. These templates are built on a common format which leaves some flexibility for adaptation to the needs of the DGs. They will be used in the annual activity reports for 2007 and a monitoring and peer-review process will ensure their consistent application. DGs will be challenged to provide a clear explanation of system weaknesses and the actions they are taking to address them.

***Impact: AARs for 2006 were already improved as a result of action 3, reflected by the more positive assessment from the ECA in its annual report of the quality of AARs; Increase understanding of different control systems. ■■□□□.***

***Probable evolution: Significant improvements are expected for 2007 AARs reflecting reinforced Standing Instructions, a stronger peer review, and – in the area of shared management – the use of Annual Summaries received from Member States.***

***Action 3N: strengthening the link between reasonable assurance and payments***

<sup>5</sup> See COM(2007) 86 for more details on specific simplification initiatives.

<sup>6</sup> Guidelines on FP7, guidelines on the implementing rules for Structural Funds 2007-13, Guidelines for Education Policy 2007-13.

**Action completed:** the Synthesis Report on 2006 set out clearly the reservations to global assurance, including specific identification of the sectors and/ or Member States concerned. It identified the corresponding financial corrections or suspensions of payments. This policy is being reinforced.

***Impact:*** *In the area of the Structural Funds, the Commission Action Plan to strengthen supervision under shared management<sup>7</sup> has already established a very direct link between audit findings, reservations and action plans by regions or Member States thereby ensuring that timely decisions on suspensions and financial corrections will be taken in 2008.*

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***Probable evolution:*** *Implementation of the Structural Funds action plan will ensure that the absence of reasonable assurance will lead to either improved systems or suspension of payments and financial corrections.*

***Action 4: Initiate inter-institutional dialogue on risks to be tolerated in the underlying transactions***

**Action cancelled but to be taken forward in action 10:** zero risk is impossible to achieve at a reasonable cost. The Court has indicated that the Commission needs to take action to sufficiently mitigate the risk of error. It stressed the need to define a "tolerable level of risk" and to adapt control systems to achieve this. While the Legislative Authority did not incorporate this into the revised Financial Regulation, the Commission is taking forward this action with actions 10 and 11 (see below).

## 2.2. Management declarations and audit assurance (actions 5-8)

***Action 5: Promote operational level management declarations and synthesis reports at national level***

**Action completed:** shared management legislation for 2007-13 requires Member States to provide an annual audit opinion and details of the results of controls. Furthermore, the revised Financial Regulation requires an annual summary of available audits and declarations, due for the first time by 15 February 2008 (for the year 2007). For agriculture, the heads of paying agencies are obliged to provide an annual declaration of assurance. The obligation to produce an annual summary was clarified in Article 7(5) of Regulation (EC) No 885/2006 and further detailed guidelines were addressed to Member States in December 2007. For Structural Funds, detailed guidelines were presented to the Coordination Committee of the Funds in October 2007 and issued in a final form in December 2007.

The Commission has strongly underlined the importance of the summaries and by the 27 February had received summaries on the Structural Funds from 25 Member States. While the nature of assurance which can be drawn from these documents can only be assessed following a review of their content and quality, the Commission considers this a success that it can build on to make further progress. As the process evolves and the implementation of 2007-2013 programmes begins, the summaries will provide additional support to assurance.

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<sup>7</sup> (COM(2008)97)

The Commission will send reminders to those countries from which summaries have not yet been received (Austria and Germany) and give them a month to comply. Four Member States (Eire-Ireland, Greece, Luxembourg and the Czech Republic) have not provided information on the 2000-2006 programmes.

Providing summaries is a legal obligation under the existing financial rules. If the situation is not remedied for Member States which did not provide any summary, or if the content of the summaries does not conform to the obligations under the Financial Regulation, the Commission is determined to open an infringement procedure.

For agriculture, nearly all heads of paying agencies (75 out of 83) provided their annual accounts together with their declaration of assurance as well as the certification report by 1 February 2008 (the remainder should be transmitted by end February). All Member States where more than one paying agency is accredited have the obligation of producing an annual summary by 15 February 2008. All of them respected the deadline, except one which is expected by the start of March.

The Commission welcomed the voluntary declaration by the Dutch government, and the accompanying report and opinion of the Dutch Court of Auditors. It also welcomed the certification of EU expenditure by the Danish SAI and the intentions announced by the UK to take action in this area. The Commission will support similar national initiatives.

***Impact: Increased assurance in shared management*** ■■■□□

***Probable evolution: A gradual improvement in control systems can be expected as the process is embedded and Member States take greater accountability for EU Funds (depending on Member States' compliance).***

***Action 6: Examine the utility of management declarations outside shared and indirect centralised management***

**Action cancelled but to be taken forward another way:** the extension of management declarations to external policies was not considered cost-effective nor likely to add assurance due to the risk of duplication with beneficiaries' existing contractual obligations on financial management. For internal policies it was felt more effective to increase assurance via audit certificates (see Action 7 below).

***Impact: See action 7 below.***

***Action 7: Promote best practices for increasing cost-benefit of audits at project level***

**Action partially completed:** the Commission's internal control framework relies in many cases on the work of other auditors, including those of Member State authorities in shared management and contracted auditors in centralised direct management. The achievement of effective results from different levels of audit requires clear working procedures and mandates.

The Commission has re-examined its procedures for audit opinions and the quality and independence of auditors. For External Aid and for the seventh Research framework programme it has based its approach on the international standard on 'agreed upon

procedures'. These, together with accompanying guidelines, clearly define the scope of the assignment, the format and content of reports, the accreditation requirements and the auditor's obligations. The approach will be extended to Education and Culture in 2008.

In the Structural Funds, the 2007-13 legislation sets out the roles of the different Member State bodies (including the certification of expenditure claims by the certifying authority and annual audit opinions by an audit authority). The SF audit manual is being revised to take account of the new regulatory requirements. It will include the sampling guide for Article 16, Commission Regulation (EC) No. 1828/2006, discussed with Member States in November 2007 which will be finalised by mid-2008.

In agriculture, the annual certification covers, as of financial year 2007, the proper operation of the paying agencies' internal control procedures and the certification bodies are required to verify and validate control statistics and post-payment checks.

***Impact: Improved standardisation and quality of audit work and improved reporting of representative error rates*** □□□□

***Probable evolution: Steady reduction in error rates***

***Actions 8 and 8N: Facilitate additional assurance from Supreme Audit Institutions***

**Action 8 completed:** while not part of the internal control framework, independent Supreme Audit Institutions, as external auditors of national public spending, play a key role in the audit of public - including EU - funds. The Commission has provided data on payments made in 2005 and 2006 to all SAIs and will continue to provide such information.

**Action 8N almost complete:** the Commission has conducted a case study with the Slovenian SAI which has enabled it to improve the standard reports. This will facilitate future use by SAIs in the context of national audits.

***Impact: Increase number of SAIs using Commission data and reporting on the use of EU funds*** ■□□□

***Probable evolution: SAIs are independent but a gradual increase in their involvement may be expected as the quality of Commission reports increases.***

**2.3. Single audit approach: sharing results and prioritising cost-benefit (actions 9-11)**

***Actions 9 and 9a1N: Construct effective tools for sharing audit and control results & promote the single audit approach***

**Action almost complete:** the Court proposed that audit results should be encoded in a common database<sup>8</sup>. The Commission has integrated audit data within its financial and accounting system to facilitate co-ordination of audits and sharing of results between DGs: over 2,700 audits are currently registered.

<sup>8</sup> Para 46 & 47 Opinion 02/2004.

DGs in shared management coordinate audits with Member States and audit progress is monitored via IT systems, regular reporting and the annual coordination meetings. Structural Funds legislation for 2007-13 requires the co-ordination of controls between different actors in the control chain, and the audit authority must provide an audit strategy for approval by the Commission within 9 months of programme adoption, which is updated and reviewed bilaterally each year. System audit reports are exchanged between the Commission and national audit services. Training workshops on the audit and control provisions of the new regulations were provided to the Structural Funds audit authorities of almost all Member States during 2007, to promote a common understanding of the new legislative requirements.

**Impact: Better coordination of audit activity and audit methodology. ■□□□□**

**Probable evolution: Improved consistency and quality of audit work. Increased reliance on the work of the national audit authorities.**

***Action 10 and 10N: Conduct an initial estimation and analysis in the costs of controls and examine the cost-benefit ratio of control***

**Action underway:** the Commission is completing the assessment of the costs of control in Agriculture, ERDF and direct centralised management. The results will form the basis of a Communication by the Commission in October 2008 which will examine the cost benefits of control systems and the analysis of residual risk which DGs for whose policy areas the Court of Auditors' assessment is "red" are required to include in their 2007 Annual Activity Reports. This Communication will form the basis for taking forward discussion on residual risk of error.

The analysis of the impact of programme design on risk foreseen in action 10N has been slower than hoped, mainly due to the lack of appropriate centralised data.

**Impact: Understanding of the levels of residual risk in major policy areas ■□□□□.**

**Probable evolution: Depends on follow-up to the October 2008 communication.**

***Action 11: Recoveries and benefits of control***

**Action close to completion:** many benefits of control are difficult to quantify (the deterrent and preventive effects, the impact of systems audit on improving Member State or beneficiaries' management and control systems). Analysis at this stage is therefore limited to readily quantifiable benefits (recoveries and reduction of payments).

**Impact: Quantification of the benefits of control in terms of recovery of amounts in error □□□□□**

**Probable evolution: Full information will be collected for 2008 onwards under Action 11N.**

***Action 11N: Recoveries of errors***

**Action under way:** recovered amounts have been reported in the 2005 and 2006 accounts. However a direct link between the results of control and recoveries is yet to be established. To ensure the financial results of controls can be identified and tracked, from 28 February 2008

the central financial and accounting system will record information on the control authority and the type of error. This information, to be retroactively encoded for all recoveries launched in 2008, will be reported in the 2008 accounts, presented in March 2009. This will allow, inter alia, the year in which an error occurred to be compared with the year of detection and will be a basis for assessing the effectiveness of multi-annual recovery systems.

Meanwhile, in October 2007 the Commission included as an annex to the Annual Report on the Structural Funds information on Commission corrections and, for the first time, provided figures for the execution of financial corrections at national level through withdrawals and recoveries by the Member States. The Commission will take action in 2008 to obtain better compliance with reporting requirements and will verify the accuracy of the data provided by a sample of Member States.

***Impact: Evidence that multi-annual control systems are effectively correcting errors***

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***Probable evolution: Full data on Structural Fund corrections will be collected for 2008 and Commission corrections will be recorded directly in the accounting system.***

#### 2.4. Sector-specific gaps (actions 12-16)

##### *Actions 12 and 12N: Address gaps identified by participating services*

**Action completed:** the Commission will ensure the multi-annual audit strategy continues to ensure an adequate balance between risk and representative sampling<sup>9</sup>. Extensive guidelines on audit sampling in line with international auditing standards have been prepared in the Structural Funds to promote coherence in testing done by Member State audit authorities<sup>10</sup>. The Commission has provided guidance on best practice in the management of external audit framework contracts to ensure a consistency and high quality of audit results<sup>11</sup>.

The FP6 audit strategy based on a detailed analysis of the beneficiary population, in the ECA's opinion "represents a sound basis for addressing the problems identified by the Court"<sup>12</sup>. While recognising that the approach is not directly transposable to all areas, the Commission will issue guidance to its services on sampling strategies by July 2008 based on experience with the research audit strategy.

Compared with the 45 audits done in 2006 for FP6, the Research DGs exceeded the target of 300 set in the March 2007 progress report<sup>13</sup> by performing 378 audits in 2007. The results of these audits will be reported in the DGs' annual activity reports. This effort will be continued in 2008 and the progressive build-up of audit results and the corresponding corrections and recoveries will provide a clear overview of residual error in FP6.

***Impact: Progressive reduction of error across all management modes. ■□□□□***

<sup>9</sup> Para 48 & 49 Opinion 02/2004.

<sup>10</sup> Para 40 & 49 Opinion 02/2004.

<sup>11</sup> Para 37 Opinion 02/2004.

<sup>12</sup> ECA Annual Report on the implementation of the budget concerning the financial year 2006.

<sup>13</sup> COM(2007) 86.

**Probable evolution: Increasingly improved evaluation by the Court of Auditors**

***Action 13: Analyse controls under Shared Management at regional level and the value of existing statements***

**Action completed:** the Structural Funds DGs report their assessment of Member States' control systems in their annual activity reports. This assessment will be partly based on the information provided by Member States in their annual summaries of available audits (see action 5 above).

**Impact: Improved quality of Member States control systems as evidenced by the annual activity report process and the evaluation of the ECA. ■□□□□**

**Probable evolution: Improved evaluation by the Court, but this is likely to vary between Member States**

***Action 14: Provide greater guidance for structural funds on managing the risk of error***

**Action completed:** In 2007 the Structural Funds DGs issued guidance on audit strategy and compliance assessment (documents to be submitted by the audit authorities within 12 and 9 months respectively of programme adoption), annual summaries and financial corrections for public procurement irregularities. During 2008, guidance notes on sampling, systems assessment and revisions of the notes on primary level management verifications and certification will be revised to take into account the provisions of the new regulations. A seminar for managing authorities is planned by mid-2008.

**Impact: Reduced error rates through successful implementation of guidance. □□□□□**

**Probable evolution: Significantly improved guidance issued in 2008 on all key issues.**

***Action 15: Promote 'Contracts of Confidence' for Structural Funds***

**Action will not be completed for all Member States but will be achieved through legislation for the 2007-2013 period:** contracts of confidence have been signed with six Member States: Austria, UK (Wales), Denmark, Portugal, Slovenia and Estonia. Further contracts could be signed during 2008, where the results of audit work show that the conditions are fulfilled. Although the Commission has not met the ambitious target of signing contracts with all Member States (for 2000-06), the promotion of this initiative has driven improvements in the coordination of audit work and has created a bench-marking procedure. The fundamental concepts of this initiative are incorporated in the 2007-13 Structural Funds legislation.

**Impact: Greater control consciousness in Member States ■□□□□**

**Probable evolution: As the 2007-13 programmes are implemented, improvements in Member States' control systems are expected and more will fulfil the requirements of the "contract of confidence".**

***Action 16: Establish common guidelines per policy family***

**Action to be completed:** internal guidelines have been prepared on accreditation, training and monitoring of external auditors. The research family has established an audit manual for the sixth framework programme to promote consistency in audit work. The audit manuals for the Structural Funds are being revised in line with the new legislation.

Common approaches have been developed to representative sampling in research. Progress in other areas is slower, but analysis has been carried out and a draft sampling guide prepared, inter alia for structural actions, developing the principles established in the 2007-2013 legal framework. These will be finalised and made available to services by mid-2008.

***Impact:*** *Standardisation of audit principles and methodology. For example, better information on error rates through application of common sampling guidelines* ■□□□

***Probable evolution:*** *Impact demonstrable in Research for 2008, other sectors will follow.*

### 3. CONCLUSIONS

Most of the gaps identified in the Action Plan have been filled. Those actions not yet completed will be finalised in 2008 meaning that the integrated internal control framework envisaged in 2006 will soon be in place.

To make progress on risk management and residual risk, the Commission will pursue its work on the cost-benefit-risk balance. It welcomes the interest of the Council and Parliament in pursuing the residual risk of error concept, especially as this is heavily influenced by complex rules which lead to a high risk of error. For this purpose, a Communication will be prepared for October 2008 to bring together the results of the evaluation of the costs and benefits of control and the analysis of residual risk which DGs for whose policy areas the Court of Auditors' assessment is "red" are required to include in their 2007 Annual Activity Reports.

The Commission can show that it has made concrete progress. However, it is the **impact** of the actions which will form the basis of the evaluation of the success of the action plan through decreasing error rates and improved ratings of systems by the Court. Early in 2009 the Commission will prepare a further impact assessment as at 31 December 2008.