



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

PhD Theses

by

**Judit Fortvingler**

Ph.D. Supervisor: Dr. Agnes Laab

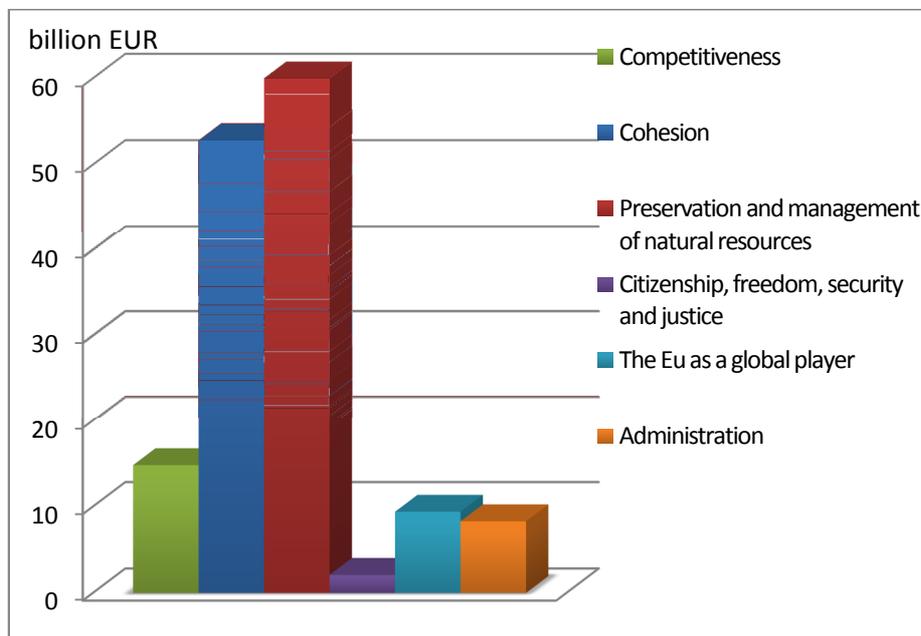
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## Table of contents

1	Background and Context .....	3
2	Scope and Objectives .....	5
3	Research methodology .....	7
4	Achievements .....	9
5	Overview of Dissertation .....	15
6	Literature .....	16

# 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.



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

source: [www.ec.europa.eu](http://www.ec.europa.eu)

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?**

## 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.

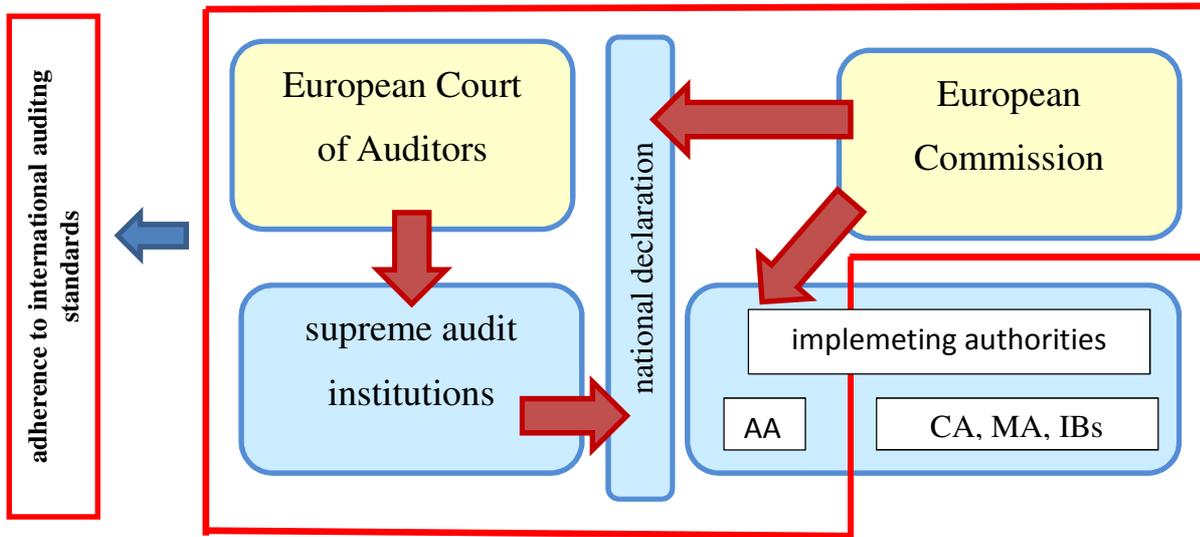
Consequently, I am examining the actors of the internal control and external audit systems from the aspect of whether they apply the International Standards on Auditing. From an auditor's point of view, the reliance on each other's work cannot be realised in the case of actors who do not perform their 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:



**Figure 2. The actors of the internal control and external audit systems**

where:

- AA - audit authority, MA - managing authority, CA - certifying authority, IBs - intermediate bodies
-  : the potential direction along which the utilisation of the audit work of others could arise
-  : national level
-  : EU level

### 3 Research methodology

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.

## 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.**

## 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.

## 6 Literature

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