A CO-ORDINATED MODEL OF AUDITING EU FUNDS UNDER SHARED MANAGEMENT

A thesis submitted for the degree of Doctor of Philosophy at Budapest University of Technology and Economics

by

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Attestation

I understand the nature of plagiarism, and I am aware of the University’s policy on this.

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person, except where due acknowledgement has been made in the text.

Signature       Date
Acknowledgements

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### Abbreviations

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<tbody>
<tr>
<td>ADAR</td>
<td>Audit Development and Reports</td>
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<td>APM</td>
<td>Audit Planning Memorandum</td>
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<td>CAPS</td>
<td>Court Audit Policy and Standards</td>
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<td>CEAD</td>
<td>Coordination, Evaluation, Assurance and Development</td>
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<td>CF</td>
<td>Cohesion Fund</td>
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<td>DAS</td>
<td>Declaration d’Assurance</td>
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<td>DG</td>
<td>Directorate General of the European Commission</td>
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<td>EAG</td>
<td>European Auditing Guidelines</td>
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<td>ECA</td>
<td>European Court of Auditors</td>
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<td>ERDF</td>
<td>European Regional Development Fund</td>
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<td>ESF</td>
<td>European Social Fund</td>
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<td>EUROSAI</td>
<td>European Organisation of Supreme Audit Institutions</td>
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<td>FCAM</td>
<td>Financial and Compliance Audit Manual</td>
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<td>FR</td>
<td>Financial Regulation</td>
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<td>IFAC</td>
<td>International Federation of Accountants</td>
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<td>INTOSAI</td>
<td>International Organisation of Supreme Audit Institutions</td>
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<td>ISA</td>
<td>International Standard on Auditing</td>
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<td>MUS</td>
<td>Monetary Unit Sampling</td>
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<td>FR</td>
<td>Financial Regulation</td>
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<td>SAI</td>
<td>Supreme Audit Institution</td>
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<td>SFM</td>
<td>Sound Financial Management</td>
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<td>SPF</td>
<td>Statements of Preliminary Findings</td>
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<td>TFEU</td>
<td>Treaty on the Functioning of the European Union</td>
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<td>VFM</td>
<td>Value for Money</td>
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<td>VGAP</td>
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1 Introduction

1.1 Background and Context

Besides sustainable and balanced development, the European Union’s Cohesion policy, as the ‘invisible hand’ of the market, promotes economic integration in the whole EU (European Commission, 2008). The EU assigned various financial funds in the interest of successfully accomplishing these objectives: the European Regional Development Fund (ERDF), the European Social Fund (ESF) and the Cohesion Fund (CF). The significance of Cohesion policy is well demonstrated by the fact that for the 2007–2013 programming period it represents about one third of the total EU budget.

![Bar chart showing EU budget allocations](source: www.ec.europa.eu)

Figure 1. The EU budget 2012, assigned to the main policy areas

source: www.ec.europa.eu

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1 See Appendix 1.
A common feature of the aforementioned funds is that the execution of the budget is implemented through *shared management*. In such a management model, the utilisation of funds, and the corresponding audit and control activities are implemented jointly, through the cooperation of Member States and the European Commission. In order to achieve a successful implementation, an appropriate management and multi-level control system was established in each Member State that aims to ensure the sound financial management, moreover, regularity and legality of the use of those funds.

In its annual report for the financial year of 2010, for the policy group of *Cohesion, energy and transport*, the European Court of Auditors (ECA) estimated a 7.7% error rate, exceeding that of the preceding year, which was higher than the error rate assessed for the entire EU budget (3.7%). The majority of errors were due to breaking the public procurement rules and the reimbursement of ineligible expenditures. Furthermore, the audit authority was evaluated by the European Court of Auditors as partially effective ensuring the regularity of underlying transactions. As a consequence of the high estimated error rate and the deficiencies identified in the control system, Member States still have several issues to resolve in the field of the utilisation and auditing of EU funds assigned to Cohesion policy.

In recent years, the amounts spent on auditing increased (Annual activity reports of the Directorates-General of the European Commission, European Parliament, 2011). Mendez and Batchler (2011) are of the opinion that the administrative reform of the European Commission actually led to an audit explosion.

Based on the above, the following questions arise: how could audit efficiency be increased within the current institutional framework? How could coordination be better implemented within the current frameworks of the internal control and external audit systems?
1.2 Scope and Objectives

The research focuses on examining how a greater level of efficiency could be achieved by having the various players rely on the audit results produced by others. The issue of the need for an enhanced coordination of audits has been raised by many scholars.

Within the context of the present thesis, I am interpreting coordination as a sort of methodological convergence, the aim of which is to decrease the differences between the methodologies applied and their harmonisation with respect to one another. The professional justification for this is that from the aspect of auditing, coordination in itself cannot improve efficiency. This positive effect can only be observed if professional framework allows those performing the audits to rely on one another’s work. In this respect, the basis to be applied is mainly made up of the International Standards on Auditing (ISAs). Within these, the standards dealing with the exploitation of the work of internal auditors (ISA 610 - Using the Work of Internal Auditors) and representations made by the management (ISA 580 - Written Representations) are of particular significance.

Consequently, I am examining the actors of the internal control and external audit systems from the aspect of whether they apply the International Standards on Auditing. From an auditor’s point of view, the reliance on each other’s work cannot be realised in the case of actors who do not perform their audit activities according to these standards. On the basis of the above, the research explores three directions.

Firstly, I examine how a higher rate of methodological convergence could be achieved among players who perform their activities according to relevant standards, and how, as a positive effect, the possibility of relying on the work of auditors could be increased, resulting in an increase of efficiency.

Secondly, I investigate how efficiency could be accomplished in that part of the audit chain which does not perform its activities according to the ISA-based audit methodology.

Finally, I review the whole system to see whether there are still reserves within that could improve system operation quality without a significant increase in costs.

The diagram below illustrates the area of research and its main correlations:
The thorough examination of the audit methodology served as a solid basis for the research, which was realised through qualitative procedures. Besides critical evaluation of relevant literature, the research results are based on empirical investigations.

**Reviewing of relevant literature**, I collected the related international and Hungarian literature related to the research topic. As part of this work, I went through:
the relevant EU-level legislative environment, which includes the provisions with regards to the institutional system to be found at the national level,

- the system of institutions introduced in the Hungarian environment as well as its legal background,

- the tasks, audit practices and inter-relationships of EU and national-level players,

- the methodology applied by auditors and controllers, and the relationship of these methodologies to international standards (IFAC and INTOSAI standards),

- earlier efforts made to improve the internal controls system and its implications (Caldeira, 2005, 2008; European Commission, 2011; European Court of Auditors, 2004; European Parliament, 2009, 2011)

- the legislative background between the European Court of Auditors and the supreme audit institutions of Member States, as well as the practical realisation and results of cooperation, (European Court of Auditors, 2007; the activity of the Contact Committee of the Supreme Audit Institutions of the European Union), and

- the international and the national requirements regarding the IT system.

During the research, it was of crucial importance that due to the Postgraduate Research Grant Programme of the European Court of Auditors and the Historical Archives of the European Union, I had a unique opportunity to consult the documents of the European Court of Auditors between 1977 and 2012. Consequently, I had the chance to research and systematise the development of the ECA’s audit methodology, which served as a starting point to support the thesis statements formulated during my research.

At the focus of empirical methods there were in-depth interviews (Appendix 2) with professionals of the EU and the Hungarian audit and control systems. In Hungary, I contacted:

1. the State Audit Office of Hungary, as the external independent auditor of the budget,
2. the National Development Agency, as the managing authority,

3. the Directorate General for Audit of European Funds, as the audit authority,

4. WELT 2000 Ltd., as the developer of the background IT system.

I also had the opportunity to interview experts at the European Court of Auditors in Luxembourg who have been participating in methodological developments for longer periods and who have conducted actual audit activities in certain Member States. Furthermore, during my work I also built on valuable remarks made by auditors of the European Court of Auditors in relation to my presentation in Luxembourg on the research topic.

Besides the above, the methodological seminar organised by the State Audit Office of Hungary and held in November 2010 by auditors of the European Court of Auditors, and the workshop aimed at explaining the new Financial and Compliance Audit Manual held in October 2011 in Luxembourg also served with useful lessons with regard to the research direction.

1.4 Achievements

The framework of the cooperation between the European Court of Auditors and the audit institutions of Member States is defined by the Treaty on the Functioning of the European Union, according to which these audit institutions ‘shall cooperate in a spirit of trust while maintaining their independence’ (Article 287).

The obligation of cooperation, however, does not necessarily mean an increase in efficiency is embedded. From a professional point of view, the international standards determine the prerequisites along which auditors can rely on each other’s audit results, thereby decreasing the extent of audits to be carried out. In this sense, an improvement in efficiency can only be accomplished if the auditors, beyond meeting other criteria, perform their activities based on commonly accepted professional standards and methodologies. Coordination is, therefore, a necessary but not sufficient condition of improving efficiency.
There are significant discrepancies between the audit practices applied by the national audit bodies of the Member States, a fact also supported by the experiences gained from interviews conducted at the State Audit Office of Hungary. The pilot project realised with the participation of the European Court of Auditors as well as the Danish and Czech supreme audit institutions examined the possibility of coordinated audits. It was revealed that the methods applied vary vastly from Member State to Member State.

Attempts have already been made for years to strengthen the convergence of the methodology applied by auditors. In 2006, the Contact Committee of the Supreme Audit Institutions of the European Union set up a working group in order to ‘to draw up common audit standards and comparative audit criteria, based on national audit standards and applicable in the EU environment’. As part of this project, the practices of Member States were mapped and the cooperation between institutions was reinforced. However, the purpose of setting common standards was not realised.

Given the above, it is unlikely that the need for convergence will be manifested uniformly and occur voluntarily within the entire EU. The experience gained from the interviews, namely that the supreme audit institutions, due to misinterpretation of what the international auditing standards include for the purpose of taking each other’s work into account, feel a threat to independence, decreases the chances of voluntary convergence even further.

This is the reason why a generally accepted methodology is required, one that would serve and should be applied as a sort of standard. I have reviewed the development of the ECA’s audit methodology from 1977 to nowadays, as I was looking for an element within the audit system that could be considered stable, and which furthermore could be dynamically adapted to the changes of the external environment.

In summary, the demand for voluntary convergence formulated at the national level is unlikely to occur uniformly. In order to achieve methodological convergence, and thus improve efficiency, a point of reference is necessary to be determined, and the methodology of the European Court of Auditors fits this role.
Thesis statement 1:

In the field of auditing funds assigned to Cohesion policy, the prerequisite of convergence is the determination of a point of reference, and the audit methodology of the European Court of Auditors is appropriate for this purpose.

According to the European Union’s Financial Regulation (Council Regulation (EC, Euratom) 1065/2002), the Member States prepare the annual summary of available audits and declarations. This document first had to be submitted in 2008 for the 2007 financial year. Furthermore, certain Member States have issued the so-called national declarations on a voluntary basis, which are audited by the supreme audit institutions. In the Netherlands for instance, the Minister of Finance signs the national declaration, while in Sweden, the Prime Minister and the Minister of Finance certify the document, which is audited by the national audit office. In general, with respect to the EU environment, the issuer of this document is a member of the government of the Member State, while the declaration is audited by an external independent auditor who cannot be linked to the declaration itself.

From an auditor’s aspect, the annual summary is a non-audited document which cannot be considered decisive audit evidence. At the same time, the national declaration can be interpreted as a management representation to which ISA 580 refers. This in itself does not constitute sufficient and appropriate audit evidence, but it does carry important content: in this, the management acknowledges its responsibility in relation to preparing financial statements and the completeness of information provided to the auditor.

The impact of the annual summary and national declarations on financial management and the extent of the audit activity have been examined by many authors.

In 2007, the European Court of Auditors published its ‘opinion on the annual summaries and national declarations of Member States, and the audit work on EU funds of national audit bodies’. This document examines three closely linked topics. Firstly, the European Court of Auditors recommended for the European Commission to create added value to the annual summaries in order for these to be more than just
sector-specific summaries, thereby allowing for them to become actual supplementary elements of internal control systems. Secondly, in the opinion of the European Court of Auditors, the national declaration, as the new element of accountability, is a voluntary initiative the applicability of which depends on the scope and quality of the audit that serves as its basis. Finally, the European Court of Auditors’ s opinion contains the possibility of relying on the work of supreme audit institutions, thus the national declaration audited by them, should those have been prepared in line with international auditing standards, with appropriate audit scope, approach, timing and quality.

In light of the first experiences, the Directorate-General for Internal Policies of the European Parliament assessed the annual summaries as well as their impact on the work of the European Court of Auditors in a study (2009). The authors emphasise that there is an accountability gap between the national and the EU levels, as the acknowledgement of responsibility of Member States is missing from the system. In the meantime, the declarations made at the level of the European Commission by the Directorates General in the subject are mandatory requirements. Furthermore, the study also proposes that the national-level declaration should be audited by the Member State supreme audit institution or an independent audit firm.

From a professional aspect, the introduction of the national declaration is justified as it closes up the accountability gap between the EU and national levels. From an auditing aspect, the audited national declaration allows the possibility of the European Court of Auditors to rely on the work of Member States’ supreme audit institutions, which in turn results in the improvement of audit efficiency. It must, however, be emphasised that the fact of auditing in itself is insufficient for an auditor to interpret a written representation as evidence. It is a necessary prerequisite that the applied approach and methodology be identical, and that the period covered by the declaration be appropriate for the auditor.

The Directorate-General for Internal Policies of the European Parliament argues that Member States’ audit institutions or private companies could be auditors of the national declarations. Over the course of my research, I examined and assessed the theoretical possibility of the European Court of Auditors auditing these declarations; what benefits and disadvantages would there be. In the end, I came to the conclusion that in an ideal model the European Court of Auditors has a dominant role, where, as a
sort of knowledge center, it lays down a uniform framework for auditing national declarations and does not distract this audit task from supreme audit institutions. Member States’ accountability increases with the introduction of national declarations and their subsequent compulsory auditing, while due to methodological convergence, audit efficiency improves by taking the work of other auditors into account.

**Thesis statement 2:**

A uniform methodology, developed by the European Court of Auditors for the purpose of auditing ‘national declarations’ the compulsory adaptation of which is explicitly included in the legal environment, supports the convergence process.

The internal control system put in place at national level is highly complex. The certifying authority, the managing authority and the audit authority (in Hungary these are typically the Hungarian State Treasury, the National Development Agency and the Directorate General for Audit of European Funds) have different audit mandates, and all base their activities on different audit methodologies. Besides the above organisations, there are several intermediate bodies in Hungary supporting the implementation tasks of the managing authority.

With the exception of the audit authority, the methodologies of the elements of the internal control chain are not of an ‘audit nature’ and the International Standards on Auditing are not applied. The method of sampling is also fundamentally different as the latter use risk-based sampling, while the audit authority applies statistical sampling and conforms to international standards during its activity.

Consequently, to improve efficiency, audit levels based on a more unified methodology could and should be rationalised. Since the managing authority is the central element of the system and has significant auditing capacity, it would make sense to integrate the audit tasks of the certifying authority among the tasks of the former. This would eliminate the efficiency-deficit arising of uncoordinated audits, while not resulting in a change in quality as these authorities perform similar types of
audits. With such a change in the system, communication and coordination improve within the auditing process and the possibility of audit overlaps also narrows.

The shortening of the audit chain does not have an impact on the activities of the audit authority. As this is the first among audit levels which performs audits based on internationally accepted standards, from a professional aspect it cannot rely on the audit results of the aforementioned authorities.

**Thesis statement 3:**

**If the audit assignments of the certifying authority were to be performed by the managing authority, audit efficiency would improve considerably.**

One of the basic criteria for management and control systems is that Member States are obliged to have reliable accounting, monitoring and financial reporting systems in computerised form (Council Regulation (EC) 1083/2006). Ensuring this computerised system is the responsibility of the managing authority. This system is capable of providing data on fund utilisation for purposes of financial administration, monitoring and ex-post audits. The current European Union legal environment, therefore, only stipulates general requirements for this electronic background, and does not provide detailed regulations with regard to such IT structures: it approaches this field from a direction that focuses on what basic support tasks this IT background should perform (e.g. recording and reporting financial transactions, irregularities, and financial corrections imposed by Member States).

In Hungary, the Unified Monitoring Information System (UMIS) was introduced as the IT background for the ERDF, ESF and the CF. The system, besides being a data bank containing all basic data related to grants, can also be used for supporting monitoring and ex-post audits. The implementing authorities, the beneficiaries and at a national level, external and internal auditors have access rights to the system.

For EU auditors, the provision of information regarding basic data is often quite complicated and this impacts the efficiency of their activities. The direct access to them is, however, more than simple time-saving. From an auditing aspect, this allows...
for them to draw conclusions through the direct analysis of basic data regarding the operation of the control system. Why is this particularly important? According to the system-based approach applied by the European Court of Auditors, the audit begins with the examination of the internal control system of the audited entity in the interest of allowing the auditor to collect evidence of its efficient operation. In such cases, there is less need to directly test grants and this allows for time savings.

There exist various degrees of integration concerning access to core data. The setting up of a common integrated database for the whole of the EU would represent a higher level of integration than the simple access to core data.

**Thesis statement 4:**

The audit efficiency would improve to a certain extent if EU (the European Court of Auditors, the European Commission) auditors were to have direct access to the core database.

### 1.5 Overview of Dissertation

After the first *Introduction* chapter, the doctoral dissertation is organised into three parts.

In Chapter 2, I briefly review the significant literature related to the research topic in order to summarise what aspects of the subject scholars examined and what results they reached. The comprehensive presentation of authoritative literary sources also allows for me to distinctly present the added value of the thesis.

Chapter 3 contains the presentation and critical assessment of the complex internal control and audit systems of EU funds under shared management. As a first step, I will review the regulatory system for the various audit players, and the type of audits they perform, and I highlight the current points of interaction. A separate chapter deals with the European Court of Auditors as this particular institution has special significance with respect to my thesis. At the end of the chapter, deficiencies of
the current system will be summarised as this will provide the guideline for other sections of the dissertation.

**Chapter 4** deals with the convergence of audit methodologies. First of all, I will review the attempts aimed at harmonising the various methodologies. At the heart of these is the ‘single audit’ concept, as this is the approach that represents the claim for audit coordination and reliance on various audit results. I will interpret this concept as well as its feasibility, its criteria towards the various players of the control and audit systems. I will then present the current framework which defines the cooperation between the various audit players. I will examine the development of the ECA’s audit methodology in a separate sub-chapter, as this a priority field of my research and as such receives special emphasis in my theses.

Finally, I will uncover some points in the control system in connection with which I am proposing changes in order that a more efficient system could be achieved.

I conclude the dissertation with my conclusions.
2 Literature review

A core pillar of the methodology for this research is a literature review, the basic objective of which is to deliver a comprehensive overview of international literature on methodological issues relating, by some means, to the analysis of future convergence.

Even though existing literature, focusing on cooperation, is already extensive, it mainly examines three aspects. First, the mutual cooperation between the Court and supreme audit institutions (SAIs) has been dealt with for years. Castells (2005) highlights the characteristics and audit activity of the ECA, and, in addition, describes its unique characteristics: the diversity of traditions, complexity of audit engagements due to variety of budget areas, and a singular character. Castells suggests coordination between external auditors, the ECA and the SAIs of the Member States, for cost minimisation. Nevertheless, he emphasises some difficulties to be resolved. With respect to joint audits, the professional background, the audit methods applied may defer, and misalignment of audit timetables across Member States may exist. In case of placing reliance on SAIs’ work, the ECA would become responsible for the audit activity performed by SAIs or it would be forced to establish common standards and supervise SAIs’ work, which definitely raises the issue of independence. The pilot project on coordinated audit and the activity of the Contact Committee of the Supreme Audit Institutions present remarkable examples of their commitment to achieve a higher degree of collaboration. Desmonds (1996) evaluates the relevant provision of the EC treaty, with regards to collaboration between SAIs and the ECA, as the establishment of a ‘functional link’.

Secondly, the Commission’s internal control framework has been reviewed by scholars numerous times. It is a common view that the Commission has made tremendous efforts to construct its multi-level assurance system in order to accomplish smoother financial management. Nevertheless, there is still room for further improvement. Caldeira (2008) argues that majority of errors arise at the beneficiary level and the primary controls do not operate properly. He warns that deficiencies of the primary and secondary controls cannot be balanced by the European Commission’s audits. The milestones and the underlying EU literature on the evolution of the internal
control system are detailed in Chapter 4.1, with special emphasis on the so-called ‘single audit’.

Thirdly, another field of interest has been the evolution of the European Court of Auditors. Laffan (1999) analyses the subject from the aspect of ‘historical institutionalism’, in other words, how the ECA defined its mission and place in the EU governance sphere. Levy (1996) examines the development of value-for-money (bonne gestion financière) audits in the context of diversity, caused by the variety of programmes, the different budgetary frameworks, multi-cultural background, the lack of pre-defined objectives, and finally the structure of the ECA itself.

Scholars primarily investigate the development of the internal control system of EU funds and the enhancing cooperation between the Court and the SAI’s when searching for the remedy for the high error rate. Less attention has been paid to the potential of the existing IT background to support controllers and auditors. It was detectable during the interviews prepared at Hungarian or even EU level that the IT aspect, as a source of evidence for audit purposes, has not been fully exploited yet. An objective of the thesis is to address this deficiency by investigating how the IT aspect can add value to the work of auditors and controllers.
3 The internal control and external audit system of EU funds under shared management

The implementation of the Union’s budget varies according to the provisions of the Financial Regulation. Should there be a *centralised management*, the European Commission is responsible for the implementation. Centralised direct management means that the Commission itself selects contractors, transfers funds, and performs monitoring activities. By contrast, in case of centralised indirect management, the implementation is delegated to agencies by agreements, and the Commission plays a supervisory role over the system.

In the case of *shared management*, the implementation is delegated to the Member States, who are in charge of taking all the necessary measures to ensure the financial interest of EU taxpayers. The Member States have to prevent irregularities and fraud by means of an effective and efficient internal control system. The method of *decentralised management* is performed when the implementation is delegated to third countries, not belonging to the European Union. Finally, *joint management* is a tool for delegating tasks to international organisations.

Funds for Cohesion policy are delivered to beneficiaries under the shared management system, which accounts about four-fifths of the total EU budget\(^2\).

![Figure 3. The methods of implementation of the EU budget](source: www.ec.europa.eu)

\(^2\) The implementation of funds for Common Agricultural Policy (CAP) is also carried out under shared management. However, the thesis concentrates alone on Cohesion spending.
The budget implementation under shared management associates with a higher delegation risk from the European Commission’s point of view. To ensure the legal and regular utilisation of funds, in accordance with the principle of sound financial management, a complex management and control system has been set up for the implementation of Cohesion policy.

The aim of Cohesion policy is to reduce disparities and promote the economic and social cohesion, which strengthen the harmonious development of the European Union as a whole, and the less-developed regions to catch up\(^3\). Cohesion policy is financed from three funds:

- the European Regional Development Fund (ERDF), which delivers funds for environmental and infrastructural projects, urban and local economic development;
- the European Social Fund (ESF), which favours development of education, training;
- the Cohesion Fund (CF), which finances special transport and environmental infrastructure projects.

![Figure 4. The EU budget allocated to CF, ERDF, and ESF (2007-2011)\(^4\)](image_url)

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\(^3\) The Cohesion Fund is open to countries with a GNI of less than 90 percent of the Union average.

\(^4\) Based on data available on [www.ec.europa.eu](http://www.ec.europa.eu) (see Appendix 3)
Prior to the multifaceted examination of the current system, with the intention to identify the points to be rethought, the individual system components, its functions, and the relationship among them have to be introduced, which serves as a solid base for the subsequent evaluation. First, the audit and control systems are presented at EU level. Special attention has been paid to the European Court of Auditors. Secondly, the implementation of the international legal framework into national level is explored. A distinct part describes the monitoring and information system, put in place in Hungary. Finally, the deficiencies of the current system are identified, for which solutions are to be found.

3.1 The internal control system

Under shared management, the European Commission carries out a supervisory role over the system, while the Member States bear responsibility for control activities of funds. At the EU level, the Commission itself has Internal Audit Service (IAS) beside the audit capacity of its departments, the so-called Directorates-General (DGs). The supervision for Cohesion policy is mainly performed by the DGs for Regional Policy and for Employment, Social Affairs and Inclusion (DG REGIO for ERDF and CF, and DG EMPL for ESF). The IAS prepares an annual internal audit report on the audits performed, the recommendations made, and the action taken. In addition, in 2011 the IAS issued an overall opinion on the financial management, for the first time. The opinion declares that the Commission fulfilled its duty in connection with internal control procedures and risk management and reached reasonable assurance, with certain limitations in policy areas, revealed and affirmed in the DGs’ assurance statements.

At national level, different layers of control have been set up to ensure that EU sources are used in legal and regular manner, respecting the principle of sound financial management. The budgetary principles of sound management are described by reference to economy, efficiency, and effectiveness. In practice, it means that pre-defined objectives are monitored against performance indicators to make the best use of EU funds.
According to the current regulation, each Member State has to designate authorities with different mandates:

- a **managing authority**: a public authority or a public/private body to manage the operational programmes;

- a **certifying authority**: a public authority/body to certify statements of expenditure for payment before they are submitted to the Commission;

- an **audit authority**: a public authority/body, functionally independent of the aforementioned authorities, which is in charge of verifying the effective functioning of the management and control systems;

- **intermediate bodies**: optional, the managing or certifying authority may delegate tasks to those.

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![Diagram](image)

**Figure 5.** **The complexity of the internal control system**

The key responsibility of the **managing authority** is to implement the operational programmes\(^5\) complying with the principle of sound financial management, which includes:

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\(^5\) Operational programmes are prepared by the Member States and are adopted by the European Commission, which set up priorities for the programming period in effect.
ensuring that decisions on projects for funding are made in accordance with adequate criteria fulfilling EU and national rules;

verifying that the expenditure declared is real, incurred in accordance with the approval decision, and complies with EU and national rules;

ensuring that there is a computerised system for recording and storing necessary data for planning, evaluation, verifications, and audits;

evaluating operational programmes;

ensuring that the certifying authority has all the necessary information to verify these items for the Commission;

submitting to the Commission the annual and final reports on implementation.

The control activity of the managing authority, as the first level of control, must include administrative verifications for each application for reimbursement submitted by beneficiaries, in addition to on-the-spot verifications of individual operations. The authority has to launch written standards and procedures for the verifications. Documents of verifications have to be available for other national authorities (i.e. certifying or audit authority) or authorized officials of the EU.

As the second layer of control, the primary task of the certifying authority is to submit to the Commission certified statements of expenditure and applications for payment. This activity assures the Commission that the statement of expenditure is accurate and can be reimbursed, it derives from reliable accounting systems, and the expenditure was incurred in accordance with the applicable EU and national rules. To expedite its activity, the certifying authority is given information from the managing authority on verifications and from the audit authority on the audits performed. To fulfil its duty, the certifying authority is entitled to carry out both administrative and on-the-spot check at the organizations involved in the financial management.

Thirdly, as a key objective of its activity, the audit authority verifies that the operation of the management and the control system is effective. The Commission supervises the audit work of the authority from several aspects. It has to provide an audit strategy to the Commission within nine months of the approval of the operational
programme, including the audit method to be used, and the sampling method. On a yearly basis, it submits an annual control report on the audits performed during the previous twelve-month period ending on 30 June of each year, and an opinion whether the management and control system operates effectively, in order to provide a reasonable assurance that statements of expenditure submitted to the Commission are accurate and the underlying transactions are legal and regular.

While carrying out audits, the audit authority has to keep to internationally accepted audit standards. It does so when the authority performs system audits or project audits of a sample. The sample is based on a random statistical sampling method and the conclusions are drawn according to ISAs. The sample to be audited each twelve-month period has to be selected from the expenditures that have been submitted to the Commission in the preceding year.

The audit authority carries out on-the-spot audits during which the documentation and the records held by the beneficiary are checked for correlation with the expenditures declared. In addition, the selection criteria and the implementation in accordance with the approval decision are examined.

The managing authority, altogether with monitoring committees, have to ensure the quality of the implementation, by comparisons to financial indicators. Those approve the criteria for selection and amendments, review the progress and the results of the implementation, and approve the annual report and final report of the managing authority. Finally, monitoring committees may suggest revision of the operational programmes. Monitoring Committees do not themselves perform direct audit or control activities, thus they remain out of the scope of the further analysis.

Due to its responsibility for the existence and effective operation of management and control systems, the Commission supervises the activity audit authorities, by means of compliance assessment, the approval of audit strategies and the inspection of annual reports. The Commission may conclude that it can rely on the opinion issued by the audit authority; hence, it will perform its own on-the-spot audits only if there is evidence of shortcomings in the national system.
The audit and control activities of the European Commission and the Member States, embedded in different types of checks with varied frequency, are executed in the whole budget cycle: from setting till closure.

3.2 The external auditor of EU finances: the European Court of Auditors

Prior to the establishment of the European Court of Auditors, the external audit function of the Community was carried out by two bodies: an Audit Board for the accounts as a whole and, on the other hand, an Auditor for the operational revenue and expenditure of the European Coal and Steel Community. Due to the enlargement of the Community, and the growing size of the budget in parallel, it became apparent that the Audit Board is not in the position to ensure the expected quality of external control of the Community’s finance.
In 1973, Heinrich Aigner published a report, *The Case for a European Audit Office*, which initiated the idea of placing on the agenda the question of transforming the Audit Board into a European Audit Office. After a two-year debate, the European Court of Auditors was established, and it started its operation a few years later; the long story of methodological evolution began.

### 3.2.1 Legal framework

From the legal aspect, the roots of the ECA go back to the Treaty of Brussels in 1975, when certain financial provisions were amended and the ECA was created. Becoming operational in 1977, the ECA was established as an external body to replace the antecedent audit bodies and to foster the transparency and the credibility of the European finances. With the entry into force of the *Maastricht Treaty* (TEU - Treaty on European Union) in 1993, the role and the power of the ECA was remarkably strengthened as it was ranked as one of the institutions of the European Union.

The *Treaty of Amsterdam*, effective from 1 May 1999, authorized the ECA to perform sound financial management audits and to seek remedy at the Court of Justice in the pursuit of fight against fraud even when other European Union institutions are affected.

*The Treaty of Nice*, in 2001, stressed the importance of the cooperation between the ECA and the supreme audit institutions of the Member States, and established that the ECA should be composed of one member from each Member States.

According to the *Treaty on the Functioning of the European Union* (TFEU, Article 287), the tasks of the ECA are set out as follows:

- examination of the accounts of all revenue and expenditure of the Union and of all bodies, offices or agencies set up by the Union;

- issuing a statement of assurance, known as DAS (Déclaration d’Assurance) for its French acronym, for the European Parliament and the Council concerning the reliability of the accounts and the legality and regularity of the underlying transactions;
examining whether all revenue has been received and all expenditure incurred in a lawful and regular manner, and whether the financial management has been sound.

The ECA has the mandate to perform audits both based on records and on the spot in any institution, agency etc., which manages EU funds even in the Member States, down to the final beneficiaries. While doing so, the ECA and the audit bodies of the Member States ‘shall cooperate in a spirit of trust while maintaining their independence.’

In addition to treaties, the Financial Regulation (FR) lays down the basis for the whole budget cycle, from drafting until the implementation. As such, FR mentions special licences the ECA has. While performing its audit task, the ECA is empowered to consult all information and documents considered to be of importance.

The ECA performs two types of audits, namely financial audit and performance audit. The objective of financial audits is to examine whether the financial statements present a true and fair view, and the underlying transactions have been executed conforming to regulations and rules. It addresses the legality and regularity, and the reliability of accounts. The performance audit, also known as value-for-money or sound financial management audit, focuses on the evaluation of the economy, the efficiency, and the effectiveness, the ‘3Es’ in short.

Based on its activity, the ECA produces different types of publications:

- annual reports for each financial year;
- special reports on specific questions (result of performance and compliance audits);
- specific annual reports concerning European Union bodies (result of financial audits);
- opinions at the request of other institutions of EU.

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6 TFEU, Article 287
3.2.2 Professional standards

Performing its audits task laid down in TFEU and FR, the ECA strictly adheres, as far as applicable to ECA’s work, to internationally accepted standards: the International Standards on Auditing (ISA) and the International Standards on Assurance Engagements (ISAE), both issued by the International Federation of Accountants (IFAC), the INTOSAI standards, and the European Implementing Guidelines for the INTOSAI Auditing Standards. The process to converge the ECA’s standards and international ones is of crucial importance because it seriously influenced the evolution of the ECA’s methodology, detailed in Chapter 4.3.1. Consequently, the necessity of giving a summary of the fundamental standards is beyond dispute.

The first significant sign of efforts towards the harmonization of internationally accepted standards in ECA’s practice was in 1991, when the Contact Committee of the Presidents of the Supreme Audit Institutions of the European Union established an ad-hoc working group on auditing standards. The group was designed to develop guidelines based on the INTOSAI Auditing Standards, accepted at the 1992 INTOSAI Congress, which are applicable in the European Union and serve as a common methodological point of reference. In 1994, the group prepared a set of eight draft guidelines, and identified the need for further ones. At this stage, some important issues were raised:

- what are the benefits of adopting the INTOSAI standards and European guidelines in particular; what problems could be expected to encounter if the ECA did adopt them?
- to what extent are the INTOSAI standards and European guidelines compatible with the ECA’s Audit Manual and the approach it has adopted for the DAS audit?
- are these standards and guidelines compatible with the TEU and the FR?

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Draft Guidelines on Auditing Standards, 31.08.1994 (ECA internal document)
what are the implications of adopting the INTOSAI standards and European guidelines for both internally within the ECA and the ECA’s external relations?

Even at the beginning of the work, all agreed that the adoption and implementation of INTOSAI Auditing Standards and developed guidelines would have been beneficial for the ECA, and voted for a test period of the standards.

At this stage, the ECA’s audit manual was under revision and the European Guidelines were taken into consideration in this process.

In addition to the INTOSAI Standards, the birth of ISAs in 1991, transforming the former guidelines to standards, was also a fundamental element of the framework of the ECA’s work.

In 1997, the ECA adopted the Court Audit Policy and Standards (CAPS) that served as a framework for the implementation of the revised Audit Manual\(^9\). The CAPS, codifying the ECA’s practice, did not imply significant changes but synthesised three fundamental sources:

- the INTOSAI Auditing Standards;
- the IFAC International Standards on Auditing; and
- the ECA’s audit policy.

From a structural point of view, the CAPS, the INTOSAI, and IFAC standards are structured approximately the same, only did the extent differ from a few aspects. Nevertheless, the adoption of the CAPS is considered to be of huge importance as it formally declared the usage of harmonised standards in the ECA’s practice.

The adherence to relevant international standards has remained high priority henceforward and has been under review constantly. The ECA’s Quality Assurance system, launched in 1998 as an a posteriori tool, has monitored compliance with CAPS from time to time. Not only did the internal quality assurance system evaluate the compliance but also external reviewers assessed it. In 2008, the International Peer Review of the European ECA of Auditors\(^10\) reached the conclusion that the ECA

\(^{9}\) Revision of the ECA's audit manual - Adoption of ECA audit policies and standards and the procedure for adopting the revised manual, 03.04.1997 (ECA internal document)

\(^{10}\) International Peer Review of the European Court of Auditors, 2008
conforms to international auditing standards. The second peer review, focusing on the performance audit activity of the ECA, will take place in 2013, with the participation of representatives of the German, the French, and the Swedish supreme audit institutions.

To conclude this part, the ECA has made noteworthy efforts to comply with international standards in the past twenty years, and reviews have proved that those were effective.

3.3 The national level – the example of Hungary

In Hungary, there are 15 operational programmes, approved by the Commission, within the framework New Hungary Development Plan for the programming period 2007-2013 (Appendix 4). The operational programmes are the basis for funds to be allocated to selected projects of beneficiaries, as it lays down the economic fields to be developed from EU funds, the ESF, ERDF, and the CF for Cohesion policy.

![Figure 7. Structural funds and Cohesion fund allocated to Hungary](image)

**Figure 7. Structural funds and Cohesion fund allocated to Hungary**

The characteristics, the items granted and the total amount of grants, significantly vary across operational programs (OPs). For instance, the

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11 Based on data available on [www.ec.europa.eu](http://www.ec.europa.eu) (see Appendix 5). Structural funds: ERDF and ESF.
Environment and Energy OP and the Transport OP are typical examples of funds with the highest volume, while the Economic Development OP and the Social Renewal OP have the highest number of funded items (Appendix 6). This diversity should have implications on control and audit activities.

3.3.1 The institutional background at the national level

3.3.1.1 The internal control system

Examining the internal control system in Hungary, the implementing authorities, the tasks of which have been enumerated in Chapter 3.1, have been set up as follows:

− managing authority: the National Development Agency under the surveillance of the Government Commissioner for Development;
− audit authority: Directorate General for Audit of European Funds, under the governance of the Minister of National Economy, in charge of compiling the ‘annual summary’;\(^{12}\);
− certifying authority: Hungarian State Treasury, under the governance of the Minister of National Economy;
− intermediate bodies: several bodies, supervised by the National Development Agency (Appendix 7).

Under the Hungarian regulation, the intermediate bodies perform on-the-spot checks by risk-based selection with varying intensity, depending on the amount of the funds the beneficiary receives.

\(^{12}\) A summary of the available audits and declarations (Article 53b (3) of FR).
<table>
<thead>
<tr>
<th>Funds received</th>
<th>Percentage of projects to be selected for on-the-spot verification</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;=36.000 EUR</td>
<td>At least 5 percent</td>
</tr>
<tr>
<td>36.000 EUR &lt; &lt;=90.000 EUR</td>
<td>At least 25 percent</td>
</tr>
<tr>
<td>90.000 EUR &lt; &lt;=900.000 EUR</td>
<td>At least once before closing the project</td>
</tr>
<tr>
<td>900.000 EUR &lt;</td>
<td>Yearly and on closing</td>
</tr>
</tbody>
</table>

**Figure 8. The frequency of on-the-spot checks**

The National Development Agency, as it delegates its own duty to intermediate bodies, has to supervise their control activities by examining the project selection procedures of at least 5 percent of the projects, excluding the so-called *simplified project selection*, when the decision on funds depends only on the compliance with the selection criteria. The report on the outcomes has to be sent to the certifying and the audit authorities.

**3.3.1.2 The external auditor at the national level**

Under the current regulation\(^{14}\), the State Audit Office of Hungary’s (SAO) financial audit also includes the utilisation of EU funds and national payments related to EU membership. The SAO, being the external financial auditor of the public finances, is empowered to conduct audits in any fields utilising public money, containing funds received from and amounts paid to the EU, the opinion on which a ‘Trend Report’ is published on an annual basis. During audit engagements, the adherence to relevant legal regulation and professional standards and methods is a must.

The roots of the cooperation between the State Audit Office of Hungary and the European Court of Auditors goes back to the 1990’s, when regular meetings took place and SAO’ staff was welcome at internship in Luxembourg (Mészáros, 2007).

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\(^{13}\) The Gov. Decree No 4/2011 (I. 28.) on the rules for the use of funds from the European Regional Development Fund, the European Social Fund and the Cohesion Fund in the programming period 2007 to 2013 determines the thresholds in Hungarian currency. The figure includes amounts exchanged at 278 HUF/EUR.

\(^{14}\) Act LXVI of 2011 on the State Audit Office of Hungary
possible accession of Hungary provoked an intensifying Hungarian - EU relations brought about by the requirement that Hungary had to catch up in all areas, including the area of financial control. The European Court of Auditors, for the first time in 1993, held a seminar in Berlin for SAIs of the Central and Eastern European Countries, and three years later in Luxembourg. Based upon the European Commission’s proposal, a ‘twinning system’ facilitated the adaptation of the aquis. The The relation with the National Audit Office of the UK was of paramount importance, which helped the SAO apply the international standards and methods. The SIGMA’s major goal was to develop the candidate countries' administrative systems. After the accession, the Contact Committee of Presidents of EU SAIs, the Liaison Officers of the SAIs, and Working groups compose the forum of multilateral relations.

The SAO, since 2003, has participated as an observer during ECA’s audit visits in Hungary. It has coordinated the preparation for on-the-spot checks, and it has shared the previous audit experience in order to facilitate the work of the ECA.

According to the current SAO’s strategy, a special attention is paid to the enhancement of reliable financial management and the SAO’s advisory role in the audit of EU funds, with an emphasis on the ECA’s and the Commission’s audit activities.

3.3.2 The IT background

The general principles of the management and control systems, established according to the provisions of Commission Regulation (EC) No. 1083/2006, include the requirement that Member States shall arrange for ‘reliable accounting, monitoring and financial reporting systems in computerised form’. In addition to that, the Regulation delegates to the managing authority the duty of operating such a system, which records and stores all the data on implementation necessary for the financial management of funds, monitoring, verification, and audit activities. Furthermore, the certifying authority should have accounting records of expenditure confirmed to the European Commission in computerised form.

15 The title of the twinning project was ‘Preparation of the Hungarian State Audit Office for the controlling task emerging from Hungary’s joining the EU’
It is of prime importance to emphasise that regulatory framework at EU level defines neither detailed characteristics nor accurate structure of such an IT system, but rather it stipulates features it must be capable of (e.g. recording and reporting financial transactions, irregularities, and financial corrections imposed by Member States).

Turning to the national context, the Unified Monitoring Information System (UMIS) has been developed to store and synchronize all the core data for policy areas financed by the European Regional Development Fund, the European Social Fund, and the Cohesion Fund. The complexity of UMIS forms a basis for monitoring and ex-post audit activities, as it covers the whole project cycle: from planning until evaluation:

- electronic submission of applications, automatic input of electronic applications;
- on-line information for applicants (status of application/project, contract modifications, submission of missing underlying documents);
- electronic submission of payment claims (input of invoices);
- electronic submission of project reports (input of indicators into UMIS monitoring module);
- data input from web based functions is stored in a separate web database and automatic data exchange occurs every 10 minutes, which synchronizes core data among systems;
- public information on the managing authority’s website (statistics, reports, report generators).
Figure 9. **The complexity of UMIS**

*source: Welt 2000 Ltd.*

Frequent data exchange occurs with public databases. For instance, UMIS provides the national monitoring system of the Hungarian State Treasury with project and payment data, and the account management system of the Treasury with electronic payment requests. Additionally, the National Tax and Customs Administration of Hungary makes certain information available to UMIS, as beneficiaries of EU funds are not allowed to accumulate tax or other public charge obligations. Otherwise, the reimbursement is suspended.

### 3.4 The deficiencies of the current system

Cohesion policy has been spotlighted over the past few years, due to deficiencies in the control system and the high error rate, still over five percent.

The following figure presents the findings of the ECA’s annual reports for the period 2006-2010.
Not surprisingly, Cohesion policy is a risky business by nature. The most hazardous characteristics of the systems are (Weber, 2010):

- large number of beneficiaries;
- numerous authorities at national level;
- pressure to absorb the EU funds;
- complex regulatory framework.

Mendez et al. (2011) argue that the Commission’s administrative reform has generated an audit and control explosion in the field of Cohesion policy since the mid-2000s. Besides the internal organizational change, the drive to achieve a positive Statement of Assurance\textsuperscript{16} and the intention to improve the internal control framework, all contributed, as a secondary effect, to the intensification of audit and control activity. A study on the implications of the legislation for cost effectiveness of structural funds affirmed that the programming period of 2007-2013 has experienced a massive increase in the audit effort (European Parliament, 2011). Some scholars share the idea that the quantity of audits is sufficient; therefore, not more audits but better coordinated ones are desirable.

\textsuperscript{16} The Court’s opinion on the reliability of the EU accounts, and on the legality and regularity of the underlying transactions
According to a study on ‘Administrative workload and costs for Member State public authorities of the implementation of ERDF and Cohesion Fund’ (SWECO, 2010), the total administrative costs are estimated to be about 12.500 million EUR out of the total eligible expenditure of 390.000 million EUR during the programming period of 2007-2013. It turned out that despite the fact that the original goal of the changed regulations from 2000-2006 to 2007-2013 was the simplification of rules and diminishment of administration costs, the requirement of statistical sampling by audit authorities, and verification and monitoring activities of the managing authority (and intermediate bodies) imposed extra costs. In addition, obligations concerning publicity and communication also increased costs.

The DG REGIO assessed at 62 percent the proportion of the costs of control out of total administration costs, amount to about 7.700 million EUR.

Figure 11. Total control costs and control costs for ERDF and CF funding


National coordination: includes the preparation of the National Strategic Reference Framework, which constitutes the reference document for European Union funds at national level, for the programming period 2007–2013.

Programme preparation: relates to the tasks of preparing OPs. Setting up of the management and control system is also contained.

Programme management: covers tasks of management such as project selection, monitoring, publicity etc.

Certification: includes verifying expenditure.

Audit: audit activities laid down in the legal framework.
To resolve the problem of increasing audit costs, a stronger cooperation and coordination between auditors at different levels has been suggested. With respect to internal control, the so-called ‘single audit model’ has become widely accepted, a model which favours the idea that different building blocks of the system place assurance on the work of previous controls performed by lower layers, which diminishes the danger of duplication. Regarding external audit functions, there is an increased cooperation between the Court and SAI's. Though the Treaty of Amsterdam declares that the Court and the SAI's 'shall cooperate in a spirit of trust while maintaining their independence', these institutions witness implementation problems caused by different mandates and dissimilar relationships with their national parliaments. A pilot project on coordinated audit, with the participation of the Court and a few SAI's, proved that this divergence represents a real challenge for the auditors and has an impact on future cooperation.

To reduce the error rate, the European Commission has suggested a few amendments to the FR. Interim payments will be restricted to 90 percent of funds due to Member States, and the remaining amount will be at disposal following the annual clearance of accounts. The introduction of an annual clearance of accounts and of an annual closure of completed expenditure are expected to reinforce the quality controls, and consequently the financial management in Member States. As anticipated, these measures will decrease the error rate below 5 percent, approaching the 2 percent materiality threshold set by the European Court of Auditors. The proposal to concentrate audit resources to programmes with a higher estimated risk allow and allow proportionate control activity for programmes with effective internal control system are expected to create motivations for a more effective system operation at the Member State level.

The proposed changes, as estimated by the European Commission, will not affect the level of control costs, it will remain cca. 2 percent of the total funds. However, the rearrangement of control costs will shift the whole internal control system towards a more effective functioning.
4 Towards convergence in audit methodology

The widely proposed enhancement in coordination is not a sufficient but necessary prerequisite for the efficient and effective operation of the audit and control system across the whole Union. To reap the benefit, in addition to improved coordination, methodological convergence has to be achieved and spread to save EU’s financial interest.

This chapter first gives an overview of the subject from a historical perspective, concentrating on the milestones of the process. The term of ‘single audit’ is interpreted to both internal control and external audit levels, at the heart of which concept the reliance on others’ work has been conceived. Secondly, the legal and the professional frameworks for a better cooperation are elaborated. Thirdly, the potential role of the ECA is delineated based on the research of methodological evolution. Finally, some amendments are suggested in order to improve audit efficiency.

4.1 The single audit concept from a historical perspective

In Opinion No 2/2004 on the ‘single audit’ model (and a proposal for a Community internal control framework), the ECA highlighted the significant pitfalls of the internal control system and proposed an internal control framework to reinforce the effectiveness of the control function at the Commission and Member States levels. Appreciating the efforts invested by the Commission and results achieved, the ECA outlined the characteristics of a well-designed and -managed internal control system. The opinion itself did not entail a specific definition of what is meant by single audit, still the concept was delineated. Irrespective of geographical view, whether it is applied in the U.S, the Netherlands or even in the European Union context, its aim is to avoid duplication of audits by relying on the work of other auditors; and to improve financial management through an efficient and effective internal control system. The main prerequisites, enumerated by the ECA, to accomplish the single audit are:

- common principles and standards;
- coordinated audits to avoid overlaps;
transparency in order that the results can be used and relied upon in the chain of control procedures;

− appropriate legislation for all levels of the system; and

− partnership between the European Commission and the Member States to improve their internal control systems.

The Opinion described an example of a so-called chain-based model, in which different layers of control activities were delineated. The term of primary controls covered those performed by the paying entity of grants, which includes administrative checks and on-the-spot checks. Secondary controls, carried out by separated units on a risk-based basis, are to examine if primary controls function effectively and regularly. Also at national level, central controls oversee the operation of the aforementioned two levels. Finally, the Commission’s own supervision is a guardian of what has been done at national level with respect to internal controls.

In response to the Opinion, the Commission suggested a ‘Roadmap to an Integrated Internal Control Framework,’ and prepared the ‘Action Plan towards an Integrated Internal Control Framework’ in January 2006. In the pursuit of a positive DAS (Declaration d’Assurance, issued by the ECA on the reliability, regularity and legality of the accounts), it became clear that it is not possible to maintain further development in the internal control system unless Member States can provide the Commission with reasonable assurance for the transactions implemented at national level. The Roadmap suggests that with respect to the single audit approach, common standards, audit methods (including determination of sample size, sampling techniques etc.), and guidance should be provided. The Action Plan identified different fields for action of which a fundamental part is concerned with management declarations and audit assurance, which have crucial importance for this paper. Another field of interest of the Action Plan deals with the single audit approach: better coordination of work with respect to audit strategies, planning, follow-ups and relying on the results of the work of others.

The voluntary initiative of the ‘contract of confidence’ was introduced to simplify the audit work of Cohesion policy by empowering the European Commission to rely on the audit activity performed at national level, and consequently diminishing the need for auditing by the Commission (Mendez, 2011).
To promote the convergence in audit approaches across Member States, the Contact Committee Working Group on Common Auditing Standards and Comparable Audit Criteria, founded in 2006 and chaired by the ECA, had the mandate to work out common auditing standards and comparable audit criteria, based on internationally accepted auditing standards. As stated earlier, common standards and methodology are preconditions in the single audit concept in order to rely on the work of others.

The Treaty of Lisbon, signed in 2007, which entered into force on 1 December 2009, has arguably become of huge importance by declaring that ‘the Commission shall implement the budget in cooperation with the Member States’\textsuperscript{18}. To reflect the increasing accountability of the Member States, the Commission made a proposal on national audit statements on EU expenditure. After being rejected by the Ecofin Council, composed of the Economics and Finance Ministers of the Member States, the idea was refined, and finally the amended FR included that ‘the Member States shall produce an annual summary of the available audits and declarations at the appropriate national level’\textsuperscript{19}. Annual summaries were delivered for the first time in 2008 for the financial year of 2007. The rationale to introduce annual summaries was to reinforce the accountability of Member States disposing EU funds under shared management. On the other hand, information included in AS also provides evidence with respect to the legality and regularity of expenditure for the annual activity report of the Directorates General of the Commission. In addition, Implementing Rules and Guidance Note to the FR were provided to the Member States to support them fulfilling their obligation as laid down in the amended FR. Under the FR, the presentation of expenditure certified to the European Commission and the audit activity is key, and more importantly, mandatory elements of the annual summaries, while an overall analysis and an overall level of assurance statement are optional parts. The European Commission’s review activities on annual summaries include, on the one hand, an analysis if the summaries fulfil the minimum requirements (compliance check), and, on the other hand, if those provide any benefit (quality check)\textsuperscript{20}.

\textsuperscript{18} The Treaty of Lisbon, 2007, Article 317
\textsuperscript{19} Council Regulation No 1605/2002, Article 53b
\textsuperscript{20} Moore Stephens LLP (2011)
Although the Commission’s initiation of national audit statements failed and was excluded from the amended FR, a few Member States (Denmark, Sweden, the UK, and the Netherlands) have issued national declarations on a voluntary basis and have had them audited by SAIs. Taking the Dutch example, the minister of Finance signs the declaration on behalf of the government and an extra assurance derives from the independent opinion of the Dutch SAI. In Sweden, the declaration, issued by the Government, and signed by the Prime Minister and Minister of Finance, is an element of the Annual Report for Central Government, which is audited by the Swedish National Audit Office.

In the same year, the ECA adopted an opinion (6/2007) on the annual summaries of Member States; ‘national declarations’ of Member States; and audit work on EU funds of national audit bodies. The opinion addressed three related issues; it ruled on whether those constitute consecutive evidence for the ECA in its audit work. First, the compulsory application of annual summaries, required by the FR, is definitely a new element of the internal control system in the chain-based model in shared management areas. The AS can be regarded as a sort of summary, being unaudited, instead of a source of conclusive audit evidence which the ECA can rely on for DAS. Likewise, national declaration and those being audited by SAIs as voluntary initiatives of some Member States (Denmark, Sweden, the UK, and the Netherlands) are considered to be additional elements of the internal control framework and could also contribute to the improvement of the internal control. Nevertheless, the ECA declared in this opinion that national declarations themselves are not regarded as consecutive evidences for the ECA. With regards to audited national declarations, those might be evidence if the ECA wishes to rely on them. Thirdly, the work of SAIs auditing EU funds required by national regulation may have impact on the ECA’s audit work as long as those adhere to international auditing standards. To conclude, the ECA’s view on annual summaries is that in that form annual summaries are only cross-sector summaries and the Commission has to create added value to those, while national declarations are of even greater importance under shared management. The ECA enumerated the potential benefit of cooperating with SAIs: increasing accountability and transparency, diminution of the contradicting results, and extended ground for audit evidence.

In 2008, a progress report on the Action Plan stated that the introduction of the framework contributed significantly to the reduction of errors. In parallel, for the first
time, the ECA did not show the ‘red light’ to any of the supervisory and control systems.

The application of annual summaries itself, encouraged by the process for improvement of the internal control of EU spending, hardly lived up to expectations. A European Parliament study on annual summaries, published in 2009, evaluated the compliance, the benefit, and the effect of such annual summaries on the Member States. It proved that the annual summaries mostly contained the minimum requirements but lacked overall analysis in many cases; hence, the overall assurance deriving from those was quite limited. The European Parliament could not perceive any direct impact of annual summaries on improvement of the financial management of funds, and found that ‘the opinions of the key stakeholders are rather moderate’. Hence, a management representation on the adequate operation of internal control systems, as well as on the legality, the regularity and the accuracy of expenditure reported to the Commission was promoted. In addition, the results of the study suggested that the management representation itself be subject to an external audit performed by a private audit firm or SAIs dependent on the Member State’s choice.
### Auditor of management representation

<table>
<thead>
<tr>
<th>Auditor of management representation</th>
<th>Benefits</th>
<th>Shortcomings</th>
</tr>
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<tbody>
<tr>
<td>SAI</td>
<td>– knowledge of operation of administration, specific regulation, language</td>
<td>– absence of link of reporting outside the Member States</td>
</tr>
<tr>
<td></td>
<td>– less intensive presence from EU institutions</td>
<td>– independence from the ECA which would rely on SAI’s work if audits are performed according to ISAs</td>
</tr>
<tr>
<td></td>
<td>– experience in audit of co-financed projects</td>
<td></td>
</tr>
<tr>
<td>Private audit firm</td>
<td>– terms and conditions laid down in contract are more flexible (i.e. direct reporting abroad)</td>
<td>– not exhaustive experience of audits in EU financed projects</td>
</tr>
<tr>
<td></td>
<td></td>
<td>– parallelism in audit of EU funds between SAI and private firm, competence of SAI is affected</td>
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<tr>
<td></td>
<td></td>
<td>– possible bigger increase in audit expenditure</td>
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</table>

**Figure 12. The benefits and the shortcomings of alternatives of auditing management representation**

*source: European Parliament, Directorate-General for Internal Policies, 2009*

The authors of the study argued that the ECA as an auditor of management representation would be out of the question, as knowledge of operation of administration and Member State-specific regulation is absent, and furthermore, the more intensive presence of the ECA would not be desirable.

The study drew attention to the existence of both legal and technical restraints for which solutions need to be found:

- financial years vary across Member States, hence the period attached by the management declaration runs accordingly, while the financial year of EU accounts being audited by the ECA starts on 1 January and ends 31 December each year;
- diversity of methodology in use;
- ECA performs audits per clusters of Activity Based Budgeting (ABB) and not per Member States;
In summary, the European Parliament concluded that, in accordance with the 
Opinion No. 6/2007, the accountability at Member States level could be increased by 
the issuance of a management representation on the adequacy of control systems, as 
well as accuracy and regularity of underlying transactions, which should be subject to 
external audits.

Moving forwards, in October 2010, the Working Group on Common Auditing 
Standards and Comparable Audit Criteria finished a four-year long project. It prepared 
three documents, which were added to the final report and the resolution: ‘Information 
on SAI practices in auditing EU funds/policies within the framework of INTOSAI 
standards’ concerning:

- SAIs mandates and audit activities in the EU field – the result of a 
  ‘mapping exercise’;
- Compliance Audit; and
- Performance Audit.

To a certain extent, the working Group failed to accomplish its original task as no 
standards were developed. Nevertheless, it enhanced the cooperation between SAIs 
and provided examples of auditing EU funds in different Member States.

A few years later, the ECA emphasized in Opinion No. 1/2010 that there was room 
left for the Commission, together with Member States to improve the quality of annual 
summaries so as to raise the level of assurance drawn from them.

From the aspect of reliance on the work of other auditors, the ECA has launched a 
Pilot Project on co-ordinated audits focusing on the examination of the legality and 
regularity with the DAS approach, only for agricultural expenditure, in the 
participating Member States (the Netherlands, and the Czech Republic). The 
underlying principle of the project is that the ECA would take into account outputs 
certified by SAIs, such as audited national declarations in the DAS process if those 
were more common and better structured.

21 APM: Pilot project on Co-ordinated Audits, 22.04.2010 (ECA internal document)
The phrase of coordinated audit is defined as such type of cooperative activity where SAIs ‘coordinate or harmonise their audit approaches in some way’ but variations may still exist (INTOSAI, 2007), resulting in national or joint audit reports. By contrast, joint audits require identical approach and result in a joint report, while in case of parallel audits, the approaches differ and each SAI issue an independent report.

The pilot project revealed the divergence in audit methodology, which highly influenced the work in all phases and resulted delays. At this stage, no efficiency goal was attained but there might be some in the future. As positive, non-quantitative impacts, the ECA’s auditors expanded their knowledge of national control systems, while the participating SAIs gained enriched audit results. With an eye to the future, the ECA recommended a commonly defined and agreed audit methodology in case of further coordinated audits.

A study on Annual summaries – a comparative study of added value (Moore Stephens LLP, 2011) was published in spring of 2011 in the context of shared management for annual summaries of the period 2007-2009. About half of the Member States proved to have made significant efforts to improve the standards of their annual summaries, while 30 percent did not manage to make progress with respect to compliance.

Concerning the quality aspect of the summaries, half of the Member States did not provide voluntary information on the internal control environment, thus the original goal, namely to improve risk management and raise the awareness of financial management was not accomplished. The content of 5 out of the 27 Member States’

![Figure 13. The outcomes of compliance and voluntary assessments](source: Moore Stephens LLP: Annual summaries – a comparative study of added value, 2011)
annual summaries provided added value to the stakeholder, with special attention to DGs of the European Commission.

The authors argue that the initiative of national declarations, generally speaking, does not directly lead to improved financial management, though it appears to be an additional element in the accounting chain. Moreover, it turned out the administration structure of the Member States, irrespective of the type whether it is centralised and decentralised, had not determined the feasibility of a new reporting tool, the national declaration.

Finally, the introduction of a *managing authority statement* on internal control has been strongly advised in the study, which put the emphasis not on verifying that the internal control systems prevent errors from occurring, but rather on the effective functioning of those systems. In addition, the statement should be subject to the audit activity of the audit authority and it should form an opinion on that.

The European Commission, the ECA’s primary auditee, has proposed some amendments of the FR applicable to the management and control of funds under shared management\(^{22}\). The section on *'Clearance of accounts and financial correction'* of the proposal embodies the concept that the Member States have to submit, in addition to the certified annual accounts, the summary report of audits and controls, and the audit opinion, a ‘management declaration of assurance as to the completeness, accuracy and veracity of the annual accounts, the proper functioning of the internal control systems, as well as to the legality and regularity of the underlying transactions and the respect of the principle of sound financial management’\(^{23}\). The proposal remarkably broadens the duty of the managing authority with a management declaration ‘on the assurance on the functioning of the management and control system, the legality and regularity of underlying transactions and the respect of the principle of sound financial management, together with a report setting out the results of management controls carried out, any weaknesses identified in the management and control system and any corrective action taken’\(^{24}\).

\(^{22}\) Dated 11.09.2012.

\(^{23}\) Article 75 (b).

\(^{24}\) Article 114 (4 (e)).
In conclusion, the enhancement of the management and control systems has been a work-in-progress for several years and is expected to yield the benefit in terms of quality and diminishing error rates, not immediately but in the foreseeable future. With respect to the cooperation between supreme audit institutions of the Member States and the ECA, tremendous efforts have already been made to improve and intensify their common work, but due to diversity, there are quite a few challenges still waiting to be overcome.

4.2 The framework for enhanced cooperation and reliance

In the context of shared management, there are certain legal regulations and professional standards, which highly determine the path towards an improved level of cooperation. In this section, the applicable legal and professional frameworks are elaborated to lay down the basis for the examination of how the existing actors could work together in a more efficient way.

4.2.1 The legal framework

The principles of cooperation between the ECA and the SAIs are principally down in the provisions of the TFEU and FR, which do not precisely describe the collaboration in details, rather present the general framework.

According to the provisions of Article 287 (3) of the TFEU, ‘the Court of Auditors and the national audit bodies of the Member States shall cooperate in the spirit of trust while maintaining their independence’. The national audit bodies have to inform the ECA if they intend to participate in the audit, and they are obliged to provide the ECA with any documents that are necessary to fulfil its duty.

Articles 140-142 of the FR reaffirm the general cooperation principles of ‘spirit of trust’ and ‘maintaining independence’ and the obligation to provide all the necessary information and documents. The FR also includes the stipulation that the application of integrated computer systems must not restrain the access of the ECA to documents.

Concerning the internal control system, the framework for cooperation is set up mainly in Council Regulation (EC) No 1083/2006 and Commission Regulation (EC)
No 1828/2006. Based on provisions, the managing authority has to ensure, in general, that a ‘record is available of the identity and location of bodies holding the supporting documents relating to expenditure and audits, which includes all documents required for an adequate audit trail’. In addition, the managing authority guarantees that the certifying authority receives all the information on verifications for the purpose of certification, and it provides the monitoring committee with documents, which are necessary to fulfil its duty to deliver quality implementation. The certifying authority, in order to certify expenditure, takes into consideration all audits performed by the audit authority.

4.2.2 The professional framework: the international standards

In addition to the regulatory framework, there exist international standards the auditors have to adhere to during audit engagements. Consequently, before going into more in-depth examination of different scenarios of cooperation, it is essential to understand profoundly the applicable international standards, as it constitutes the framework in case any intention to put reliance on other auditors’ work occurs.

With regards to the International Standards on Auditing (ISAs), the fundamental references are:

- ISA 580: Written Representations (revised and redrafted due to the Clarity Project of the IFAC);
- ISA 610: Using the Work of Internal Auditors (only redrafted).

Written representation, as a type of audit evidence, is a statement made by the management to the auditor, which, in general, addresses two issues:

- the responsibility for the preparation of the financial statements according to the applicable financial reporting regulation;
- the completeness of information and recorded transactions, and access to those.

25 The ISA 620 on ‘Using the Work of an Auditor’s Expert’ is irrelevant as this paper examines the reliance between elements of the existing internal control chain and the external auditors.
If any uncertainty of the reliability of written representation (e.g. diligence of management, integrity, competence) occurs, the auditor has to assess its implications on the audit evidence in general. The auditor may conclude that due to the risk of management misinterpretation, the audit cannot be performed. In the absence of corrective measures, the auditor may consider withdrawing from the audit engagement.

If management does not present the requested written representation, the auditor has to discuss it with the management, draw the conclusions, and evaluate its impact on audit evidence and on the audit opinion itself. The ISA 580 clearly states that the auditor has to disclaim an opinion on the financial statements, if the management does not provide the written representation or the auditor finds sufficient evidence that it is not reliable.

The international standard on auditing 610 on ‘Using the work of internal auditors’ has relevance for an external auditor, if it is meant to reduce the extent of audit procedures by putting reliance on internal auditors’ work. In such case, the auditor has to judge if the internal auditors’ work appears to be adequate for his own audit purposes. When deciding on the adequacy, technical competence and objectivity as well as due professional care are under examination. As a second step, the impact of using the work of other auditors on the extent, timing, and nature of the audit has to be assessed. For instance, the threat of subjectivity by the internal auditors and the scope of the audit engagements performed by those professionals are to be considered. The external auditor has to judge how the gains coming from the work of other auditors relate to the efforts, in order to be convinced that those works are worth relying on. The ISA 610 suggests that agreement made in advance with internal auditors on some issues (materiality, sampling methods, documentation etc.) significantly expedite the audit work.

Finally, it is important to emphasize that the use of another auditor’s work does not decrease the responsibility; the external auditor bears the sole responsibility for the opinion expressed in the independent auditor’s report.

An early IFAC study (1994) on ‘Using the work of other auditors – a public sector perspective’ has also some implications for the cooperation between the ECA and the SAIs. Due to varied legal requirements across national borders, the mandates of SAIs’
and scope of audits differ accordingly. An agreement on detailed responsibilities, as a solution for the divergence, is suggested in the study. Keeping in mind that great variety, auditors have to consider the aspects of accessibility and constitution when making decision on using the work of other auditors. Accessibility refers to the fact if access is ensured to all levels of the government, while constitution addresses the right of access to the auditee’s administration. Moreover, the auditor has to make a judgement on the other’s competence, independence, and his mandate when considering whether or not to place reliance on that person.

The ISSAI 26 300 on ‘Fields standards on government auditing’ incorporates that at the stage of planning, the auditor has to assess the degree of reliance that might be placed upon the other’s work. Amongst auditing guidelines of INTOSAI, the ISSAI 1580 on ‘Written representation’, drawn on ISA 580, are interpreted in a broader context in the public sector, as the management’s responsibilities might be also more comprehensive. Accordingly, ISSAI 1610 on ‘Using the work of internal auditors’ has also a broader scope than ISA 610 for the private sector, based upon it was developed.

The PCAOB 27 Auditing Standard No. 5 on ‘An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements’ contains that the auditor has to evaluate the competence and objectivity of the other auditor to determine the extent to which the auditor may use his work. A higher degree of competence and objectivity corresponds, in general, to a greater use of other’s work. In this context, competence refers to the accomplishment of knowledge that enables the auditor to perform its duty, while objectivity brings up the ability to execute those tasks independently and with ‘intellectual honesty’.

Generally speaking, the mandatory application of the relevant international standards, with respect to management representation and the use of the work of other auditors, does not decrease the responsibility of the primary auditor, in the EU context, that of the ECA.

26 International Standards of Supreme Audit Institutions
27 Public Company Accounting Oversight Board
4.3 The role of the European Court of Auditors in the process of convergence

This chapter has two main objectives. First, to explore the development of the methodology, from the foundation of the Court until recent progresses, and thoroughly identify the factors that affected the evolution and its dynamics.

Secondly, to support further research to examine, what the potential role of the Court could be in the process of convergence to support a common methodology to EU funds across Member States.

4.3.1 The methodological evolution

The ECA’s methodology has been evolving for decades, and has been highly influenced by both internal and external factors. On the one hand, the development in compliance with standards (detailed in Chapter 3.2.2) has strongly affected the methodology in use. On the other hand, the progress of the ECA’s methodology significantly relates to the institutional evolution of the ECA. Finally, the task of issuing DAS on the reliability of the EU accounts and on the regularity and the legality of the underlying transactions necessitated development of a DAS methodology itself.

When examining the methodological evolution, one has to bear in mind that the ECA principally carries out two different types of audit, which highly influenced the dynamic of the development itself. Financial audits concentrate on reliability, legality and regularity\(^{28}\) issues, while performance audits deal with sound financial management\(^{29}\). Depending on the period under examination, methodologies of the two types of audit were developed, in some cases, with diverse dynamics or often in parallel.

Spending decades on development resulted in a well-structured, four level methodological framework. This chapter provides details of thresholds of the

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\(^{28}\) Reliability: examining the accounts of all the expenditure and revenue of the EU and the EU institutions. Legality and regularity: checking the legality and regularity of the underlying transactions of EU money.

\(^{29}\) Sound financial management: checking if the financial management of the EU has been sound.
evolution of the ECA’s methodology, from its foundation until recent developments: significant milestones of the process and its rationales are accessed.

4.3.1.1 Phase 1 (1975-1993)

After setting up the formal organizational structure of ECA, the next question became how to implement the tasks laid down in the Treaty of Brussels. The goals were clear, but the way of implementation was challenging, especially in the context of diversity of ECA members.

After starting its operation in 1977, first the ECA had to establish a philosophy thus it was unrealistic to expect rapid effect (Wallace, 1980). Given the diversity of auditing practices in the Member States, the ECA first had to establish its approach to auditing (Laffan, 1999).

In the first few months, the ECA tried to define, as a starting point, its objectives including the determination of what the phrase ‘good financial management’ really means. The ECA concerned itself with a value for money (VFM) type of audit. Meanwhile, the formation of audit working groups and the creation of rules of procedure were also of fundamental importance in order that the ECA could start its audit operation. Although there was no formal methodology used in audits at that time, the development had already occurred. As stated in the first Rules of Procedure, the President of the ECA was responsible for ensuring (to warrant) uniform auditing procedures across various sectors being audited. A general department was set up with the responsibility of improving audit procedures and of working out reference material for auditing, which can be seen as the root of methodology.

In 1978, André J. Middelhoek, who became president later, prepared a paper on working methods. He enumerated a wide range of audit methods, which were relevant to the ECA’s work. Methods differed depending on whether the regularity and legality or the evaluation of financial management was under examination. In general, methods were split into two categories:

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30 Discussion at meeting of ECA of Auditors, 26-28.10.1977 (ECA internal document)
31 Draft Rules of Procedure for the ECA of Auditors (ECA internal document)
32 Working methods and professional training (ECA internal document)
– examination of individual transactions;
– system / procedures examination.

Concerning regularity and legality, Middelhoek emphasized the necessity of computer-based auditing, the use of audit programmes, and sampling methods instead of 100% checks. To perform its task emerging from the Treaty, in 1978 the ECA adopted a broader approach, the ‘systems approach’ for the examination of legality and regularity. By definition, a system approach refers to the concept that ‘the auditor seeks to rely, as far as possible, on the systems of management and internal control applying to the particular Community body or activity being audited’ \(^{33}\) under the assumption that the auditee has an internal control function. In fact, the ECA could not hope to be able to examine each of millions of transactions attaching the EU budget, thus the system based approach seemed to work.

As for the evaluation of financial management, the core concept demanded the effectiveness and the efficiency, thus concerns of ‘why’ (objectives), ‘how’ (to implement the objectives), and ‘how much’ (cost-benefit analyses) were raised. One can judge those years as the period of trying to define the liaison between working methods and the work programme, lacking the availability of a clear, written methodology. Noteworthy efforts were made to analyse working methods, i.e. for the accounts of 1978, in order to establish \textit{common guidelines}\(^{34}\) applicable to different areas, among which methods were also included, to foster a more common approach. Nevertheless, the terms of methodology or manual were not even mentioned.

Concerning financial management, Middelhoek proposed four criteria:

- \textit{materiality}: refers to ‘relatively considerable impact in financial terms’, no detailed definition was given;
- \textit{generality}: systematic weaknesses rather than incidental cases should be considered;
- \textit{objectivity}: ‘factual substance’ of information presented; and
- \textit{political sensitivity}: consideration of political significance.

\(^{33}\) Audit guidelines, 04.07.1983 (ECA internal document)

\(^{34}\) Note to the President and the Members of the Court of Auditors, 15.11.1979 (ECA internal document)
Despite the fact that Middelhoek’s paper can hardly be judged as a methodology or even a broad approach to auditing, it can definitely be considered as a pioneer of the latter methodological evolution by analysing audit methods. Still, the constructive approach to audits remained unsolved.

Built on the outcome of Middelhoek’s work, a working party started its operation in autumn 1978 to result in an exhaustive report on the audit of financial management. That was the first meaningful attempt to set down a common approach to auditing funds by the ECA. The study\textsuperscript{35} was completed in January 1980, and was offered to the meeting of the ECA by Middelhoek. The novelty of the study was that it broke down the concept of sound financial management into three subcategories: economy, efficiency, and effectiveness. In other words, the requirement of investigating, ‘whether the financial management has been sound,’\textsuperscript{36} implies the analysis of the aforementioned ‘3E’ (economy, efficiency, and effectiveness).

\textsuperscript{35} Activités de groupe de travail dans le domaine du contrôle de la gestion financière, 30.01.1980 (ECA internal document)

<table>
<thead>
<tr>
<th>Definition</th>
<th>Economy</th>
<th>Efficiency</th>
<th>Effectiveness</th>
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<tr>
<td>- resources are available at the right time, in the right place/ quantity/quality, at the right price</td>
<td>- relationship between the goods and services produced (output) and the resources employed (input)</td>
<td>- degree of goal fulfilment in a cost-effective way</td>
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**Tasks of Financial Management**

- choosing resources in various quantities and qualities at various prices
- systems are established in a proper manner, collect evidence to prove the choice of type, quality and price

**Tasks of Audit**

- evaluate if the management establishes adequate procedures
- justify that there is a clear link between activities and main objectives
- efficiency alone does not exclude waste of resources

**Limitations of Audits**

- misinterpretation if carried out without considering the output

**Figure 14. The ‘3E’ concept**


In addition to the analyses of the abovementioned core components, the study also introduced a simple model for auditing the financial management. Forming an opinion on financial management distinctly includes the antecedent examination of:

- individual transactions/projects;
- systems operated by the management.

The model was built on the existence of a strong inter-relationship between transaction- and system-based audits. When there are deficiencies in a transaction, the grass roots have to be revealed in order to be able to eliminate procedural weaknesses deriving from the system itself. On the other hand, system weaknesses have to be reflected at transaction or project level by estimating the possible effect.

The study also defined, for the first time, the fundamental parts of auditing the financial management:
– review of the whole area, selection for examination;
– preliminary survey of selected subjects;
– execution;
– reporting.

At the selection stage, one has to take into account different aspects of subjects (i.e. the size, the importance, high risk of management problems). At the preliminary stage, the selected subjects are investigated in a broader sense. This step has crucial importance with respect to the following stage, the planning of audits. Afterwards, the execution of the audit requires significant resources primarily focused on monitoring systems of the auditee. Taking the system based approach as a starting point, if an auditor perceives the failure of the systems, further examinations must be undertaken resulting in more intensive substantive tests. Finally, the outcomes of auditing are summarized in reports.

To sum up, the report in question had two main achievements. First, it included an exhaustive description of the concept of the ‘3E’. Secondly, it gave a comprehensive picture of the stages of financial management, as it had never been defined before. It is of importance to emphasize that the approach dealt mostly with the audit of financial management, and not with legality and regularity.

In addition to the report on the audit of financial management, the year of 1980 can be seen as a threshold from the methodological point of view. Establishing audit groups in 1980 gave rise to a special unit, ADAR Group (Audit Development and Reports), which focused on, beside other tasks, the development of audit practices by moulding the diversity into a common approach, which later resulted in the Manual (Laffan, 1997).

A few years later, in a progress report of financial management audit\(^\text{37}\) it was stated that despite the efforts there had still not been a consistent approach to that type of audit. To remedy the situation, a pilot project for defining the basis for a common approach and standards was proposed. As a starting point, Aldo Angioi\(^\text{38}\) suggested a study for the structural funds alone in order that the feasibility of a comprehensive

\(^{37}\) Progress report on financial management audit, 11.09.1982, (ECA internal document)
\(^{38}\) President of the ECA from 21 December 1989 to 31 December 1992
approach could be judged. However, this proposal, a trial for structural funds alone, was not implemented.

In the pursuit of a common base for methodology, it was a substantial milestone when Middelhoek submitted the Audit Guidelines to the President and the Members of the ECA in 1983. The developed guidelines, based upon the previously used audit notices, were expected to reinforce the consistent audit approach to auditing and to form the basis for the later Audit Manual.

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<tr>
<th>No.</th>
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<th>Status</th>
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<td>1</td>
<td>Conduct of audit inquiries</td>
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<tr>
<td>2</td>
<td>The ECA’s audit approach</td>
<td>revised</td>
</tr>
<tr>
<td>3</td>
<td>Ascertaining, documenting and evaluating systems and controls</td>
<td>revised</td>
</tr>
<tr>
<td>4</td>
<td>Audit working papers</td>
<td>revised</td>
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<tr>
<td>5</td>
<td>Financial management audit</td>
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</tr>
<tr>
<td>6</td>
<td>In-depth examination of the systems and procedures of the Commission</td>
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<tr>
<td>7</td>
<td>Procedural arrangements for the Annual Report</td>
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<tr>
<td>8</td>
<td>Planning and programming the audit</td>
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<td>9</td>
<td>Internal procedural Manual on Audit Reports and Opinions</td>
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</tr>
<tr>
<td>10</td>
<td>Financial Audit</td>
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Figure 15. Audit notices in 1983

*source: Audit guidelines, 04.07.1983 (ECA internal document)*

With respect to the scope of the audit, the Guidelines made a distinction between the examination of accounts, that of legality and regularity, and the examination of financial management, complying with the provisions of the EC Treaty and the FR. Nevertheless, there is a relationship among those tasks: in order to operate in a legal and regular manner, a reliable accounting system (reliable accounts) is required. Additionally, the audit of the accounts serves as a base for the examination of regularity, legality, and financial management. Consequently, the guidelines offered an

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39 Audit guidelines, 04.07.1983 (ECA internal document)
‘integrated audit’ if there was an overlap between financial and financial management audits.

![Diagram](figure.png)

**Figure 16. The concept of integrated audit**

*source: Audit guidelines, 04.07.1983 (ECA internal document), Audit notice No. 2*

Concerning the audit approach, all agreed that examining each transaction of the Community was beyond reason due to the aspects of cost-effectiveness and the existence of the internal control system of the auditees themselves. The ECA had previously applied the system-based approach, and the Guidelines reaffirmed this viewpoint. According to the system-based approach, the auditors seek to find, as far as possible, evidences of a well-built and appropriately managed system, in order to be able to place reliance on these systems, which eventually decreases the amount of detailed testing. Irrespective of the type of the audit, whether it was financial audit or financial management audit, the system-based audit approach should contain certain phases:

i. planning;

ii. system evaluation;

iii. execution of audits;

iv. reporting.

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The Guidelines gave descriptive insight to the different stages of auditing, detailed hereafter.

i. **Planning**

Within the set of audit notices, quite an extensive one\(^{40}\) has been devoted to planning (and programming) the audit. At the planning stage, the annual work programme has been transformed into more detailed planning documents:

- audit planning memorandum (APM): overall strategic plan for the audit;
- audit programme: converting the strategic plan into detailed audit tasks;
- job budget: estimating the necessary human resources of the audit assignment, and comparing that with the resources taken.

ii. **System evaluation**

As compared to the study previously detailed, one can conclude that a new phase, the system evaluation was incorporated. At the system evaluation stage, auditors assessed whether the internal control systems had operated appropriately to ensure that the accounts are fair, the revenues and the expenditures are legal and regular, and finally, financial management is sound.

iii. **Execution**

Depending on the type of the audit assignment, the execution stage may vary in nature. To obtain reasonable assurance whether the ‘accounts are materially legal and regular,’ which is the main goal of financial audits, a combination of three types of audit procedures have to be applied:

- compliance tests to evaluate whether controls operate properly in practice;
- analytical review of trends, variances etc.;
- substantive tests of the underlying transactions.

\(^{40}\) Audit Notice No. 8
Thinking over the range of tools an auditor applies nowadays, one can state that the methods have not basically changed. Nevertheless, the interaction between elements has undergone a remarkable evolution so far.

The main objective of *compliance tests* is to find out whether reliance can be placed upon the control systems, which highly influences the auditor’s procedures. If there is any sign of system weaknesses, it is not worth investing time in compliance tests, as the area of substantive testing cannot be limited. Consequently, compliance tests should only be used if a clear link between such type of tests and substantive testing can be declared. The Guidelines included further principles to determine the volume of transactions that needed to be tested in order that the auditor could form an opinion on the operation of internal controls. The maximum number of transactions to be tested is:

\[
\text{max} = \frac{\text{total value of population concerned}}{\text{materiality limit}}
\]

(sample of 30 items is a minimum)

As it can be seen in the formula, a new phrase was introduced. According to the *materiality limit approach*, the maximum value of errors that remained undetected can be appended to an amount previously set by the auditor. In other words, materiality limit is a threshold that represents the maximum tolerable error. Although establishing the materiality is due to a sort of professional judgement of the auditor, the guidelines suggested that materiality limit for Community bodies should lie between 0.5 and 2 percent.

Highlighted in the Guidelines, *analytical review procedures* support to determine the areas where detailed substantive testing is required. These audit procedures offer a wide range of:

- trend analysis;
- computation and explanation of ratios and variances; and
- review of other internal or external bodies.

Carrying out analytical procedures needs a lower rate of investment in both time and staff. Moreover, they facilitate identification of elements of the accounts are likely to be materially correct or incorrect. Therefore, the extent of substantive testing can be
determined; if there is a likelihood of significant errors, extended substantive testing will be unavoidable.

Compliance tests and analytical review procedures present indirect evidence concerning the examination of accounts, legality, and regularity. Applying *substantive testing*, as direct evidence, a set of transactions are selected and tested to obtain, together with indirect evidences, reasonable assurance as to whether the revenue and the expenditure are materially legal and regular, and the accounts are free from material misstatements. Substantive tests have to provide evidence in connection with the ECA’s audit objectives:

<table>
<thead>
<tr>
<th>Audit objectives</th>
<th>Evidence required confirming the following for the account balances or transactions being tested</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legality and regularity</strong></td>
<td>The existence, nature, value and classification are in conformity with all relevant regulations.</td>
</tr>
<tr>
<td><strong>Completeness</strong></td>
<td>All amounts relating to the entity at the accounting data are included.</td>
</tr>
<tr>
<td><strong>Valuation</strong></td>
<td>The amounts recorded in the accounts are a reasonable reflection of the value of the underlying assets, liabilities, revenue or expenditure.</td>
</tr>
<tr>
<td><strong>Existence</strong></td>
<td>The assets, liabilities or events underlying recorded account balances or transactions actually exist at the appropriate accounting dates.</td>
</tr>
<tr>
<td><strong>Propriety</strong></td>
<td>The recorded account balances or transactions relate entirely to the entity being audited.</td>
</tr>
<tr>
<td><strong>Presentation</strong></td>
<td>All recorded account balances and transactions, as well as the underlying elements and facts, are properly presented in terms of the purposes for which the accounts are prepared and in accordance with appropriate accounting principles.</td>
</tr>
</tbody>
</table>

**Figure 17. The audit objectives**

*source: Audit guidelines, Audit notice No. 8, 04.07.1983 (ECA internal document).*
The systematic presentation of audit objectives was considered of fundamental importance as it was the first time that those had been defined in writing in an audit notice, forming the basis of the ECA’s first manual a few years later.

With respect to the extent of substantive testing, the Guidelines suggested that transactions (or items) had to be classified into three categories:

- **error-prone items** are likely to be incorrect. These items should be justified separately to avoid misleading conclusion from the sample and should be revealed during system evaluation phase, compliance tests, and analytical procedures;
- **high-value items** having special importance. Any high value errors may result in significant errors in total;
- **remaining items** forms the sample basis.

The liaison among the above elements can be illustrated as follows:

![Diagram of Different sources of audit assurance](image)

**Figure 18.** Different sources of audit assurance

source: Audit guidelines, Audit notice No. 8, 04.07.1983 (ECA internal document).
According to the approach, the higher the expected degree of assurance from substantive tests, the higher will be the number of high value and sample transactions to be justified as the overall audit assurance required, which has remained 95 percent since the publication of the Audit notice, and strongly relates to substantive tests.

<table>
<thead>
<tr>
<th>Verification situation</th>
<th>Internal control and analytical review satisfactory</th>
<th>Internal control satisfactory</th>
<th>Analytical review satisfactory</th>
<th>Neither internal control nor analytical review satisfactory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall audit assurance required</td>
<td>95 %</td>
<td>95 %</td>
<td>95 %</td>
<td>95 %</td>
</tr>
<tr>
<td>Overall audit risk tolerable</td>
<td>5 %</td>
<td>5 %</td>
<td>5 %</td>
<td>5 %</td>
</tr>
<tr>
<td>Risk of audit procedure failing to detect any evidence or error:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Evaluation of internal control</td>
<td>37 %</td>
<td>37 %</td>
<td>100 %</td>
<td>100 %</td>
</tr>
<tr>
<td>Analytical review for overall reasonableness</td>
<td>37 %</td>
<td>100 %</td>
<td>37 %</td>
<td>100 %</td>
</tr>
<tr>
<td>Substantive testing of accounts</td>
<td>37 %</td>
<td>14 %</td>
<td>14 %</td>
<td>5 %</td>
</tr>
<tr>
<td>Audit assurance required from substantive test</td>
<td>63 %</td>
<td>86 %</td>
<td>86 %</td>
<td>95 %</td>
</tr>
<tr>
<td>Appropriate extent factor</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>

**Figure 19. The degree of audit assurance required from substantive tests**

*source: Audit guidelines, Audit notice No. 8, Annex 2, 04.07.1983 (ECA internal document)*,

Being aware of the audit assurance required from substantive tests, the Guidelines described the extent of the substantive tests can be calculated following consecutive steps:
1. determination of:
   - the total value of population (all the items / transactions);
   - the materiality limit;
   - degree of audit assurance required from substantive testing (and the extent factor);
   - extent value = materiality limit / extent factor;

2. deduction of the high value items and error-prone items from the population;

3. determination of:
   - sample size = total value of the normal population / extent factor;
   - total number and value verified is in addition to the error-prone and high value items.

As a result of substantive testing, the most likely error projected, including the outcomes of the sample of the normal population as well as that of error-prone and high value items, can be determined and be compared on an aggregated basis with the materiality limit.

In comparison with the Assurance Model introduced in DAS practices in 2005, inspired by the revised DAS approach, the audit notices still did not use the terms of inherent and control risks, as those are the consequences of the evolution of ISAs. Instead, the assessment of analytical review and internal control came about. Nevertheless, the approach can be regarded as the predecessor of the current assurance model.

On the other hand, the Guidelines underlined again that soundness of the financial management had to be evaluated according to the ‘3E’ concept. The Guidelines stressed that not only are the terms of economy, efficiency, and effectiveness essential,

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41 Inherent risk, as part of the audit risk, represents the auditor's assessment that there may be a material misstatement in the financial statements, without taking the effectiveness of the related internal controls into account. Control risk, also considered as an element of audit risk, refers to the deficiencies of the internal control system: it fails to detect or prevent a material misstatement from occurring.
but also the different management tasks (i.e. goal setting, implementation, monitoring) at each level should be covered in financial management audit assignments.

A separate audit notice was devoted to working papers for internal purposes, which had never been formalised before. The Guidelines used the terms of permanent audit file and current audit file, which are applicable in current audit practices, too. Working papers, having continuing importance for successive audits, have been recorded in the permanent file, while the current file has contained the documents of the execution of the audit providing evidence for the auditor’s opinion.42

iv. Reporting

Finally, regarding the reporting stage, the tools of external communication (annual reports, other annual reports, obligatory or non-obligatory opinions, and special reports) were enumerated within the Guidelines, following the requisites laid down in the Treaty and the Financial Regulation.

In the late 80’s, noteworthy efforts were invested into the harmonization of the financial audit due to the necessity to bring audit methods together and lay down a common approach to financial audits. Through reorganization of ADAR’s role, increased level of harmonization was expected in the field of financial audit43.

It was a significant achievement in the evolution of ECA’s methodology, bearing the fruits of a considerable effort of ADAR, when the ECA published its first Audit Manual in 1990, the content of which mainly dealt with financial audits. Levy (1996) describes the Manual not as an operational guide but says it ‘codified practice on systems audit which can be used for Value for Money audits’. The Manual introduced the term VFM audit to replace the term financial management audit. To sum up the significance of the written Manual, it was a complete systematization of the former audit notices, guidelines, and unwritten practices.

42 Audit Notice No. 4 (rev. May 1983)
43 Harmonization of the financial audit, 14.09.1989 (ECA internal document)
4.3.1.2 Phase 2 (1993-2005)

With the entry into force of the Maastricht Treaty in 1993, the ECA was affected in two main aspects. First, it was ranked as a European institution, which increased its power and independence. Second, under the provisions of Article 248 of TEU ‘the ECA of Auditors shall provide the European Parliament and the Council with a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions,’ which highly influenced working methods and expanded the work.

Levy (1996) pointed out that the challenge of DAS may have distracted resources from VFM audits as that required investment in sampling rather than techniques of system analysis. There was no doubt that in order to meet the requirements, the ECA had to find the right sampling techniques to ensure the required assurance for issuing DAS. Additionally, more intensive audit activity became necessary in Member States (Laffan, 1999), all the way down to the financial beneficiaries of funds.

Regarding audit sampling techniques, the ECA had decided to use monetary unit sampling (MUS) concerning underlying transactions (Levy, 1999; White, 1999). At the beginning of its application, a sample of 600 transactions was taken with regards to both payments and commitments, later reduced to that of 400. The tasks included also on the spot audits at the final beneficiaries in the Member States. The result from the sample was extrapolated to the whole budget, while the required level of assurance remained unchanged at 95%.

Not only did the DAS requirement affect the ECA’s work and methods external factors did as well. While ADAR was revising the Audit Manual of the ECA, the case for European Auditing Guidelines, initiated by the desire of harmonisation among SAIs, was put on the agenda. The European Auditing Guidelines, based on the INTOSAI Auditing Guidelines, were developed by an ad hoc group, which was established by the Contact Committee of Presidents of EU SAIs in 1991. The ECA’s approach with respect to DAS audits proved to be consistent with the aforementioned guidelines. Nevertheless, differences in non-DAS audits between the European Auditing Guidelines (EAG) and the Audit Manual (AM) have been revealed.

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44 European Auditing Guidelines, 28.10.1994 (ECA internal document)
<table>
<thead>
<tr>
<th>Subject</th>
<th>Differences identified</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit evidence</td>
<td>EAG emphasise explicitly that audit evidence must be competent, relevant and reasonable. In AM, implicit reference.</td>
</tr>
<tr>
<td>Evaluation of risk</td>
<td>EAG analyse audit risk and examine the impact of high-risk areas. In AM, implicit reference.</td>
</tr>
<tr>
<td>The examination of systems</td>
<td>AM suggests that the auditor should examine the systems of internal control, and then should test their effectiveness.</td>
</tr>
<tr>
<td></td>
<td>EAG recommend that the auditor should go on directly substantive tests if it is more effective and economical based on professional judgement</td>
</tr>
<tr>
<td>Audit sampling</td>
<td>EAG provide more detailed guidance on sampling, also for non-DAS audits.</td>
</tr>
</tbody>
</table>

**Figure 20. Differences between the European Auditing Guidelines and the Audit Manual**

*source: European Auditing Guidelines, 28.10.1994 (ECA internal document)*

In 1997, the ECA adopted the revised Manual and the ECA Audit Policies and Standards as referred to in Chapter 3.1.2. In 1998, the European Implementing Guidelines for the INTOSAI Auditing Standards were issued, with the preface of the president of the ECA, Prof. Dr. Bernhard Friedmann. The exhaustive guidelines used the term of performance audit as a synonym for VFM audit and audit of sound financial management (SFM) in connection with the examination of economy, efficiency, and effectiveness.

The novelty of the Guidelines and the revised Manual was that both described the mathematical model of audit risk with an insight into the components of that type of risk:

\[
AR = IR \times CR \times DR
\]

where AR is *audit risk*, IR is *inherent risk*, CR is *control risk*, DR is *detection risk*.

Detection risk is attached to the likelihood that the auditor will not detect a material misstatement.
Moreover, the concept of materiality, the significance of professional judgement, and the relationship with audit risk was notably emphasized.

As a result of learning by experience, another revision of the ‘old manual’ took place in 2000. The changes, due to revision, were initiated by the process that emerged from the necessity of the harmonization of internationally accepted ‘external standards’ and that of internal practices. Concerning amendments, distinct parts were devoted to the statement of assurance and to the audit of sound financial management.

In 2000, a remarkable ambition for further development of the ECA’s SFM practice developed. ADAR, assisted by the Sound Financial Management Audit Advisory Group (known as ‘SFM group’), was expected to work out the module of SFM audit in the Manual. Beyond their freedom to act, and the expertise of its members, the SFM group was expected to adhere to certain principles, some of which related to methodology:

- ‘the starting point for SFM audits should usually be an examination of relevant key management processes and the related control procedures’, and as such its aim is to help the management overcome flaws and improve;
- the quality of management information is a matter that should be considered in every SFM audit preliminary study;
- the tendency to devote more effort to preliminary studies, since the introduction of the new Manual, must be transformed into standard practice
- using a ‘no surprises’ approach, fully openness and transparency with auditees (especially the Commission);
- as a new point of view, SFM audits should emphasize positive developments and spread best practices of financial management.

Due to the efforts invested, the ECA adopted the first performance audit module of the Manual, ‘Planning SFM audits’ in 2001.

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46 A framework for the further development of the ECA’s sound financial management audit practice, 27.06.2000 (ECA internal document)
In line with the above principles, in 2001 ADAR arranged for the audit manual to be available on the internet with the intention to demonstrate transparency and initiate the cooperation between the ECA and SAIs\textsuperscript{47}. Since then, manuals have been accessible to interested third parties.

The introduction of Activity Based Management (ABM) together with Activity Based Budgeting (ABB), allocating resources according to consistent political priorities based on pre-defined objectives, encouraged the ECA to establish a task force to examine the effects of these changes to its approach and organization. It produced a report in 2005\textsuperscript{48}, which stated that it was not impossible to comply with ABB/ABM, but still there were some arguments of importance. Obviously, an annual report including remarks for all 31-policy areas would have been out of the question and would have resulted in fragmentation of reports, not to mention the fact that it would have required more resources. Concerning the impact on the organization, the task force considered that the ECA should carry on financial audit within a single division as before and not within the context of the respective policy. As for the audit approach, it was not modified by the introduction of ABM, rather the examination of the ‘relevance of objectives, and the reliability of impact and output indicators’ was of priority. In other words, ABM reflects the auditee’s (the Commission) approach to SFM, which clearly has to be taken into account in performance audits.

A few months later, the new module of the manual, ‘Programming of the ECA’s work\textsuperscript{49}’, reflected the necessary changes. Interestingly, it introduced for the first time the term of Portfolio of Potential Audit Tasks (PPAT). The PPAT can be describe as a stand-by and up-to-date set of potential audit tasks including a list of audit topics, ranked by priority on commonly accepted criteria, with underlying arguments for proposals. The programming guidelines\textsuperscript{50} identified criteria that the topics have to be assessed upon (risk, materiality, relevance, and coverage can be low, medium, or high) and to be established by priority (low, medium and high). The programming module formalized a two-level planning system with the application of a five-year Audit

\textsuperscript{47} Publication of the ECA’s Audit Manual on internet, 10.05.2001 (ECA internal document)
\textsuperscript{48} Report by the ABM/ABB task force on the impact of the introduction of ABM/ABB on the ECA’s organisation and audit approach, and state of implementation at the Commission, 12.05.2005 (ECA internal document)
\textsuperscript{49} Programming of the ECA’s Work - Audit Manual - Module B3, 04.10.2005 (ECA internal document)
\textsuperscript{50} CEADA: Programming Guidelines for establishing the Portfolio of Potential Audit Tasks, ECA intranet
Strategy, which summarizes areas of special interest and sets up goals and framework for the audits, and the adoption of an Annual Work Programme (AWP) based on PPAT. The AWP contains the list of recurrent and permanent tasks and the resources allocated to them.

At the beginning of 2005, the framework for performance audits, as a module of the manual, was approved. The framework supports the common understanding:

- what is meant by performance audit and how does it relate to evaluation?
- what are the main differences between financial audits and performance audits?
- what are the basic questions in performance audits, and how should one apply the 3E concept?
- what are the key components of the audit process?

Regarding the audit process, a new element appeared in comparison with previous guidelines or manuals.

The appearance of management of the audit and quality control as a component of the process is undoubtedly related to the issuance of the International Standard on Quality Control 1 (ISQC 1) by IFAC, which has required the establishment and record of quality control policies and procedures since 2005.

Quality must be embedded into all stages of the audit cycle instead of concentrating quality checks at the end. This requirement implies that there will be:

- ex post quality reviews to assess the quality of work done;
- quality checks built in the audit process supported by checklists;
- on-going quality assurance reviews of procedures and strong commitment to apply those.

The year 2005 also included important methodological improvements in respect of the DAS. The ECA set up a three-member Project Team from its members in order to

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51 Module C1 - Framework for Performance Audits of the European ECA of Auditors, 31.01.2005 (ECA internal document)
update methodology. As a result of the efforts, the ECA adopted the revised DAS approach in February 2006, which was applicable for DAS 2006 for the first time. The question may arise, to what extent it amended the methodology that had been used for over 10 years and what elements the revised approach, described by ECA as ‘an evolution not a revolution’\textsuperscript{52}, incorporated. The principal areas of amendments were the following:

- the development of the assurance model with prior assessment of inherent and control risk in order to reach the expected confidence level of 95 percent and materiality of 2 percent;
- setting up a hierarchy between sources of evidence;
- introduction of decision trees;
- more extensive examination of the work of other auditors;
- strengthening risk analysis in planning.

The DAS Project Team recommended the introduction of an assurance model, the development of which was strongly based upon the model of the National Audit Office of the UK with modifications in accordance with the special characteristics of ECA’s audit environment. The use of terms of inherent and control risks in the model reflects the evolution of the components of audit risk taking place in the late 90’s in both international standards and the ECA’s methodology.

\textsuperscript{52} Practical guidelines for DAS audit work after 2005, 10.02.2006 (ECA internal document)
The assurance model suggests that if the auditor evaluates the supervisory and control system and determines that it is unable to prevent or to detect and correct errors, *focussed substantive testing* has to be carried out with an expected confidence level over 90 percent. If the inherent risk is high and supervisory and control systems are excellent or good, or the inherent risk is not high and the supervisory and control systems are good, *standard substantive testing* has to be performed. In this case, assurance derives from substantive testing with a minimum confidence level between 67 and 80 percent. If the auditors consider the inherent risk as not high and supervisory and control systems are excellent, a significant part of the overall assurance can be drawn from controls assurance, and confidence of the *minimum substantive testing* is diminished to 45 percent. Obviously, the residual level of substantive tests strongly relates to the sample size.

According to the model, the level of confidence to be obtained is dependent on the outcome of the assessment of inherent risk and evaluation of supervisory and control systems. As compared with the concept rooted in the former audit notices of the 80’s, the model presented in the guidelines for DAS work is more complex and in line with standards adopted by the ECA.
However, it is important to keep in mind that the assurance model is a useful tool of planning; its application on the other hand, does not replace the professional judgement of the auditor.

The proposed hierarchy between sources of evidence the ECA can rely is composed of two types. In the context of auditing EU funds, the principal sources derive from the examination of the supervisory and control systems and substantive testing, while the other two main sources, the work of other auditors and analysis of annual activity reports and declarations of the Director-General, can also be taken into account while finalizing an audit.

The guidelines contained a set of decision trees, which embraced the entire process from planning to the latest stage, forming an audit opinion. For instance, complex decision trees were developed in the fields of the assurance model and drawing of audit conclusion, all with the aim to support auditors’ work.

Relating to the work of other auditors, the guidelines reveal that the extent to which the ECA intends to rely on this field heavily depends on whether auditors operate within or outside the framework of the supervisory and control systems. In current practices, the parts of those systems are usually not regarded as audit evidence for the ECA but might be at a later stage. On the other hand, the work of auditors outside the internal control systems, mainly SAIs in Member States, can be considered as audit evidence for the ECA.

Finally, the guidelines stressed that the reinforcement of the risk analysis is a matter of importance. Both the assessment of inherent risk and the overall evaluation of the supervisory and control system at each level should be used as an input; the detailed risk analysis can be used as a basis in the process of planning, reflected in audit planning memorandum (APM).

In some aspects, the year 2005 can be regarded as a landmark. The introduction and the continuous update of the ECA’s Manual, with separate modules for different types of audit, concluded, and a complex framework was about to be introduced.

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53 Seminar on ECA DAS methodology and audit missions in Member States, 18 November 2010, Budapest
4.3.1.3 Phase 3: the current audit methodology (from 2006)

The next important milestone of the evolution of the methodology can be considered to be when Vítor Caldeira, Dean of the CEAD (Coordination, Evaluation, Assurance and Development) Group and the present president of the ECA, handed in a proposal for a Performance Audit Manual, together with an explanatory memorandum, to the members of CEAD Group in October 2006.

The significance of the proposal, to a certain extent a paradigm shift, is that not only has a separate Performance Audit Manual been developed, but also a multi-level reference framework has been worked out. This approach broke with the practice that audit methodology is incorporated in different modules of a single audit manual.

The former Audit Manual contained parts relevant to financial audits, performance audits, and general procedures related to both types of audit, while CAPS also included audit procedures. As intended, the new reference framework was developed to remedy those overlaps.

Level 1 includes the legal framework for the ECA, which determines its mandate and mission, and the Rules of Procedure. Level 2 contains international standards relevant to auditing, and the CAPS built upon INTOSAI and IFAC standards. Level 3, regarded as the most complex part, is composed of three different manuals:

1. the Performance Audit Manual (PAM);
2. the Financial Audit Manual (later re-named Financial and Compliance Audit Manual – FCAM); and
3. the General Audit Procedures Manual (re-named Vademecum of General Audit Procedure (VGAP)).

Finally, Level 4 comprises internally produced guidelines to provide information on audit techniques and the toolbox, which aims to present references to external sources such as INTOSAI, SAIs etc. Recently, CEAD has invested remarkable efforts in developing guidelines on audit techniques and data analysis\(^54\), to be incorporated in level 4.

\(^{54}\) Report on progress made by ADAR in developing the toolbox and guidelines on audit techniques, 04.12.2006 (ECA internal document)
With regard to level 3 of the reference framework, the modules of the old manual, adopted by the ECA in December 2006, composed the basis for the PAM. The intention in preparing the PAM was not to write a ‘cookbook’ type of manual, but rather to lay down a sound methodology base and facilitate a general understanding of performance audits, in conjunction with the professional judgement of the auditor. PAM has been rather descriptive in nature, forming the basis for common understanding. During development, associates carried out the analysis of manuals and best practices of supreme audit institutions (e.g. those of Sweden, UK, and Canada), and INTOSAI and EUROSAI guidance was also taken into account.

The VGAP of level 3 deals with subjects, which are common to financial, compliance and performance audit. Some areas of interest relate to Fraud, Statements of Preliminary Findings (SPF), Quality Control, and Quality Assurance. The development of the VGAP and the FCAM by CEAD Group has been intended to be simultaneous and of priority.

The planning memorandum for a ‘stand-alone financial manual’ presents several rationales. The old manual had not been significantly changed to reflect the development in audit methodology, especially concerning ISAs by IFAC, nor the revised DAS-approach. Finally, the concept of the new reference framework was initiated to develop a manual for financial and compliance audit applicable to both the DAS (reliability of the accounts and the legality and regularity of the underlying transactions), and also other financial and compliance audits.

The basis for the FCAM is the revised DAS-approach compliant with INTOSAI and IFAC standards. To ensure consistency, the structure of the FCAM was intended to follow that of PAM: phases of planning, execution, and reporting. During the development of the FCAM, the ECA established a ‘Think Tank’ on the DAS methodology, as proposed in the Audit Strategy 2007-2012, to support the further development of the DAS to be reflected in the FCAM. By the end of 2009, the Think Tank had prepared an ‘Issue Analysis’ paper which contained all the internal and external expertise in this field and a final report with recommendation in 2010.

56 The compliance audit is a comprehensive review of adherence to laws and regulations.
57 Status and progress of work for the Think Tank, 18.12.2009 (ECA internal document)
To conclude this part, a number of significant landmarks were identified in the development of the Court’s methodology and the whole process was broken down into three phases, which were characterised by different dynamics of development. The Court’s methodological framework reflects from all aspects the professional standards of auditing. The legal framework and the institutional evolution highly influenced the development of the methodology.

4.3.2 The prospects for convergence

As previously detailed, the dominant influencing factors proved to be the Court’s institutional development, and the on-going expectation of compliance with international standards applicable to the audit of the EU budget and the legal framework, especially the need to fulfil the requirement to issue a Statement of Assurance on the reliability of the EU accounts and on the regularity and legality of the underlying transactions.

In a broader context, the research into the ECA’s methodology serves as a reference point for the examination of the feasibility of convergence in the methodologies applied within the EU Member States.

As stated earlier, the methodological convergence is an essential precondition towards more effective control and audit systems. Lessons learnt from the past proved that harmonisation is not easy to realise, and even spread throughout the whole Union.

First, the Pilot Project on Coordinated Audit revealed and manifested the diversity of methodology used for a sample of two Member States; one can access the extent to which methodologies vary across 27 Member States.

Secondly, the attempt by the Contact Committee Working Group on Common Auditing Standards and Comparable Audit Criteria attested that to converge the different practices into common auditing standards is difficult to end with success. Nevertheless, it improved the cooperation between SAIs and extended the audit knowledge. The feeling of threat to independence, perceived during the interviews, is also detrimental to the process of convergence, and ultimately to the possibility that ECA can use SAI’s work, from professional point of view.
Thirdly, the voluntary initiative of audited national declaration, introduced by minority of Members, proved that in some Member States there is a higher chance to put reliance on SAI’s work than in the rest of the European Union. Nevertheless, methodological convergence has to spread in the entire Union to bear the fruit of enhanced cooperation.

Finally, the ECA’s methodology, developing for about 35 years, confirmed to be ISA-compliant and able to adapt to changing environment. The decision on a 2nd peer review in 2013, focusing on the performance audit activity of the ECA, is an evidence of commitment towards high quality audit work.

In conclusion, a call for voluntary convergence in methodology is unlikely to produce solid and lasting results. Closer cooperation and even common methodology could be achieved on the basis of a legal/regulatory approach, by proposing more specific provisions in this area.

**Thesis statement 1:**

In the field of auditing funds assigned to Cohesion policy, the prerequisite of convergence is the determination of a point of reference, and the audit methodology of the European Court of Auditors is suitable for this purpose.

In short, convergence must spread from the Court (and the Commission) on the basis of appropriate legislation.

As stated earlier, the key preconditions of the applicability of the single audit model are that common standards and methodology have to be laid down and audits have to be coordinated to promote the next level in the control chain. The expected result is convergence in audit approach Europe-wide.

The single audit concept contains the term ‘audit’ but the concept itself suggests that the core components are coordination, reliance on lower levels' work, and common principles. In the EU environment, it means that the Commission relies on the work of elements of the control chain as far as it is convinced that effective
systems are put in place at Member States level and appropriate assurance derives from the knowledge that underlying transactions are legal and regular.

To make a judgement on the feasibility of the concept and the potential use of auditors’ work at all, one has to make a distinction whether it is to be applied within the internal control framework or in relation to the external audit function of the EU, and whether the control activity is to be performed by auditors applying audit methodologies based on internationally accepted standards.

With respect to the external audit functions, the ECA and SAI’s and their relationship is to be evaluated on the ISA-based concept of the work of other auditors. This requires a common understanding of the approach and the methodology to be applied, right timing, and also a review of the working papers. This is a delicate subject, as a misinterpretation of the ECA’s reliance on SAIs’ work may suggest that the SAI’s are at a lower hierarchical level. Meanwhile, the Financial Regulation applicable to the general budget of the European Communities declares that the ECA and the SAIs have to cooperate in a spirit of trust and maintain their independence, which excludes any supervision. Putting ISAs into this context, the emphasis is on the possibility of using other auditors’ work and relying on them, which obviously requires audit evidence on the SAIs work but without establishing any hierarchy. This way of thinking is remarkably reflected in the pilot project of the ECA and three SAIs, called ’coordinated audit’.

If the issuance and the audit of the national declaration by SAIs remain optional, this may result in the intensity of ECA’s audit in the Member States differing from each other depending on whether they have issued such declarations or not. The difficulty of the alternative, to put reliance on SAIs’ work, is that the ECA performs its audits according to ABB clusters and not per Member States.

Previously, pros and cons have been enumerated whether a private firm or an SAI would be better to audit the highest-level management representation, the national declaration. The EP study revealed against the ECA on this, citing lack of knowledge (regarding operation of administration, national specific regulation etc.). To have the declaration audited by the ECA is also a possible scenario and has some advantages. First, the threat to independence may not occur, as the work of the SAIs is not
examined in terms of the international standards. The national declarations audited by the ECA itself would thus constitute direct consecutive evidence.

Secondly, if the ECA audited the national declaration, the EP's main argument, the absence of knowledge of national environment, would be defeated—but possibly not in the short run. It is also an alternative that the ECA could have ‘offices’ with its own professionals in the Member States or ‘regional offices’ to which a few Member States’ audits would belong, which would mean a more intensive presence of the ECA at national level. A stronger presence of the Court in the Member States (e.g. regional offices) would have a positive impact on convergence, but this would obviously require additional Court resources. The regional solution may be more practical due to the ABB-clustered audit work of the ECA. In this case, the familiarity threat has to be addressed according to the International Standard on Quality Control 1, known as ISQC 1 by auditors. It can be achieved either by rotation of professionals or quality control review procedures.

Nevertheless, ECA, as a potential auditor of national declaration (or any management representations), is not the best alternative: this duty should not be distracted from Member States. Instead, the ECA should play a dominant supervisory role, where it lays down a uniform framework for auditing national declarations across the European Union. Meanwhile, it acts as a knowledge center and promotes knowledge transfer.

The EP study also mentioned private audit firms, as possible auditor of national declarations and enumerated pros and cons. Generally speaking, this alternative do not reduce the degree of divergence of methodologies applied in Member States, however, there is an option to move towards convergence. Should a quality assurance system be introduces, in which private companies have to obtain a licence to audit ND, the methodological convergence could be reached. The issuer of such an authorisation should be an external, independent ‘auditor’ with unquestionable knowledge and experience of auditing EU funds: the European Court of Auditors. The privilege to possess a licence would mean that the uniform methodology is applied.

Irrespective of the fact that the national declaration is audited by the SAIs or private audit firms, in both cases it may represent conclusive audit evidence. The ECA’s opinion on the legality and regularity of the underlying transactions is based on the
assessment of the internal controls, for the operation of which the national declaration provides evidence, not to mention the substantive testing. If an effective control system exists, the extent of substantive testing, in other words, the sample size, can be reduced, and thus the audited national declaration has a strong direct influence on the ECA’s audit. Nevertheless, the content of the national declaration has to be harmonized with the ABB clusters in order to maximise the gains.

This would mean the accountability of the Member States, and thereby the financial management of the EU finds may improve. Obviously, it is not only the question of a cost-benefit analysis of quantifiable and non-quantifiable gains, but requires political commitment at both the EU and the Member State levels.

Finally, the audited national declaration means not only the accountability of the Member States and a source of assurance the Commission and the ECA may rely on, but by making annual summaries and national declarations public in all Member States EU citizens would be assured that their money is managed in the best possible way.

**Thesis statement 2:**

A uniform methodology, developed by the European Court of Auditors for the purpose of auditing ‘national declarations’ the compulsory adaptation of which is explicitly included in the legal environment, supports the convergence process through reinforcing the legal environment.
4.4 The path towards convergence in the internal control system

Auditors in the framework of the supervisory and the control systems in the field of cohesion policy are audit authorities and Commission’s own ISA-based audit work. Other actors of the internal system are part of the control chain but do not carry out audit work but control activity. Consequently, there are two potential fields to enhance cooperation and reliance, and to increase efficiency, under the assumption that shortening the control chain may lead to more effective communication and faster active responses in the field of financial management. On the one hand, between the Commission and the national audit authorities, on the other hand, in the rest of the control chain (managing authority, intermediate bodies, certifying authority).

Figure 22. Auditors within the framework of the supervisory and control systems

There are some arguments that the Commission itself could take over the role of the audit authority, hence the control chain would be shortened. Consequently, time savings could be achieved since methodology transfer and extra communication between the Commission and the Member States would become unnecessary, as the Commission’s auditors would directly operate at national level on a permanent basis. However, as also argued in the context of external auditors, eliminating the audit authority from the system, and intensify the Commission’s audit activity instead is not
rational. Extracting audit licence from Member States could not represent the best alternative. In short, this part of the chain is not to be shortened.

Nevertheless, in exploring sources with which the Commission may gain an additional assurance, it is worthwhile examining what kind of management representations the existing financial reporting system includes. One may ask whether they share the characteristics, which make them appropriate audit evidence from which an audit assurance may be derived. Interpreting what ISA 580 contains on the written representation in the context of the EU:

- the annual report on the implementation of the operational programme, issued by the managing authority of the Member States on a yearly basis: it cannot be judged as a management representation, as there is no assurance statement provided;
- the previously mentioned annual summary can neither be seen as management representation, as the assurance statement is an optional part;
- the statement of expenditure covering all the operating programmes, issued by the certifying authority each time an interim payment is submitted to the Commission, cannot be regarded as a valuable management representation;
- the annual control reports, provided by the audit authority at national level every year, are not a source of assurance at Member States level, as the audit work of the Authority is supervised by the Commission itself.

At the EU level, the Commission’s synthesis report on the DGs’ achievement bears the features of management representation, providing additional assurance from the DGs’ Annual Activity Reports with an assurance statement. Consequently, an assurance gap can undoubtedly be perceived at Member States level, and the mandatory issuance of national declaration can be seen as a remedy for this. Arguments for the next step towards an even higher level of assurance, the audited national declaration, are made hereinafter as this subject strongly relates both to the evidence the ECA wishes to rely on, and to the cooperation between the ECA and SAIs of the Member States.
There are arguments that the control activity of the Certifying Authority could be taken over by the Audit Authority, which has all the expertise and an ISA based methodology. This would result in a shorter control chain, eliminating audit overlaps and achieving time savings; furthermore the activity of the Audit Authority would become more preventive due to an on-going monitoring of the system for certifying statements of expenditure to the European Commission and the ISA based methodology would spread at a lower level. Finally, if the fields where the activity of independent auditors (who are obliged to adhere to ISAs) is a necessary project-level requirement for the granting of EU funds were extended at national level, this could be regarded as a first level of audit to prevent errors from occurring.

**Thesis statement 3:**

If the audit assignments of the certifying authority were to be performed by the managing authority, audit efficiency would improve considerably.

Cohesion Policy under shared management is the most risky business of the EU where Member States bear distinct responsibility. To improve the financial management not more audits, but better coordinated audits become necessary, and thus the reliance on others’ work is unavoidable. In the internal control framework, the ISA-based reliance exists only between the Commission and the audit authority, while other parts of the system in the control chain build on the features of the single audit concept, but not according to the international standards. To shorten the control chain, the elimination of certifying authority has been proposed. Outside the internal control system, the ECA, the external auditor of EU finances, may take into account the SAIs or private auditors’ work, all strictly adhering to internationally accepted audit standards. The cooperation between the ECA and the SAIs will be strongly influenced by the decision as to who will be responsible for auditing the national declaration, if that becomes mandatory at all.
4.5 The potential in IT

One can hardly expect that with enhanced cooperation between audit and control functions, the problematic issues of increasing costs and material error can be tackled in the short term. What other possibilities are there to exploit the full potential of the current system? IT database is certainly one.

The increasing cost of controls and audits has been a cause of concern for a number of years. This subsection puts forward the idea of how the existing non-human resources (e.g. IT) could be better exploited without requiring additional financial resources. How could the IT systems add value to audit and control functions to make audits more efficient? How could the UMIS contribute to transparency in the utilization of EU funds and support the work of both external and internal auditors?

In fact, the degree of contribution greatly depends on the level of IT system integration and rights of access, thus several scenarios exist. *Level 1* represents the current situation where each Member State has its own management and control IT system, and auditors at EU level have no direct access to national systems. Consequently, data service, required by the Court or the Commission for audit purposes, is time-consuming, as, in the long information chain, it sometimes goes back too slowly to the developer of UMIS. The interviews with professionals of the Court revealed a perceptible time lag in data transfer, which has influence on the timing of audit visits to Member States. On the other hand, data transferred to EU auditors appears to be rather stocktaking in manner: it includes funds, which have been allocated to certain projects / programmes at a given time. Owing to the lack of access to core data, no further conclusions could be drawn from analysing changes in historical data recorded in the IT system, with respect to the overall functioning of the management and control systems.

*Level 2* suggests a more developed and coordinated system, built on a stronger exploitation of UMIS. In this scenario, the national IT systems remain unchanged but EU auditors have direct access to those systems. From the IT aspect, it could easily be solved and it is a cost-effective way of utilizing the existing sources.

In parallel, what kind of benefits could be achieved for auditors of funds of Cohesion policy? First, the direct access by the Court and the Commission to core data
stored in the UMIS would result in time savings due to the elimination of time-consuming data inquiries from the supreme audit institutions and audit authorities at national level. This is rather a technical point of view. More importantly, from the professional aspect, direct audit evidence could be gained for system assessments with respect to management and control systems operating in Member States. Unlike Level 1, either the database could be analysed or the control activity of the managing authorities or intermediate bodies could be examined. Hence, it would be possible to bring together additional information for system assessment, which greatly influences the extent of substantive testing.

The direct access to core database addresses the issue of transparency. Cipriani (2010) emphasises that financial correction often manifested in substitution of ineligible cost, and ‘Member States tend to over-declare national expenditure in order to create a buffer of eligible items’. Although the regulatory framework permits such substitutions, there is a considerable debate whether this practice is desirable and conforms to the original aim of Cohesion policy. In this field, the Court suggests some issues for consideration. First, ineligible expenditure might be systemic by nature, and if not addressed appropriately, it can be substituted by another ineligible one. Secondly, if the replacing expenditure has originally been financed by national funds, ‘cohesion spending is turned into ex post support for the budgets of Member States’ (ECA, 2012). The Commission’s view on substitution of ineligible expenditure is that Member States should have the right to make such changes to optimize the utilization of EU funds if deficiencies appear at national level.

In case of direct access to core database, auditors would have insights into the practice of substitution of ineligible expenditure by new expenditure, which would be an additional source of information when determining the outcomes of system assessment. At first sight, one can expect that difficulties may derive from the fact that auditors have to be familiarised with national IT systems. However, this obstacle can definitely be overcome; auditors frequently face the challenge of getting to know different IT systems and solutions in their day-to-day activities (e.g. computer-assisted audit techniques – CAATs).

To sum up, a slight change (direct access to core data) at IT level, though supported by professional arguments, opens up a more political point of view.
Finally, *level 3* represents the pinnacle of IT integration. At this stage, Member States use a unified IT system for recording and storing data of EU funds. The advantages of the previous level could be enumerated here as well. In addition, time savings could be reached deriving from not having to know the diversity of IT systems across the EU. From the aspect of auditing, this alternative is the most ‘convenient’ way of collecting data for system assessment and for sampling. To a large extent, the unified IT system at EU level is inevitably a politically sensitive question; it would require a political consensus at the highest level, embedded in EU legislation, and not *modus vivendi*.

<table>
<thead>
<tr>
<th>Characteristic of IT system</th>
<th>Degree of convergence</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
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<tr>
<td>National IT system for recording and storing core data</td>
<td><strong>Level 1</strong>&lt;br&gt;No access to national IT systems by EU auditors</td>
<td>- Right of access does not occur</td>
<td>- Time-lag in data transfer&lt;br&gt;- Lack of deep analysis of core data</td>
</tr>
<tr>
<td></td>
<td><strong>Level 2</strong>&lt;br&gt;Direct access to national IT systems by EU auditors</td>
<td>- Timesavings&lt;br&gt;- Additional audit evidence for system assessment&lt;br&gt;- Core data base analysis&lt;br&gt;- Higher level of transparency</td>
<td>- Tackling right of access&lt;br&gt;- Variety of IT system put in place by Member States</td>
</tr>
<tr>
<td>Unified IT system at EU level</td>
<td><strong>Level 3</strong>&lt;br&gt;Direct access to unified IT system by EU auditors</td>
<td>- Timesavings&lt;br&gt;- Easier data collection for system assessment and sampling</td>
<td>- Political sensitivity&lt;br&gt;- Additional regulation for the unified system</td>
</tr>
</tbody>
</table>

**Figure 23.** Scenarios of management and monitoring IT systems integration

A higher integration between IT systems at EU level would result in a more efficient audit system. As a first step, the right of access to core data stored in national databases opens up the possibility for auditors to draw conclusions on system assessment by the analysis of historical data. The increasing transparency over EU funds due to access to core data would shift Member States to a more efficient implementation of the budget that could result in a diminishing error rate. This is not to say that an even stronger cooperation between SAIs and the development of the internal control system is not worthwhile. It has to be emphasised that the IT aspect is only one of the building blocks of a complex system, which could help secure EU citizens’ interests in achieving the original goal of Cohesion policy.
Earlier I referred to the context of the shared management of EU funds, in Hungary the UMIS has been developed to store and synchronize all the core data for the European Regional Development Fund, the European Social Fund, and the Cohesion Fund. During the interviews\(^58\), a not wide, but perceptible, communication gap was perceived between what the UMIS developer has been told that the UMIS should be capable of and what its users can expect from it. To close this gap and exploit the potential in IT, an enhanced communication is strongly advised.

To conclude this part, the UMIS could contribute towards transparency in the utilization of EU funds and support the work of both external and internal auditors at EU level. The potential of the Court and the European Commission having direct access to data stored in the UMIS was also highlighted: time savings and additional direct audit evidence for system assessment.

\[\text{Thesis statement 4:}\]

\[\text{The audit efficiency would improve to a certain extent if EU (the European Court of Auditors, the European Commission) auditors were to have direct access to the core database.}\]

\(^{58}\) During my research I had the opportunity to interview qualified experts from the following bodies and Institutions: European Court of Auditors, State Audit Office of Hungary (SAI in Hungary), Directorate General for Audit of European Funds - DGAEF (Audit Authority in Hungary), National Development Agency - NDA (Managing Authority in Hungary), Welt 2000 Ltd. (Unified Monitoring Information System -IT background).
5 Conclusion

For years, the estimated error rate for Cohesion policy has been exceeding the one for the EU budget as a whole, which in the majority of cases has been caused by the breach of the procurement rules, and the reimbursement of ineligible costs. Deficiencies of the internal control systems at the national level have also been emphasized from time to time.

Meanwhile, the European Commission has made tremendous efforts to improve the quality of the chain based model of internal controls, resulting in increased control costs.

This quasi-contradiction raised the research question of how audit efficiency could be increased within the current institutional framework, and how coordination could be better implemented within the current frameworks of the internal control and external audit systems.

The sole improvement of coordination can hardly live up to expectations in this field, as it cannot improve efficiency in itself. Methodological convergence has to be achieved, which, built on the relevant international standards, allows auditors to rely on each other's work.

The original aim of annual summaries, first issued for the financial year of 2007, was to reinforce the accountability of Member States in the implementation of funds under shared management. However, impact analyses revealed that those mainly contained the minimum requirements but lacked overall evaluation in many cases; hence, the assurance deriving from those was rather limited. To improve accountability, the introduction of a managing authority statement on internal control has been strongly advised. Moreover, it was argued that the national declarations, the voluntary initiative of a few Member States, do not directly result in an improved financial management.

Lessons learnt show that there exists a variety of audit methodologies applied by SAIs across the Union. To promote the convergence in audit approaches across the European Union, the Contact Committee Working Group on Common Auditing

Moore Stephens LLP, 2011
Standards and Comparable Audit Criteria mapped the audit practices and enhanced the cooperation between SAI's, but the original goal of setting standards was not realised.

The Pilot Project on co-ordinated audit, concentrating on the examination of the legality and regularity with the DAS approach for agricultural expenditure, proved that due to divergence of methodology, auditors face some implementation challenges during different phases of audits.

During the interviews, a feeling of threat to independence was perceivable, due to the misinterpretation of what the ISA's include for the purpose of taking each other’s work into account, which reduces the chance of convergence even further.

Consequently, the voluntary convergence at the Member States level is not likely to occur uniformly, which is detrimental to the process of placing reliance on other’s work. For funds assigned to Cohesion policy, the precondition of methodological convergence is the determination of a point of reference.

The ECA’s 35-year old methodology has been highly influenced by both internal and external factors: the institutional evolution, the development in compliance with standards, and legal requirements. Being stable and able to adapt to changing environments, in addition to being committed to high standard audits, the audit methodology of the European Court of Auditors proved to be the appropriate point of reference.

The initiative of national declaration, issued by a few Member States, revealed the divergent practices with respect to, on the one hand, bearing the responsibility of budget implementation of EU funds, and on the other hand, applying approaches and methods in those countries that issue that sort of declaration. From an auditing aspect, the audited national declaration opens up the possibility for the European Court of Auditors to rely on the work of Member States’ SAI's, or alternatively independent audit firms, which in return may result in the improvement of audit efficiency. The audited national declaration (or any management representations) may constitute conclusive audit evidence for the ECA only if the underlying methodology is common. To achieve this assurance, in addition to common base and methodology, political intention is necessary between Member States and ECA. Audited national declarations have a potential use for the ECA’s work in shared management areas, and can be evaluated as other auditor’s work for DAS purposes in line with the International
Standards on Auditing. In the pursuit of a positive DAS, Member States could provide assurance by national declaration, or such type of management representation, for the money they have spent from the EU budget. It would improve financial management of EU funds in shared management on the one hand, and would allow the Member States to take responsibility for those funds on the other hand.

For private audit firms, the common methodology could be achieved through the introduction of a quality assurance system, in which private companies have to obtain a licence, issued by the European Court of Auditors, to audit ND. The privilege to hold a licence would mean that the uniform methodology is applied.

In general, the European Court of Auditors should have a dominant role, laying down a uniform framework for auditing national declarations that does not take away this audit task from the national level. Member States’ accountability increases with the introduction of audited national declarations and, due to methodological convergence, audit efficiency improves by taking the work of other auditors into account. In other words, a uniform methodology, developed by the European Court of Auditors for the purpose of auditing national declarations, the compulsory adaptation of which is explicitly included in the legal environment, supports the process of audit convergence.

Coming to the point of the internal control system, the methodologies of the parts in the internal control chain, except for the audit authority, are not ISA compliant. As a result, neither the audit authority nor the ECA are allowed to rely on their work from a professional point of view. However, to advance efficiency in the control chain, it would make sense to integrate the audit tasks of the certifying authority with the tasks of the managing authority. This amendment would eliminate the efficiency-deficit arising from uncoordinated audits, and the overlaps of audit overlaps would decrease.

For EU auditors, collecting core data from Member States is often quite complicated and may influence the efficiency of their audit activities. The possibility of direct access is more than simple time savings. From an auditing aspect, this would allow them to draw conclusions through the direct analysis of core data regarding the functioning of the internal control system.
The following figure captures the concept and summarises the proposed changes:

**Figure 24. The co-ordinated model of auditing funds assigned to Cohesion policy**

where:

- MS 1 …… MS ‘n’: Member States of the EU
- QAS: Quality Assurance System to ensure that national declarations (or any Member State-level management representation) are audited on a common methodology
- represents direct access to core data at national level

To conclude, as long as the underlying approach and methodology is not common, one can hardly expect improvement in the way different auditors rely on each other’s work, regardless of whether they are internal or external. In other words, the path towards a more coordinated audit model leads through methodological convergence.
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Websites:


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61. http://www.asz.hu/ (State Audit Office of Hungary)


## Appendix 1  The EU budget for 2012

<table>
<thead>
<tr>
<th>Heading</th>
<th>CA: Commitment appropriations</th>
<th>PA: Payments appropriations</th>
<th>% change from 2011</th>
<th>% of total budget</th>
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<td>6.9</td>
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<td>and justice</td>
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<td>3a. Freedom, security and justice</td>
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<td>Total</td>
<td>147.2</td>
<td>129.1</td>
<td>1.12</td>
<td>0.98</td>
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CA: commitment appropriations - PA: payments appropriations

source: http://ec.europa.eu/budget/figures/index_en.cfm
### Appendix 2 Draft of in-depth interviews

#### I. Interviewee

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<tr>
<td>- experience:</td>
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<td>- knowledge of relevant international standards</td>
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#### II. Methodology

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### IV. Problems and perspectives

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## Appendix 3  The EU budget allocated to CF, ERDF, and ESF (2007-2011)

### (EUR million)

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| TOTAL EXPENDITURE | 113 953.3 | 116 544.5 | 118 361.0 | 122 230.7 | 129 394.9 |
Appendix 4  Operational programmes for 2007-2013 in Hungary

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<td>Social Infrastructure OP</td>
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source: www.nfu.hu
### Appendix 5  Cohesion fund and Structural funds assigned to Hungary

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<td>Cohesion for growth and employment</td>
<td>1 304</td>
<td>4</td>
<td>1 189</td>
<td>3</td>
<td>2 174</td>
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<td>Structural funds</td>
<td>934</td>
<td>3</td>
<td>775</td>
<td>3</td>
<td>1 316</td>
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<td>1 427</td>
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<td>Cohesion Fund</td>
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<td>414</td>
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<td>12</td>
<td>658</td>
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*source: http://ec.europa.eu/budget/figures/interactive/index_en.cfm*
Appendix 6  Average fund per OPs in Hungary

The figure includes amounts exchanged at 278 HUF/EUR.

source: based on data available – www.emir.nfu.hu

average = total amount / number of projects
<table>
<thead>
<tr>
<th>OP</th>
<th>Distribution of Projects by OPs (Item)</th>
<th>Total Amount by OPs (HUF)</th>
<th>Average (HUF)</th>
<th>Average (EUR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Reform OP</td>
<td>431</td>
<td>26 914 510 839</td>
<td>62 446 661</td>
<td>224 628</td>
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<tr>
<td>South Great Plain OP</td>
<td>1436</td>
<td>178 427 396 362</td>
<td>124 253 062</td>
<td>446 953</td>
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<tr>
<td>South Transdanubia OP</td>
<td>841</td>
<td>169 774 311 552</td>
<td>201 871 952</td>
<td>726 158</td>
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<tr>
<td>North Great Plain OP</td>
<td>1650</td>
<td>214 496 898 711</td>
<td>129 998 120</td>
<td>467 619</td>
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<tr>
<td>Electronic Administration OP</td>
<td>67</td>
<td>79 761 838 794</td>
<td>1 190 475 206</td>
<td>4 282 285</td>
</tr>
<tr>
<td>North Hungary OP</td>
<td>1932</td>
<td>221 258 687 287</td>
<td>114 523 130</td>
<td>411 954</td>
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<tr>
<td>Economic Development OP</td>
<td>19041</td>
<td>530 246 179 609</td>
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<tr>
<td>Central Transdanubia OP</td>
<td>892</td>
<td>112 773 846 969</td>
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<td>454 777</td>
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<td>Environment and Energy OP</td>
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<td>363 032 438 524</td>
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<td>Transport OP</td>
<td>353</td>
<td>1 777 401 218 260</td>
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<td>923</td>
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<td>Social Renewal OP</td>
<td>8564</td>
<td>714 680 649 988</td>
<td>83 451 734</td>
<td>300 186</td>
</tr>
<tr>
<td>Social Infrastructure OP</td>
<td>1937</td>
<td>395 299 409 026</td>
<td>204 078 167</td>
<td>734 094</td>
</tr>
</tbody>
</table>
Appendix 7 Intermediate bodies in Hungary

### SECTORAL PROGRAMMES

<table>
<thead>
<tr>
<th>Sector OP</th>
<th>Organization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Development OP</td>
<td>MAG - Hungarian Economic Development Centre Ltd.</td>
</tr>
<tr>
<td>Social Renewal OP</td>
<td>ESZA Társadalmi Szolgáltató Nonprofit Kft. Wekerle Sándor Alapkezelő</td>
</tr>
<tr>
<td>Social Infrastructure OP</td>
<td>ESZA Társadalmi Szolgáltató Nonprofit Kft. Wekerle Sándor Alapkezelő</td>
</tr>
<tr>
<td>Environment and Energy OP</td>
<td>Environmental Development Directorate &quot;Energy Centre” Energy Efficiency, Environment and Energy Information Agency Non-Profit Company</td>
</tr>
<tr>
<td>Transport OP</td>
<td>KIKSZ - Közlekedésfejlesztési Zrt.</td>
</tr>
<tr>
<td>State Reform OP, Electronic Administration OP</td>
<td>VÁTI Nonprofit Kft.</td>
</tr>
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</table>

### REGIONAL PROGRAMMES

<table>
<thead>
<tr>
<th>Region OP</th>
<th>Organization</th>
</tr>
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<tbody>
<tr>
<td>West Pannon OP</td>
<td>Nyugat- dunántúli Regionális Fejlesztési Ügynökség Kht. VÁTI West Pannon Regional Office Sopron</td>
</tr>
<tr>
<td>Central Transdanubia OP</td>
<td>Közép- Dunántúli Regionális Fejlesztési Ügynökség Kht VÁTI Central Transdanubia Regional Office Székesfehérvár</td>
</tr>
<tr>
<td>South Transdanubia OP</td>
<td>Dél-Dunántúli Regionális Fejlesztési Ügynökség VÁTI South Transdanubia Regional Office Pécs</td>
</tr>
<tr>
<td>Central Hungary OP</td>
<td>MAG - Hungarian Economic Development Centre Ltd. Pro Régió Közép-Magyarországi Regionális Fejlesztési és Szolgáltató Kht</td>
</tr>
<tr>
<td>South Great Plain OP</td>
<td>DARFU Dél-alföldi Regionális Fejlesztési Ügynökség Kht. VÁTI Regional Office Szeged</td>
</tr>
<tr>
<td>North Great Plain OP</td>
<td>ÉARFU Észak-Alföldi Regionális Fejlesztési Ügynökség Nonprofit Kft. VÁTI North Great Plain Regional Office Debrecen</td>
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<tr>
<td>North Hungary OP</td>
<td>Észak- Magyarországi Regionális Fejlesztési Ügynökség Kht. VÁTI North Hungary Regional Office Miskolc</td>
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60 Gov. decree 4/2011