EUROPEAN
COURT
OF AUDITORS

Background paper

The ECA's modified approach to the Statement of Assurance audits in Cohesion

December 2017

In our 2018-2020 strategy the European Court of Auditors (ECA) decided to take a fresh look at how we audit the EU budget and to increase the added value of our Statement of Assurance (SoA). We in particular wanted to make better use of the work of other auditors and the information provided by our auditee on the legality and regularity of spending. This ECA background paper provides some information on the first pilot of such a modified approach.

For the financial year 2017, we will test the accuracy of the information provided by the European Commission on the legality and regularity of Cohesion spending. In practice, we will scrutinise the checks already carried out by the European Commission and by the audit authorities in Members States, through a review of audit files and the re-performance of audit work carried out at beneficiary level. On this basis, we expect to be able to conclude whether the information on the legality and regularity of Cohesion spending reported by the Commission, and in particular the residual total error rates of the programmes examined, is reliable or not. This work will also provide an input to our overall opinion on the legality and regularity of EU spending.

The audit work is currently ongoing and its results will be reported in our next annual report in 2018.

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OUR AUDIT OPINION ON EU FINANCES - THE STATEMENT OF ASSURANCE

What is the Statement of Assurance?

As the external auditor of the EU, we, the European Court of Auditors, provide the European Parliament and the Council with an **annual audit opinion** on the EU's finances, the so-called **statement of assurance (SoA)**. According to our mandate we have to provide opinions on the reliability of the EU's accounts and, for both revenue and expenditure, on the legality and regularity of the underlying transactions[1].

We therefore assess whether or not the implementation of the EU budget is in **compliance** with the applicable rules. In practice, we test against the rules set out in the EU financial regulation, the sectorial regulations and, where applicable, national legislation and rules. On the basis of our findings we issue a statement of assurance which can take the form of an unqualified (clean), qualified or adverse **opinion,** or a disclaimer of opinion.

In addition to the overall audit opinion, we also provide **specific assessments** on selected areas of the EU budget, including cohesion policy. These specific assessments provide more detailed information on the specific risks and findings relating to the area concerned.

In our work, we apply international audit standards[2]. Further information on the approach for our SoA audits can be found in our **Annual reports**[3] on the EU budget and in our **Financial and Compliance Audit Manual**[4].

What made us reconsider our approach?

Our SoA audit work over the past 20 years has contributed to considerable **improvements in EU financial management**. This is reflected in our 2016 Annual Report, in which, for the first time since 1994, we have given a **qualified opinion** on the legality and regularity of expenditure instead of an adverse opinion[5].

These positive developments have led us to reconsider our current SoA approach, which was designed at a time when internal controls were weak and the Commission provided only limited information on the legality and regularity of EU spending. Additionally, the European Parliament has asked us to provide more geographical and fund-specific insights into EU financial management[6].

In its **2018-2020 strategy,** we therefore decided to take a fresh look at how we audit the EU budget and how to increase the added value of our SoA[7].

PILOTING A FRESH APPROACH FOR OUR 2017 SOA COHESION AUDIT

Starting with the 2017 SoA, we have taken the initial steps to enhance our approach in the area **of economic, social and territorial cohesion**. The EU's cohesion policy aims to reduce development disparities between regions, restructure declining industrial areas and encourage cross-border, transnational and interregional cooperation. It comprises two main parts:

- **regional and urban policy**, which is mostly implemented through the European Regional Development Fund (ERDF) and the Cohesion Fund (CF); and
- **employment, social affairs and inclusion policy**, which is mainly financed by the European Social Fund (ESF).

Under the EU's 2014-2020 multiannual financial framework (MFF), **€325 billion** are allocated to cohesion policy, which is approximately **36% of the EU budget** for that period.

The Member States share responsibility for managing expenditure in this area, which involves co-financing multi-annual **operational programmes** (OPs) through which individual operations and projects are funded. For the 2014-2020 programming period there are 391 OPs under the **European Structural and Investment Funds (ESIF)**, including the ERDF, ESF and CF. These OPs cover the entire duration of the MFF. Eligibility rules for the reimbursement of costs may be national or regional, and vary from one Member State and/or programme to another.

<u>Box 1</u> contains background information on management and control systems under **cohesion policy**.

<u>Box 1</u>: Management and control systems under cohesion policy

The following **programme authorities** help to implement the OPs in the Member States:

- the **managing authorities** (and their delegated intermediate bodies) are in charge of the overall management of each OP, including selecting eligible operations and carrying out the financial control of these operations;

- the **certifying authorities** are responsible for preparing the annual accounts and certifying their completeness and accuracy (including the financial corrections recorded). They are also responsible for submitting payment applications to the Commission;

- the **audit authorities** are the independent national or regional bodies responsible for establishing whether or not the annual accounts submitted by the certifying authorities paint a fair and accurate picture, the expenditure declared to the Commission is legal and regular, and the OP control systems function properly[8].

Altogether, there are more than 100 audit authorities in the 28 EU Member States. These authorities carry out hundreds of audits on the functioning of internal controls and thousands of audits of sampled operations at beneficiary level. In 2015, they examined nearly 12300 operations, covering around 29% (ERDF/CF) and 15% (ESF) of the certified 2014 expenditure[9]. Based on their work, audit authorities prepare an **annual control report** (including an audit opinion) covering their three areas of responsibility (see above) and calculating the residual amount at risk.

The European **Commission** bears the ultimate responsibility for implementing the EU budget and therefore is also responsible for supervising the functioning of these programme authorities. In particular, it is responsible for reviewing, validating and consolidating the information provided by the audit authorities. On the basis of this information, the Commission **accepts or rejects the annual accounts** and settles outstanding EU contributions, resulting in a payment from the EU budget. If any serious weaknesses in the management and control systems have gone undetected, uncorrected or unreported by the programme authorities, the Commission may impose additional net corrections.

The following sections provide more information on how our approach will change, why we selected cohesion policy for this pilot approach and why starting in 2017, how we will assess the internal control systems in this area and how we will select our sample and carry out the testing. Finally, we summarise some of the expected advantages of this modified approach in gathering the necessary audit evidence for our audit opinion.

How has our approach been modified?

Up to and including the 2016 SoA, our assessment of the legality and regularity of cohesion spending was organised as a '**direct reporting engagement'**[10]. We assessed compliance for a random, statistically-representative sample of operations. We selected this sample from all interim and final payments made from the EU budget to operational programmes (OPs) during the year.

During the pilot, we will focus on testing the **information provided by the Commission** on the legality and regularity of EU spending, making better use of the work of audit authorities. In practice, this means that we will focus on assessing and testing key elements of the **internal control systems** in place, both at Commission and Member State level. This will form our basis to reach a conclusion on the estimated levels of the residual error that are subsequently published by the Directorates-General for Regional and Urban policy and for Employment, Social affairs and Inclusion in their **Annual Activity Reports**.

This modified approach is a first step towards what is referred to as **'attestation engagement'**[11] in audit terminology. In such audit engagements, as compared to 'direct reporting engagements', it is the auditee that measures compliance against established criteria and presents a relevant indicator for that purpose. The auditor then gathers sufficient appropriate audit evidence to reach a conclusion on the reliability of the information presented by the auditee.

This **pilot exercise** is currently ongoing and its audit results will be reported in our next annual report in 2018.

Box 2: 2014-2020 programming period - new key elements of internal control in Cohesion policy

There are a number of new regulatory provisions in the **Common Provision Regulation**[12], the e legal framework for the 2014-2020 period in Cohesion designed to strengthen the internal controls.

First, an **acceptance of accounts** procedure has been introduced by which the Commission accepts (or rejects) the accounts of each OP (or group of OPs) on a yearly basis. This previously did not take place until closure.

Second, the Commission's assessment of the annual OP accounts is based on a comprehensive '**assurance package**' comprising:

a) the certified accounts prepared by the certifying authorities in the Member States for the accounting year (July to June);

b) the managing authority's management declaration and annual summary of controls and verifications; and

c) the audit authority's annual control report and audit opinion, including the financial corrections implemented at national level.

Third, **10 %** of the amounts certified is systematically retained from every interim payment paid to the Member States. This retention mitigates to some extent the inherent risk that expenditure declared by Member States contains errors. If the Commission accepts the accounts, the sum retained can be released.

Fourth, a **net financial correction** (cancellation of all or part of the EU contribution) is applied where either the Commission (through its own checks) or the ECA detects serious irregularities undetected, unreported or uncorrected by the programme authorities. The irregularities identified must however demonstrate serious deficiencies in the effective operation of the OP management and control systems.

Why start with Cohesion?

A key factor enabling us to pilot a different approach in the area of Cohesion is that the European Parliament and the Council have introduced several new elements in the **legal framework for the 2014-2020 period** (see ***Box 2***).

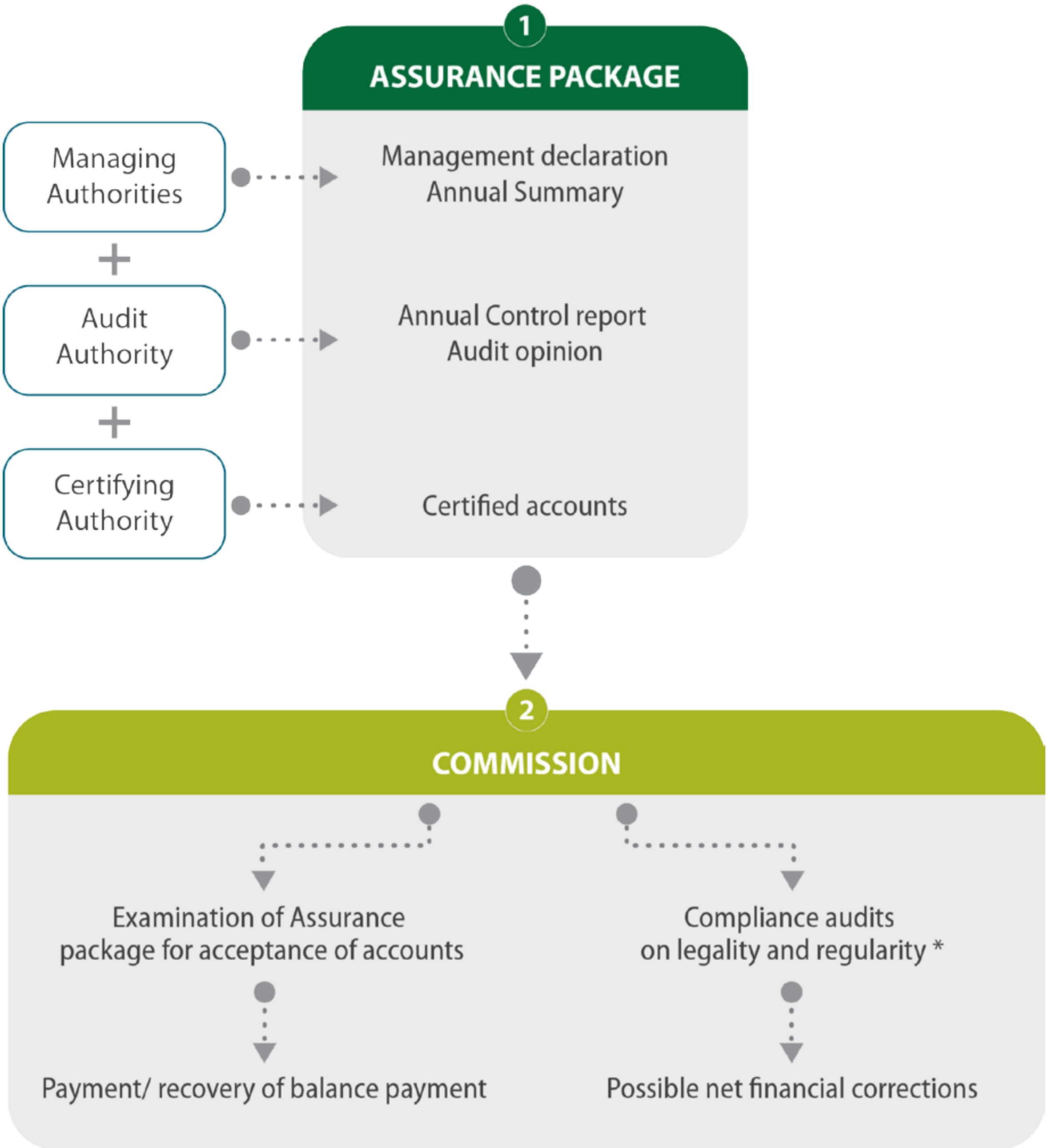
The aim of these newly-designed **control systems** for the 2014-2020 period OPs is to ensure that the **residual error rate (i.e. after corrections) is below the 2 % materiality threshold** on an annual basis. These changes are in accordance with our recommendation that the Commission put in place an **integrated control framework** for the EU budget where each control level builds on the preceding one[13].

Our work in the context of the SoA in recent years also shows that the **reliability of the information on legality and regularity** provided by the audit authorities in the Member States and validated by the Commission has continuously improved. Moreover, the necessary **conditions for using the work of audit authorities** (i.e. their independence, professional competence, scope of the work, cost-effectiveness, audit conclusion based on sufficient evidence) are set out in the legislation for the 2014-2020 period. We will now need to ascertain whether or not these conditions are met in practice.

Finally, our recent audit work on the preparation of the **closure of the 2007-2013 programming period**[14] and on the implementation of **financial corrections**[15] found that the Commission had made adequate arrangements for Member States to close their 2007-2013 OPs and that the Commission had made effective use of measures at its disposal to protect the EU budget from irregular expenditure during the period.

Figure 1 provides an overview of the Commission's validation of the work of audit authorities and certifying authorities during the 2014-2020 period.

Figure 1



* In cases in which a specific risk of irregularity or fraud or evidence of serious deficiencies in the effective functioning of the management and control systems has been established by the Commission through its own checks or by the ECA, the Commission may carry out 'Compliance audits' of operations up to three years after the acceptance of the 'assurance package'.

Source: European Commission

Why as of 2017?

We had three reasons for choosing 2017 as the year in which to pilot our modified audit approach for Cohesion spending:

- 2017 is the **first year with cleared expenditure of the 2014-2020 period**, which has been subject to the reinforced internal control provisions (see ***Box 2***);

- the closure of the **2007-2013 programming period** will start in 2017 and consequently our sample of payments for this period in 2017 will consist solely of final balance settlements. Since the process for 2007-2013 closure payments is very similar to the 2014-2020 payments, including the audit of financial corrections by the audit authorities as well as the Commission, we can apply the same audit approach as for the 2014-2020 expenditure; and

- carrying out a piloting exercise during 2017 will help us to assess how effective the 2014-2020 systems function in their first year of operation, and make **recommendations for improvement** and, if necessary, **adjustments to our approach for the following years** when higher amounts of Cohesion spending are expected to be cleared.

How do we assess the internal control systems?

The starting point of the audit is an assessment of key elements of the internal control systems, which provide information on the legality and regularity of Cohesion spending:

- at **Commission** level, we focus on the work carried out to prepare the **Annual Activity Reports** of the **Directorates-General** for **Regional and Urban policy** and for **Employment, Social Affairs and Inclusion**, which together provide information on the legality and regularity of Cohesion spending. These reports are presented each year to the European Parliament and Council. For the 2017 Annual Activity Reports, we examine the review and validation of the annual accounts and closure decisions, including the review by the Commission of the residual error rates for OPs.

- at **Member State** level, we review the work of the **audit authorities**. This work is the main source for the Commission's reporting on the legality and regularity of Cohesion spending. We examine whether the Commission's decisions on partial annual closures for OPs (or group of OPs), which are mainly based on the opinion and findings reported by the audit authorities, are justified. Hence we examine for each OP sampled the audit authorities' audit strategy, their sampling approach, the identification, quantification and extrapolation of errors and their work on the accuracy and reliability of the financial corrections implemented at national level, amongst other aspects.

How do we select our sample and carry out testing?

The aim of our testing is to assess whether or not the **Commission**:

- presents **reliable estimates of the residual error rate** in its Annual Activity Report; and

- is effective in detecting and correcting shortcomings in the work of the audit authorities when **validating and consolidating the residual error rates** reported by them.

The samples are selected so that we can ascertain whether or not the **expenditure has undergone all internal controls** once it has been validated by the Commission:

- for the 2014-2020 programming period, we sample from the expenditure of the accounts accepted by the Commission by 31 May 2017; and

- for the 2007-2013 programming period, we sample from the expenditure covered by the closure decision and settled in 2017.

The individual transactions to be tested are selected in **three stages**:

- first, we identify the **OPs/assurance packages (2014-2020)** and **closure decisions (2007-2013)** to be examined;

- second, we identify the **operations** within the OP/assurance package or closure decision to be examined. All these operations have already been audited by the audit authority when preparing its audit opinion for the OP and the audit authorities' work has been validated by the Commission. We test a representative, randomly-selected sample of operations through a **review** (i.e. a desk-based examination of supporting documentation relating to the checks carried out by the audit authority). This sample may be enlarged if significant shortcomings are identified in the work of the audit authority; and

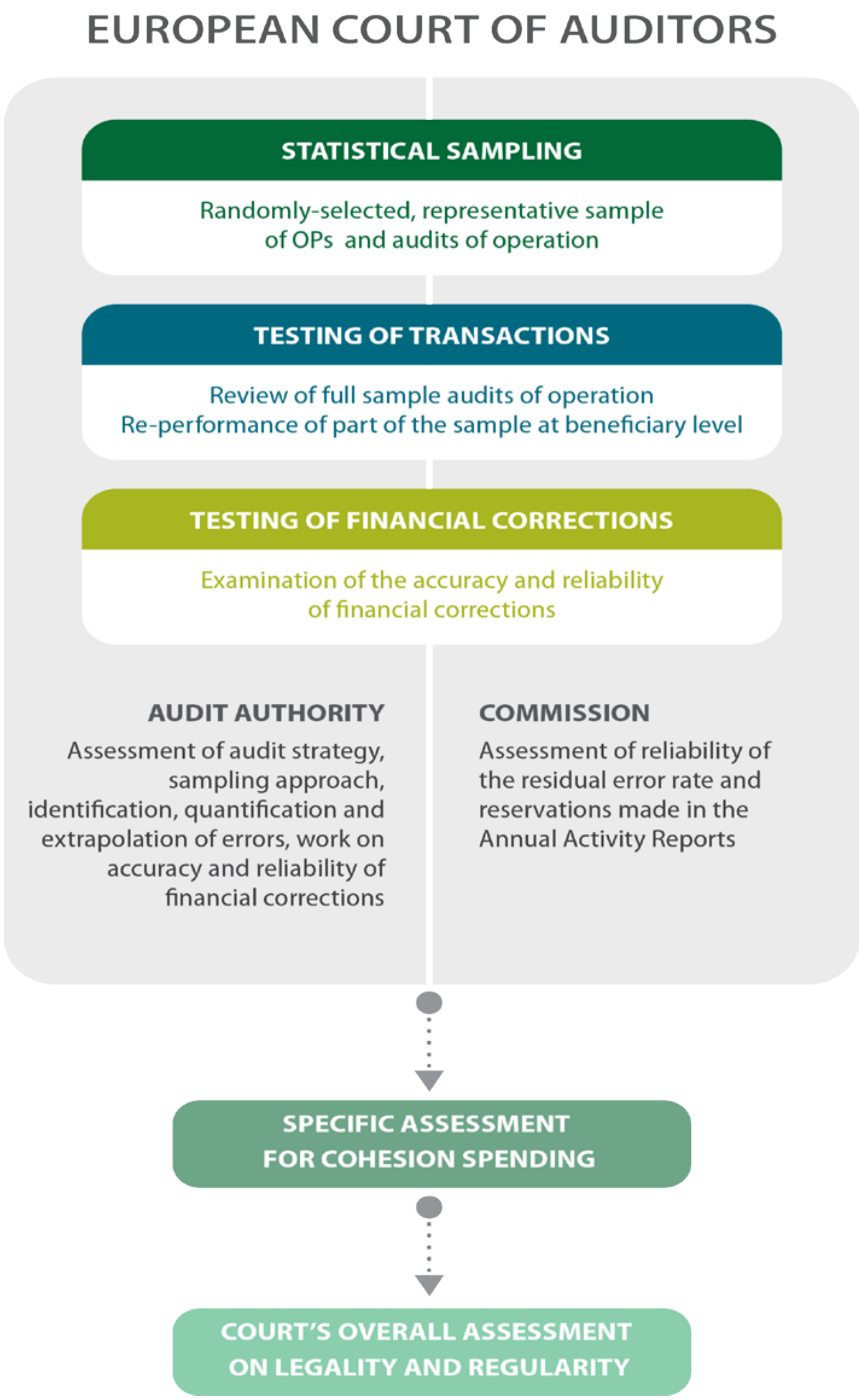
- third, our own auditors **re-perform** a sub-sample of these audits of operation at beneficiary level.

For the review and re-performance of audits of operations at beneficiary level, we continue to apply the **same level of scrutiny** as in previous years.

At the same time, the overall scope of our testing has been extended in comparison with previous years. In the case of **financial corrections** recorded in the accounts, we now also test, for each OP sampled, how the audit authority has checked the **accuracy of the calculations** made by the **certifying authorities** and their implementation. This additional step is necessary in order to assess whether or not the **residual error rates** reported by the Commission in its **Annual Activity Reports** for the OP are reliable.

The bulk of the audit field work will be carried out between June 2017 and May 2018, following the acceptance of the 'assurance packages' and the resulting payment from the EU budget in early 2017. ***Figure 2*** provides an overview of the main stages of our audit approach.

Figure 2



Source: ECA.

EXPECTED ADVANTAGES

This modified approach to gathering the necessary evidence in the area of Cohesion to produce an audit opinion also aims at providing more informative results for our stakeholders in a cost-effective manner:

- **Assessing the reliability of the Commission's information on the legality and regularity of Cohesion spending:** our audit work will provide an independent external assessment of the Commission's information on the legality and regularity of EU spending in Cohesion. The evidence underpinning error rate calculations by the Commission and the ECA will be the same. The reasons for any differences between the two rates will therefore be more apparent. This should provide a more robust and transparent basis for the European Parliament's and the Council's discharge procedure.
- **Audit results which better take the functioning of internal controls into account:** since sampling is based on payments that have undergone Commission clearance and are linked to the accepted accounts rather than a mixture of interim and final payments, our audit results will be more informative. All corrective measures taken by the Member State before certifying expenditure to the Commission, and/or instigated by the Commission when validating the reported error rates, will be taken into account. Finally, our audits will take better account of the corrective capacity of the system on an annual basis (rather than only on closure of a programming period).
- **Better geographical and fund-specific insight across the EU:** audit findings could be grouped by country, by region, by programme type or by fund, based on the information reported by the Commission and examined by us. This would give a better insight into the functioning of the control systems, the remaining shortcomings and the main sources of error, allowing us to make more targeted recommendations.
- **Additional corrective action:** our audit work should allow the Commission to make additional adjustments based on our audits before submitting its Annual

Activity Reports to the European Parliament and the Council. This reflects standard audit practice. Moreover, if our audits detect irregularities after submission of the 'assurance package' that have not previously been detected and reported by the audit authority, and these irregularities demonstrate serious deficiencies in the effective operation of the management and control systems, this may result in net financial corrections. This is only possible under the new regulatory arrangements for the 2014-2020 programming period.

- **Reduced administrative burden for beneficiaries:** our modified approach is based on existing legal provisions and the work already carried out by the audit authorities in the Member States. We can therefore reduce the number of on-the-spot audit visits we make to beneficiaries, as we only repeat audit work at beneficiary level for part of the overall sample. This should make the approach more cost-effective for us, and also reduce the administrative burden for beneficiaries overall.

ABOUT ECA AUDIT REPORTS AND BACKGROUND PAPERS

In our annual reports we provide an overview of EU financial management during the year and make suggestions on how it could be improved. In so doing, we assist the European Parliament and the Council in their scrutiny of the way in which EU funds are used.

Background papers provide information based on preparatory work undertaken before the start of an ongoing audit task. They are intended as a source of information for those interested in the policy and/or programme examined by us.

Please do not hesitate to contact the audit team at:
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[1] Article 287 of the Treaty on the Functioning of the European Union.

[2] ISSAI 100 - Fundamental Principles of Public-Sector Auditing, ISSAI 400 - Fundamental Principles of Compliance Auditing and ISSAI 4000 - Compliance Audit Standard.

[3] European Court of Auditors, Annual Report concerning the financial year 2016, Annex 1.1.

[4] European Court of Auditors, Financial and Compliance Audit Manual.

[5] European Court of Auditors, Annual Report concerning the financial year 2016 and European Court of Auditors, 2016 EU audit in brief.

[6] European Parliament resolution of 29 April 2015 for the financial year 2013, paragraph 54: "*Asks the Court of Auditors to develop its own country-specific reporting method, bearing in mind not only the amounts at risk but also the Member States' management and control systems, together with the corrective mechanisms applied by the Commission and the Member States in order to adequately assess the evolution of the management in the worst performing Member States and recommend the best possible solutions.*"

[7] European Court of Auditors' strategy for 2018-2020: Fostering trust through independent audit, June 2017.

[8] European Court of Auditors, Special Report No 16/2013: Taking stock of 'single audit' and the Commission's reliance on the work of national audit authorities in Cohesion.

[9] European Parliament, Study for the CONT committee "Proceedings of the Workshop on Post-2020 Audit Reform: Mission Possible", Directorate General for Internal Policies of the Union, PE 603.805, October 2017.

[10] ISSAI 4000, paragraph 37, as endorsed by the International Organisation of Supreme Audit Institutions (INTOSAI): "*In a direct reporting engagement, it is the auditor who measures or evaluates the subject matter evidence against the criteria. The auditor is responsible for producing the subject matter information. The auditor selects the subject matter and criteria, taking into consideration risk and materiality. By measuring the subject matter evidence against the criteria, the auditor is able to form a conclusion. The conclusion is expressed in the form of findings, answers to specific audit questions, recommendations or an opinion.*"

[11] ISSAI 4000, paragraphs 40 and 41, as endorsed by the International Organisation of Supreme Audit Institutions (INTOSAI): "*In an attestation engagement the responsible party measures the subject matter against the criteria and presents the subject matter information, on which the auditor gathers sufficient and appropriate audit evidence to provide a reasonable basis for forming a conclusion. The conclusion is expressed in the form of findings, conclusions, recommendations or an opinion. In an attestation engagement with reasonable assurance the auditor's conclusion expresses the auditor's view that the subject matter information is/is not in accordance with the applicable criteria.*"

[12] Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund.

[13] European Court of Auditors, Opinion No 2/2004 on the 'single audit' model.

[14] European Court of Auditors, Special Report 36/2016: An assessment of the arrangements for closure of the 2007-2013 cohesion and rural development programmes.

[15] European Court of Auditors, Special Report No 4/2017 on financial corrections implemented by the Commission in Cohesion during the 2007-2013 programming period.