

Council of the European Union

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COVER NOTE	
From:	Mr Klaus-Heiner LEHNE, President of the European Court of Auditors
date of receipt:	28 November 2017
То:	Mr Märt KIVINE, President of the Council of the European Union
Subject:	Report on the annual accounts of the European Institute of Innovation and Technology for the financial year 2016 together with the Institute's reply

Delegations will find attached the European Court of Auditors' report on the annual accounts of the European Institute of Innovation and Technology for the financial year 2016.

This report is accompanied by the Institute's reply and will shortly be published in the *Official Journal of the European Union*.

Encl.: Report on the annual accounts of the European Institute of Innovation and Technology for the financial year 2016 together with the Institute's reply.¹

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¹ In English only. The other languages of this report are available on the European Court of Auditors' website: http://eca.europa.eu/.



Report on the annual accounts of the European Institute of Innovation and Technology for the financial year 2016

together with the Institute's reply

INTRODUCTION

1. The European Institute of Innovation and Technology (hereinafter "the Institute", aka "EIT"), which is located in Budapest, was created by Regulation (EC) No 294/2008 of the European Parliament and of the Council¹. The Institute's objective is to contribute to sustainable European economic growth and competitiveness by reinforcing the innovation capacity of the Member States and the European Union. The Institute awards grants to an increasing number of "Knowledge and Innovation Communities" (KICs), linking the higher education, research and business sectors with one another and aiming thereby to boost innovation and entrepreneurship. KICs coordinate the activities of hundreds of partners. The grants provided by the Institute reimburse partners' costs and costs stemming from the KICs' coordination activities.

2. **Tables 1 to 3** present key figures on the evolution of budget and staff figures for the Institute².

	2015	2016
Budget (million euro) ³	232	283
Total actual staff as at 31 December ⁴	50	59
(established posts)	(62)	(63)

TABLE 1: KEY FIGURES FOR THE INSTITUTE

Source: data provided by the Institute

- ² More information on the Institute's competences and activities is available on its website: <u>www.eit.europa.eu</u>.
- ³ Budget figures are based on payment appropriations.
- ⁴ Staff includes officials, temporary and contract staff and seconded national experts.

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¹ OJ L 97, 9.4.2008, p. 1.

TABLE 2: EVOLUTION OF KEY FIGURES SINCE 2011

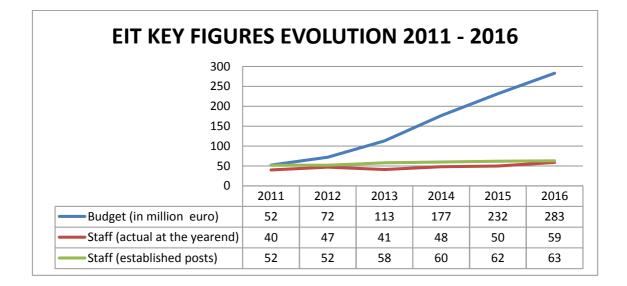
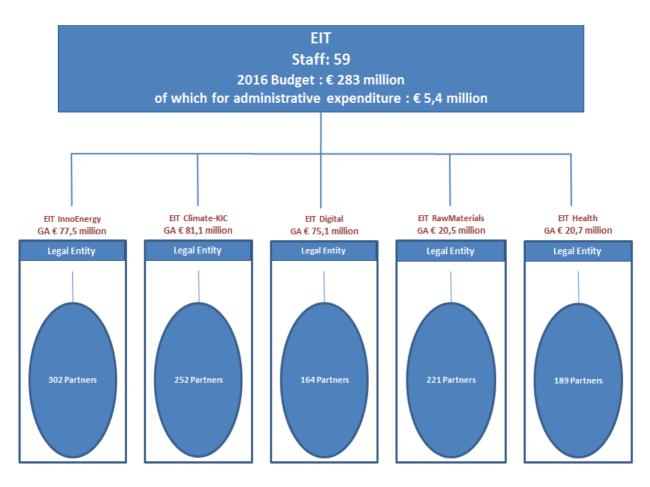


TABLE 3: 2016 KEY FIGURES FOR THE INSTITUTE BY ACTORS



Note: Appropriations amounting to 2,7million euro were budgeted for other operational activities.

INFORMATION IN SUPPORT OF THE STATEMENT OF ASSURANCE

3. The audit approach taken by the Court comprises analytical audit procedures, direct testing of transactions and an assessment of key controls of the Institute's supervisory and control systems. This is supplemented by evidence provided by the work of other auditors and an analysis of management representations.

OPINION

- 4. We have audited:
- (a) the accounts of the Institute which comprise the financial statements⁵ and the reports on the implementation of the budget⁶ for the financial year ended 31 December 2016, and
- (b) the legality and regularity of the transactions underlying those accounts,

as required by Article 287 of the Treaty on the Functioning of the European Union (TFEU).

Reliability of the accounts

Opinion on the reliability of the accounts

5. In our opinion, the accounts of the Institute for the year ended 31 December 2016 present fairly, in all material respects, the financial position of the Institute at 31 December 2016, the results of its operations, its cash flows, and the changes in net assets for the year then ended, in accordance with its Financial Regulation and with accounting rules adopted by the Commission's accounting officer. These are based on internationally accepted accounting standards for the public sector.

⁵ The financial statements comprise the balance sheet, the statement of financial performance, the cashflow statement, the statement of changes in net assets and a summary of significant accounting policies and other explanatory notes.

⁶ The reports on implementation of the budget comprise the reports which aggregate all budgetary operations and the explanatory notes.

Legality and regularity of the transactions underlying the accounts

Revenue

Opinion on the legality and regularity of revenue underlying the accounts

6. In our opinion, revenue underlying the accounts for the year ended 31 December 2016 is legal and regular in all material respects.

Payments

Opinion on the legality and regularity of the payments underlying the accounts

7. In our opinion, payments underlying the accounts for the year ended 31 December 2016 are legal and regular in all material respects.

Responsibilities of management and those charged with governance

8. In accordance with Articles 310 to 325 of the TFEU and the Institute's Financial Regulation, management is responsible for the preparation and presentation of the accounts on the basis of internationally accepted accounting standards for the public sector and for the legality and regularity of the transactions underlying them. This responsibility includes the design, implementation and maintenance of internal controls relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error. Management is also responsible for ensuring that the activities, financial transactions and information reflected in the financial statements are in compliance with the authorities which govern them. The Institute's management bears the ultimate responsibility for the legality and regularity of the transactions underlying the accounts.

9. In preparing the accounts, management is responsible for assessing the Institute's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting.

10. Those charged with governance are responsible for overseeing the entity's financial reporting process.

Auditor's responsibilities for the audit of the accounts and underlying transactions

11. Our objectives are to obtain reasonable assurance about whether the accounts of the Institute are free from material misstatement and the transactions underlying them are legal and regular and to provide, on the basis of our audit, the European Parliament and the Council or other respective discharge authorities with a statement of assurance as to the reliability of the accounts and the legality and regularity of the transactions underlying them. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit will always detect a material misstatement or non-compliance when it exists. These can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these accounts.

12. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the accounts and the legality and the regularity of the transactions underlying them. The procedures selected depend on the auditor's judgment, including an assessment of the risks of material misstatement of the accounts and of material non-compliance of the underlying transactions with the requirements of the legal framework of the European Union, whether due to fraud or error. In making those risk assessments, internal controls relevant to the preparation and fair presentation of the accounts and legality and regularity of underlying transactions, are considered in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal controls. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the management, as well as evaluating the overall presentation of the accounts.

13. For revenue, we verify the subsidy received from the Commission and assess the Institute's procedures for collecting fees and other income, if any.

14. For expenditure, we examine payment transactions when expenditure has been incurred, recorded and accepted. Advance payments are examined when the recipient of funds provides justification for their proper use and the Institute accepts the justification by clearing the advance payment, whether in the same year or later.

15. In preparing this report and Statement of Assurance, we considered the audit work of the independent external auditor performed on the Institute's accounts as stipulated in Article 208(4) of the EU Financial Regulation⁷.

Other matter

Significant shortcomings of KIC Legal Entities (KIC LEs) procurement procedures

16. The coordination and representation of the KICs is carried out by KIC LEs which are almost fully financed by the Institute. The Court in its audit gave particular attention to the procurement procedures carried out by these entities which it considers to be a high risk area.

17. Under the 2015 Grant Agreements (GA) KIC LEs and/or KIC Partners must ensure that any procurement achieves best value for money or, where appropriate, is made at the lowest possible price. For all contracts exceeding 60 000 euro, the GA stipulates that KIC LEs and/or KIC Partners have to invite at least three economic operators for tender and to document the procurement procedure demonstrating its transparency. The Court audited a sample of procurement procedures for a value of some 7 million euros carried out by KIC LEs which were fully financed by the EIT. The audit showed significant weaknesses such as direct award of contracts, absence of essential elements in tenders, significant extensions of initial contracts in time and/or volume, contracts unlimited in time and/or volume or quality/price weightings neutralising competition on price. The 2016 payments related to these irregular procurement procedures amounted to 2,2 million euro. The Institute had also identified the procurement weaknesses for one KIC LE and put in place an action plan to improve all KIC LEs' future procurement procedures.

18. There is currently legal uncertainty as to whether KIC LEs represent contracting authorities⁸. If this was the case, they would be required to apply public procurement rules as laid down in the Public Procurement Directive 2004/18⁹ (Directive) which are stricter than those required under the GA. The Institute, together with the Commission's services, is discussing the matter in order to achieve legal certainty for KIC LEs in the future.

 ⁷ Regulation (EU, Euratom) No 966/2012 of the European Parliament and of the Council (OJ L 298, 26.10.2012, p. 1).

⁸ Article 1(9) of Directive 2004/18/EC

⁹ Articles 7 and 9 of Directive 2004/18/EC amended by Commission Regulation (EU) 1336/2013

Capacity to deal with the expanded workload

19. Despite the large increase in the budget from 309 million euro (2008-2013) to 2,4 billion euro (2014-2020) and the rise of KICs from three to six at the end of 2016, the Institute's authorised number of posts did not change significantly (see Table 2). The Court in its Special Report 04/2016¹⁰ pointed to the risk that the Institute will not have sufficient capacity to deal with the expanded workload. The Institute's interim Director referred to this risk in the Institute's Annual Activity Report for the year 2015.

20. The comments which follow do not call the Court's opinion into question.

COMMENTS ON INTERNAL CONTROLS

21. The Court found weaknesses related to ex-post verifications of procurement procedures carried out by KIC LEs. At least for one KIC LE the selection of procurement procedures to be verified was not representative for the population. In addition, the Court concluded differently on the legality and regularity of two procurement procedures. In these cases the Institute accepted the direct award or excessive extension of contracts.

22. The Commission's Internal Audit Service (IAS) in its audit report "Grant Management: Transition to Horizon H2020" dated December 2016 concluded that the Institute has successfully adapted its processes to the rules of Horizon 2020, and in particular the Rules for Participation and that the Institute's controls over the start-up process have been generally effective in supporting new KICs. The IAS also concluded that urgent actions are needed to secure a robust application of the H2020 legislative framework and to further improve the start-up process of new KICs. The Institute and the IAS agreed on an action plan to take corrective actions.

COMMENTS ON BUDGETARY MANAGEMENT

23. The level of carry-overs for committed appropriations was high for Title II at 0,4 million euro, i.e. 40 % (2015: 0,4 million euro, i.e.44 %). These carry-overs mainly relate

¹⁰ Special Report 4/2016: The European Institute of Innovation and Technology must modify its delivery mechanism and elements of its design to achieve the expected impact.

to contracts for IT services going beyond year-end and for meeting costs for which invoices had not yet been received.

COMMENTS ON SOUND FINANCIAL MANAGEMENT AND ON PERFORMANCE

24. The grants for the 2015 period were awarded only in April 2015 and the GA were signed in June and July 2015. For the 2016 period, grants were awarded and GA signed in April 2016. Despite an improvement in 2016, these delays in grant award decisions and signatures create uncertainty and undermine partners' willingness to commit resources and to start activities at the beginning of the year.

25. The latest calls for new KICs, for which the thematic areas were defined in the Strategic Innovation Agenda of the EIT for the years 2014 to 2020showed a limited competition. The 2014 call for two new KICs (Health and Raw Materials) led to only seven proposals. The 2016 call for two additional KICs (Food and Added-Value Manufacturing) received three proposals, whereby the single proposal for Added-Value Manufacturing KIC was not selected for quality reasons.

OTHER COMMENTS

26. The Institute's Director changed four times between its creation in 2008 and July 2014. Since August 2014 the position of the Director, and another managerial position since February 2013, have been filled on an ad interim basis. This is not only in contradiction with the one year maximum period set for interim placements in the Staff Regulations, but also the frequent changes and long interim solutions cause uncertainty to stakeholders and strategic continuity.

27. The Institute is an important player in the Horizon 2020 program, with 2,4 billion euro of budget allocated for the period 2014 – 2020. The Commission has created a Horizon 2020 Common Support Centre in order to ensure coherence amongst bodies implementing the programme covering aspects like legal services, IT tools, grant management, dissemination and exploitation of research results, etc. However, as distinct from other bodies like Commission executive agencies and public private partnerships, the Institute has no direct

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access to the Support Centre but needs approval on a case by case basis from its Commission Parent DG. This limitation affects the efficiency of the Institutes operations.

FOLLOW-UP OF PREVIOUS YEARS' COMMENTS

28. An overview of the corrective action taken in response to the Court's comments from previous years is provided in the *Annex*.

This Report was adopted by Chamber IV, headed by Mr Baudilio TOMÉ MUGURUZA, Member of the Court of Auditors, in Luxembourg at its meeting of 19 September 2017.

For the Court of Auditors

Klaus-Heiner LEHNE President

		Status of corrective action
Year	Court's comments	(Completed / Ongoing / Outstanding / N/A)
2012	Grant agreements did not set individual thresholds for specific cost categories (i.e. staff costs, sub-contracting, legal services, etc.	Ongoing ¹²
2014	The Institute overestimated its budgetary needs for 2014 by 13,1 million euro, i.e. 5,6 % (2013: 3,4 million euro, i.e. 2,5 %) and only 220 million of the 233,1 million euro available were committed. The low implementation rate is mainly related to non-used appropriations for grants (11,4 million euro) to fund KIC activities. The KIC's business plans, on the basis of which grant agreements were signed, did not require the use of total 2014 appropriations available to the lnstitute. The appropriations not used will be re-entered in the Institute's budgets for the years 2015-2017 as stipulated in the Institute's Financial Regulation.	Ongoing ¹³

Follow-up of previous years' comments

¹² According to EIT, ceilings have been set for 2016 grant agreements.

Budgetary needs for 2016 were overestimated by 13,1 million euro, i.e. 5,0 % (2015: 25 million euro, i.e. 9,4 %) and only 249,9 million euro of the 263 million euro available were committed. The appropriations not used can be re-entered in the budgets for 2017-2019. 13

Annex

Year	Court's comments	Status of corrective action (Completed / Ongoing / Outstanding / N/A)
2014	While the KICs are to develop strategies for financial sustainability, to date, and in the fifth year of their existence, they remain fully dependent on financing by the Institute and KIC partners.	Ongoing ¹⁴
2014	Since its creation in 2009, the Institute has suffered from high staff turnover and instability at management level. Two of the three Head of Unit posts have been vacant since 2013. One is occupied ad interim since 2013 which is in contradiction with the Staff Regulations that stipulate a maximum period of one year. The other is currently occupied by the COO who also serves as the interim Director and who thus fulfils three roles at the same time.	Ongoing
2014	Although the situation has improved in comparison with 2013, 20 % of the posts in the EIT establishment plan were still vacant at the end of 2014 (compared with one third at the end of 2013).	Completed
2015	In 2015, the Institute informed the KICs that its financial contribution over the first five years (2010-2014), did not exceed the 25 % ceiling of their respective global expenditure. However the poor definition of KIC Complementary Activities ("KCA") impaired any clear assessment as to whether costs associated to KCA should be accepted or not in the maximum EIT contribution.	Completed
2015	The Court in its Special Report 4/2016 concluded that the funding condition that the EIT contribution to the KICs shall not exceed 25 % is of little or no added value, and removing it would alleviate much of the operational and financial reporting burden of the KIC partners ¹⁵ .	Ongoing

The EIT financed on average 90 % of eligible costs declared by the KIC's in the 2015 grant agreements. The amounts raised by the KICs from different sources reached 2,5 % of the EIT funding Requested. 14

- Special Report 4/2016: The European Institute of Innovation and Technology must modify its delivery mechanisms and elements of its design to achieve the expected impact. 5
- ¹⁶ EIT still interprets the EIT Regulation differently as described in its 2015 reply.
- In 2016 the Institute could not de-commit 14 million available from the 2015 GA. These appropriations could not be re-entered in the 2016-2018 budgets. 17

Year	Court's comments	Status of corrective action (Completed / Ongoing /
		Outstanding / N/A)
2015	The level of carry-overs for committed appropriations was high for Title II at 0,4 million euro, i.e. 44 % (2014: 0,5 million euro, i.e.36 %). These carry-overs mainly relate to contracts for IT services going beyond year-end and for meetings for which invoices had not yet been received.	N/A
2015	The original target set by the Commission for the Institute to obtain financial autonomy was 2010. However it obtained only partial financial autonomy in June 2011 under the condition of continued ex ante approval of grant related transactions and of procurements above 60 000 euro by its (parent) Directorate General Education and Culture.	Ongoing
2015	The 2014 grant agreements with the three KICs were signed after the start of the grant funded actions on 1 January 2014. Initially signed in February 2014, amendments involving 38 million euro of additional funds were signed only by the end of March 2014.	N/A
2015	The Institute funds the EIT Digital Master's programme in which 16 European universities participate. The model for reimbursing the universities' costs combines a lump sum maximum 8 000 euro per student (following the Erasmus Mundus programme provisions) plus actual costs including flat rate based indirect costs. On average a total of 15 000 euro per student was paid to the universities in 2015 on this basis (including the lump sum). However, the model has never been formally defined and does not allow a distinction between activities covered by the lump sum and those covered by the actual costs. The Institute should move towards a clear and formally defined model based on a single method for declaring costs such as a substantiated single lump-sum.	Ongoing ¹⁸

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On average a total of 17 000 euro per full year student was paid to the universities in 2016 on the basis of the model described which combined actual costs and lump sums .The model has been formally defined at the end of 2016 and will be applicable from 2017. 18

		Status of corrective action
Year	Court's comments	(Completed / Ongoing / Outstanding / N/A)
2015	Based on the decision of the KIC Supervisory Board one KIC legal entity paid gross bonuses of 646 000 euro to 55 of its staff (individual bonuses as much as 100 000 euro) which the Institute reimbursed at 100 %. Paying such bonuses using only public funds is an unusual practice and they should be taken into account in the ceiling for the EIT funding of individual salaries which will be applied with effect from the 2016 grant agreement.	N/A
2015	The principle of sound financial management was breached when a KIC partner procured public relations services with daily rates ranging from 800 euro to 3 250 euro per person, which were fully reimbursed by the Institute ¹⁹ .	Outstanding
2015	The Institute used a Commission framework contract ("FWC") for the organisation of innovation conferences taking place in 2015 and 2016. Under this FWC services were subcontracted for which prices were not set in the FWC. The prices agreed for these services range from 800 euro per day for a junior consultant to 2 250 euro per day for a senior consultant (almost four times the price agreed in the FWC for a senior manager). The cost of services procured at such prices amount to more than 100 000 euro per conference.	Ongoing

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In 2016 (2015 grant transactions) the EIT reimbursed an amount of 410 000 euro related to that contract. 19

THE INSTITUTE'S REPLY

17. The EIT agrees that the procurement processes of two KIC Legal Entities had weaknesses in the audited year (2015 grants). The EIT recognised this issue and carried out a pilot monitoring activity on the procurement procedures of one Legal Entity in 2016 and made targeted recommendations for improvement in this area. The Legal Entity in question implemented the recommendations in 2016, revised its procurement policies and procedures and provided training to its staff in charge of procurement, which will lead to an increased assurance starting from 2017. Similar monitoring activities have been conducted for all other KIC Legal Entities in 2017 and action plans for improvement have been put in place. The EIT considers that the payments in question were legal and regular, as KIC Legal Entities complied with their legal obligation to ensure best value for money and respected the principles of sound financial management for the expenditure in question.

18. The opinion of the EIT has been that KIC Legal Entities do not fall under the EU public procurement directives. However, the EIT has recently received contradicting legal opinions in the matter, which indeed leads to legal uncertainty. Nevertheless, it is important to note that, regardless of their status, ensuring best value for money for contracts concluded by KIC Legal Entities is a legal obligation in the EIT-KIC grant agreements that are based on the Horizon 2020 model grant agreement. In addition, the EIT, in consultation with the Commission services, will establish requirements for KIC Legal Entities ensuring compliance with the general principles of the EU public procurement directives.

19. The EIT agrees that its capacity is limited in terms of the number of posts allocated to the EIT compared to the tasks and budget entrusted to it. The EIT has already requested the European Commission to provide for more resources in the establishment plan. At the same time, the efficiency with which the EIT operates is noteworthy. As indicated in Table 3, the proportion of administrative expenditure at the EIT was only 1,9% of the total budget in 2016, which is significantly below the average of 4,6% reported for Horizon 2020 as a whole.

21. As regards the selection of procurement procedures to be verified during the ex-post audits, it is important to note that verifying a representative sub-sample is not a requirement under Horizon 2020. According to the Horizon 2020 audit programme, if a population contains more than 15 items, auditors have to select a maximum 15 items as follows: *"Select for testing all the items with a value higher or equal to 10% of the subcontracting costs declared. Add randomly selected items until 50% coverage of the subcontracting costs is achieved or the total maximum number of 15 items is reached."* As regards the two contracts in question, the EIT accepted the related expenditure based on its assessment that beneficiaries had complied with their legal obligation to ensure best value for money and compliance with the principles of sound financial management.

22. The IAS issued three recommendations as a result of their "Transition to Horizon 2020" audit with none of them being critical. In brief, the EIT was recommended 1) to develop and implement a comprehensive knowledge management system; 2) to strengthen its controls over the changes in the portfolio of KIC Partners during the start-up process; and 3) to improve the clarity of milestones to be achieved in the start-up process. None of the risks identified jeopardise the robust application of the Horizon 2020 legislative framework and the EIT has already taken actions to address the IAS recommendations.

23. The total amount reported by the Court consists of planned carry-overs that were necessary due to the nature of activities such as services going beyond year-end and meetings held in December 2016 for which invoices were only received in January 2017. These planned carry-overs do not indicate weaknesses in the budgetary management of the EIT but are a standard budget management tool.

24. The EIT accepts that Specific Grant Agreements were signed relatively late in 2015, which was caused by the ongoing negotiations with KICs on the new Framework Partnership Agreements that follow the Horizon 2020 model agreements. The negotiations between the European Commission, EIT and KICs took longer than initially anticipated due to the need to agree on specific provisions tailored to the needs of KICs. In the meantime, the EIT, addressing the recommendation of the Court's Special Report 4/2016, has revised the timeline for the preparation and assessment of KIC Business Plans to ensure timely signature of grant agreements. The revised timeline has been implemented successfully during 2016, which has led to a timely signature of Specific Grant Agreements 2017. Four Specific Grant Agreements were signed and pre-financing payments were transferred from

the EIT to KICs in February 2017. The 'time to grant' of 4-5 months is below the average for Horizon 2020 as whole.

25. It is important to note that the objective of the calls is to designate an excellent partnership and not to attract a certain number of proposals. For all KIC calls, an excellent partnership could be designated except for EIT Manufacturing. Nevertheless, even in the theme of Added-value Manufacturing, where only one proposal was received, it included declarations of interest to participate in the KIC from over 150 organisations. The EIT already carried out a thorough analysis of the outcome of the 2016 call with the help of external experts and involving its Governing Board. Following the outcomes of the analysis, the EIT has concluded on several mitigating measures, which will reduce the risk of receiving only one proposal in a theme in the future.

26. The EIT is not in a position to comment on the recruitment procedure for the EIT Director, as it is managed by the European Commission. The temporary arrangement is necessary to ensure business continuity until a Director is recruited and appointed. As regards the second managerial position in question, the EIT published a call for expression of interest with a view to establishing a reserve list for the profile of Head of Unit Policy and Communications on 2 December 2015. As a result of the selection procedure, the EIT offered the post to the first candidate on the reserve list, but the candidate declined the offer. This explains why the post remained vacant at the end of 2016. The EIT will complete the recruitment procedure of this management post in 2017, ending the temporary arrangement which became necessary in order to ensure operational continuity.

27. Indeed, the EIT is not currently participating directly and fully in the Common Support Centre for Horizon 2020. However, the EIT has appropriate access to some of the services of the Common Support Centre via its partner Directorate-General, DG Education and Culture. The EIT continues to work with the Commission to ensure EIT has the services and advice it needs from the CSC.