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Court of Auditors

2004/C 107/01

Opinion No 2/2004 of the Court of Auditors of the European Communities on the 'single audit' model (and a proposal for a Community internal control framework)

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I

(Information)

COURT OF AUDITORS

OPINION No 2/2004

of the Court of Auditors of the European Communities on the 'single audit' model (and a proposal for a Community internal control framework)

(2004/C 107/01)

THE COURT OF AUDITORS OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular Article 248(4), second subparagraph, thereof,

Having regard to the request of the European Parliament in paragraph 48 of its decision of 10 April 2002 concerning discharge in respect of the implementation of the general budget of the European Union for the 2000 financial year (Commission), for the Court to provide an opinion on the feasibility of introducing a single audit model applicable to the European Union budget in which each level of control builds on the preceding one, with a view to reducing the burden on the auditee and enhancing the quality of audit activities, but without undermining the independence of the audit bodies concerned,

Whereas the Commission was requested to prepare a report on the same subject by the same decision, but has not yet done so;

Whereas the Court's Opinion is intended as a contribution to the Community institutions' reflections, but does not pre-empt the Court's right to provide further opinions in accordance with Article 248(4) of the Treaty;

Whereas Article 274 of the Treaty establishing the European Community makes the Commission responsible for the implementation of the budget having regard to the principles of sound financial management, and requires the Member States to cooperate with the Commission to ensure that the appropriations are used in accordance with these principles;

Whereas the Commission's responsibility to implement the budget is subject to different methods, governed by Article 53 of Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities ⁽¹⁾;

Whereas there is no single recognised definition of 'single audit';

Whereas there is a need for efficient and effective internal control over the European Union budget;

Whereas there has been significant progress in improving internal control systems, but there still remains scope for further improving their design by establishing clear and consistent objectives, ensuring effective coordination, providing information on costs and benefits and ensuring a consistent application of requirements;

Whereas internal control systems covering European Union revenue and expenditure should provide reasonable assurance that revenue and expenditure is raised and spent in accordance with the legal provisions and managed so as to achieve value for money;

Whereas the European Court of Auditors is the external auditor of the European Union and therefore not an element of internal control;

Whereas international auditing standards, issued namely by the International Federation of Accountants and INTOSAI, provide a framework for the relation between external audit and internal control, as well as using the work of other auditors;

⁽¹⁾ OJ L 248, 16.9.2002.

In view of the observations and conclusions on the preparatory work supporting the Opinion set out in the attached document 'Information supporting the Opinion No 2/2004 on the "single audit" model (and a proposal for a Community internal control framework)',

HAS ADOPTED THE FOLLOWING OPINION:

I. In order to ensure effective and efficient internal control of EU funds, a Community internal control framework should be developed containing common principles and standards, to be used as a basis for developing new or existing control systems at all levels of administration.

II. Controls should be applied to a common standard and coordinated to avoid unnecessary duplication. The overall cost of controls should be in proportion to the overall benefits they bring in both monetary and political terms.

III. Controls should be applied, documented and reported in an open and transparent way, allowing the results to be used and relied upon by all parts of the system. The 'owner' of the checks should be the European Union, not the individual control organisations.

IV. To allow controls to be effective and efficient, legislation underlying policy and processes should be clear and unambiguous, and avoid unnecessary complexity.

V. Internal control systems should have, at their basis, a chain of control procedures, with each level having specific defined objectives which take into account the work of the others. Claims of expenditure or costs over a certain threshold should be accompanied by an independent audit certificate and report, based on common standards of approach and content.

VI. The Commission should define the minimum requirements for internal control systems whilst taking into account the specific characteristics of the different budgetary areas. Systems in each area should be accompanied by a coordinated information approach to ensure beneficiaries are clearly aware of the objectives and consequences of being checked.

VII. The internal control systems should include mechanisms to ensure that weaknesses in the systems themselves, as well as errors and irregularities in transactions, are identified and corrected, and where necessary, recoveries made.

VIII. Internal control systems require an appropriate balance between the cost of controlling a particular budgetary area and the benefits the checks bring in terms of limiting the risk of loss and irregularity to an acceptable level.

IX. The Commission should be responsible for promoting the improvement in internal control systems in partnership with Member States. The Council and Parliament should be responsible for approving the cost/benefit balance for the different budgetary areas.

X. Clearly defined standards and objectives of internal control systems would provide an objective basis against which the Court could assess their design and operation when auditing them.

XI. Many of the proposed principles and standards are either fully, or partially, in place, whilst others will need to be developed and introduced. Changes will be needed in legislation and work practices that will require considerable commitment from both the European institutions and the Member States.

This Opinion was adopted by the Court of Auditors in Luxembourg at its meeting of 18 March 2004.

For the Court of Auditors

Juan Manuel FABRA VALLÉS

President

**INFORMATION SUPPORTING THE COURT OF AUDITOR'S OPINION No 2/2004 ON THE
'SINGLE AUDIT' MODEL (AND A PROPOSAL FOR A COMMUNITY INTERNAL CONTROL
FRAMEWORK)**

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INTRODUCTION

1. In March 2002 the European Parliament expressed its wish for the Commission to prepare a report on the feasibility of introducing a single audit model applicable to the European Union budget in which 'each level of control builds on the preceding one, with a view to reducing the burden on the auditee and enhancing the quality of audit activities, but without undermining the independence of the audit bodies concerned'. Parliament also asked the Court to prepare an opinion on the same subject ⁽¹⁾.

2. Partly because there is no agreed definition of single audit, and partly because where it is applied the concept is relatively restrictive in scope, this Opinion has been prepared from the wider perspective of the whole process of internal control and external audit over the EU budget ⁽²⁾.

3. The Court has underlined in its reports the need to improve control of the EU budget in order to arrive at efficient and effective systems of internal control of EU revenue and expenditure. The Opinion puts forward the idea of a Community internal control framework (CICF), establishing a rational framework for developing new or existing internal control systems based on common principles and standards. The Opinion is intended as a contribution to the Community institutions' reflections, but does not pre-empt the Court's right to provide further opinions in accordance with Article 248(4) of the Treaty.

4. In preparing its Opinion, the Court:

- analysed the current internal control arrangements over the European Union budget; and
- identified the broad principles that might be embodied in a CICF.

In addition, the Court analysed similar concepts applied elsewhere, and identified points which could be applicable to the EU context (see Annex I).

5. The Opinion concentrates on the aspects of internal control systems which assure the legality and regularity of revenue and expenditure, and not those concerned with ensuring effectiveness or value for money ⁽³⁾.

CURRENT CONTROL FRAMEWORK

6. The European Union is a unique organisation due to its political and legal context, scale and complexity. Management of the budget involves the European institutions and Member States (and beneficiary countries outside the Union), and is complicated by the large number and varied nature of the schemes, the millions of beneficiaries, and the involvement of many different bodies in Member States, often representing different administrative cultures.

7. Oversight and control of the EU budget involves not just the Commission, the Court and the other Community institutions, but also national parliaments and audit institutions (see Diagram I). As this Opinion concentrates on internal control and external audit within the immediate Community environment, the role of these other bodies is not considered in detail.

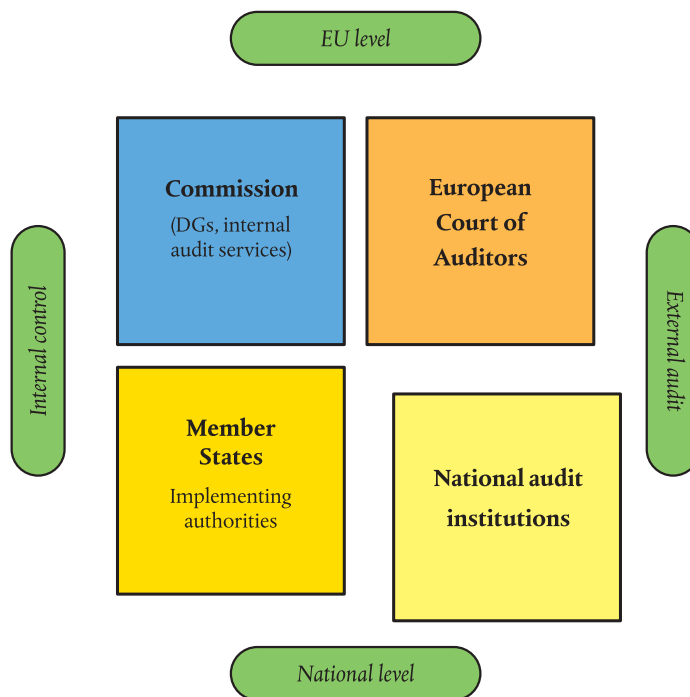
⁽¹⁾ Paragraph 48 of Parliament discharge decision on the 2000 financial year (OJ L 158, 17.6.2002).

⁽²⁾ Similar considerations apply to the internal control of the European Development Funds.

⁽³⁾ Value-for-money aspects of management generally differ significantly from legality and regularity, and the approach to internal control differs accordingly. For example, high-level considerations such as the overall conception and management of expenditure schemes by the Commission and Member States are important, as well as implementation aspects such as project-selection procedures and tendering procedures.

Diagram I

Overview of internal control and external audit of the EU budget

**Internal control**

8. The *Commission* is responsible, in cooperation with Member States, for the implementation of the budget ⁽¹⁾, and therefore for developing and implementing effective control systems to provide assurance that financial management is sound. Over 80 % of the EU budget is managed in partnership with *Member or beneficiary* ⁽²⁾ States. Partnership means that while the Commission retains overall responsibility for the budget, the Member (or beneficiary) States are responsible for the day-to-day administration and control of these schemes, following rules established by the Union. Administration involves the identification and selection of beneficiaries, and making payments thereto. The remainder of the budget ('internal policies', directly managed elements of 'external actions' ⁽³⁾ and administration) is managed directly by the Commission, including the selection of, and payments to, beneficiaries or suppliers.

9. The Commission has an *internal audit function* which helps management ensure that its procedures are being followed and its objectives met. The internal audit service (IAS) is a central service that undertakes audits on issues concerning both the institution as a whole and individual areas of interest, and provides technical support to internal audit capabilities in directorates-general.

10. The Commission is organised in *directorates-general* (DGs) that are responsible for implementing specific policy areas and the corresponding parts of the EU budget. Operational units check and approve payments before they are made. Control units make *ex post* checks that expenditure is being implemented correctly both within the Commission and in Member States, and internal audit capabilities help the management of the DG ensure that internal controls are operating effectively.

11. The administration of the budget is complex. Areas of *shared management* comprise many administrative layers, starting with the Commission services, passing through different combinations of Member State central, regional and local administrations (or agricultural paying agencies) down to the payment of EU aid to individual beneficiaries. The different layers have different roles and responsibilities, but the overall objective is the same: to make payments from the EU budget to final beneficiaries. The various intermediate levels are subject to controls by various bodies including Commission services, local or national audit bodies, internal audit services of the organisations concerned, government departments and certifying bodies.

⁽¹⁾ Article 274 of the EC Treaty states 'Member States shall cooperate with the Commission to ensure that appropriations are used in accordance with the principles of sound financial management'.

⁽²⁾ Countries outside the Union which are beneficiaries of the Community budget.

⁽³⁾ The management of external actions, which comprises aid to developing countries, is currently undergoing a decentralisation of management from central Commission services to its delegations in third countries.

12. For legality and regularity of transactions, the key part of the process is at the *boundary* where payments pass to final beneficiaries. If payments are made to beneficiaries who have made incorrect claims or who do not comply with the related criteria, then the errors will persist within the system unless identified and corrected by subsequent controls.

13. Detailed information on internal control arrangements in specific budgetary areas is provided in Annex II.

External audit

14. The *European Court of Auditors* is the external audit body of the European Union and therefore not an element of internal control. The Court is responsible for providing independent oversight of the financial management of EU funds and reports to the budgetary authority (European Parliament and Council). It assesses how the Commission has discharged its functions for the orderly management of the budget. During its work the Court checks that the financial statements are complete and accurate, transactions are legal and regular and funds have been soundly managed. The Court pays particular attention to evaluating control systems and making recommendations for corrective action.

15. Each *Member State* has a national audit institution (NAI) responsible for the independent external audit of their respective state budgets. Although the NAIs have no formal role in the internal control⁽¹⁾ or external audit of the EU budget, the Treaty requires them to cooperate with the Court in undertaking its duties. Whilst most NAIs do not audit EU funds directly, they are often responsible for auditing the national funds co-financing EU-funded projects. In addition, Member State administrations often have control units and internal audit departments who may undertake checking of the use of EU funds or national co-financing.

Current strengths and weaknesses

16. The effectiveness of the systems of administration and control over EU revenue and expenditure — in terms of design and/or implementation — has been a cause of concern for a number of years. The Court has, since it was set up, identified many instances of poor or inexistent control, exacerbated by EU expenditure programmes of high inherent risk of error, leading to errors and irregularities, or inefficient or ineffective use of funds.

17. Whilst significant progress in improving systems has been made recently, the quality of systems nevertheless remains variable. There is no overall vision or coordination of the many and varied systems, including no mechanism to ensure that improvements made to one system are taken into account for the improvement of the others.

18. For own resources and the areas of shared management (agriculture, structural measures, pre-accession aid), the systems differ in conception and implementation, and many aspects are left to the discretion of Member States. Even when systems are judged as relatively satisfactory, such as the integrated administrative and control systems (IACS) covering much of agricultural expenditure, the Court notes instances where improvements are necessary⁽²⁾.

Unclear and inconsistent objectives

19. The current internal control frameworks over the different budgetary areas have evolved in a piecemeal fashion, at different times, and with little evidence of coordination by the Commission⁽³⁾. There is no clearly established strategy leading to overall or specific objectives for the various systems (e.g. what they are intended to achieve), which makes it difficult to establish systems to the required quality, define the level of resources required, judge the results they give and provide a baseline for subsequent audit.

20. For example, without clear objectives it could be interpreted that the purpose of internal control systems is to guarantee or assure the complete legality and regularity of all transactions. This is unrealistic, due to the disproportionate cost of undertaking detailed on-the-spot checks imposed by the nature of the expenditure (e.g. information provided by the beneficiary) and the large number of geographically dispersed payments.

21. Both agriculture and structural measures are subject to control systems defined by regulation. The crux of both of these systems is the intensity of checking at the final beneficiary level, as this is where the majority of errors occur. A similar level of checking is required by the legislation in both areas, but there is no evidence of the basis on which this was agreed.

⁽¹⁾ In some cases the NAIs have chosen to take on the function of certifying body for agricultural paying agencies, which is a specific task done within the remit of internal control of the EU budget.

⁽²⁾ Court's Annual Report for the financial year 2002, Chapter 4, Annex II (OJ C 286, 28.11.2003).

⁽³⁾ Such as through the identification and promulgation of best practice.

Lack of coordination

22. Checks on EU revenue and expenditure arise from a number of different sources: the Treaty which gives the Commission overall responsibility for implementing the budget, in cooperation with Member States, the Financial Regulation which governs how EU funds are to be administered, decisions by the European Parliament and Council, specific Council and Commission regulations for particular budget areas and national rules and practices in Member States.

23. There is no formal requirement for control bodies to coordinate the planning of these checks, or to take into account the checks made by the others. With insufficient coordination there is a risk that resources are not used in the most effective way. There is a possibility that different control functions undertake the same work resulting in wasted effort, undue burden on the auditee and a poor image of the management of EU funds. Certain categories of expenditure may fall outside any effective control remit. Information provided by Member States on the results of checks is sometimes inadequate or inconsistent ⁽¹⁾.

No information on costs and benefits

24. In the areas of shared management (representing over 80 % of expenditure) the majority of the costs of undertaking controls are borne by Member or beneficiary States. However, the benefit of these controls accrues to the EU budget, and therefore only indirectly to the Member State itself. This results in little incentive for Member States to devote sufficient resources to controlling EU funds, and explains why the Commission needed to resort to defining the type and intensity of control procedures in regulation.

25. As no system can reasonably be expected to assure absolute correctness of all transactions, the extent and intensity of checking should make an appropriate balance between the overall cost of operating those checks and the overall benefits they bring ⁽²⁾. The benefit can be considered in terms of reducing or containing the incidence of error, irregularity and ineffective use of funds, as well as other considerations, such as the EU budget being seen by the citizens of the Union as well managed.

26. Within the current framework, no information is currently available on the cost of controls borne by either Member States or the Commission, or on the benefit they bring. Furthermore, the fact that much of the cost is borne by the Member States, but the benefit accrues to the EU budget, results in a lack of transparency and makes it difficult to manage the balance between the two.

Inconsistent application

27. The detailed checks of underlying transactions are required by the regulatory control frameworks covering agriculture and structural measures to be undertaken on both a risk and random basis. However, these two approaches have very different and mutually exclusive objectives (see paragraph 48), and, when insufficiently defined in the rules, result in confusion and reduced effectiveness ⁽³⁾. Even when the rules are clearly defined, the Court's audit work identifies problems of implementation ⁽⁴⁾.

28. Both the Commission and the Member States have a high level of decentralisation of control procedures, but in practice there is not always consistency on basic matters such as approach, extent, timing, coverage, margins and follow-up. As a result, there are differences between the quality of the checks ⁽⁵⁾.

29. Independent audits of expenditure claims or cost statements are used in some areas of the budget. The terms of reference setting out how the work is to be undertaken and reported are sometimes inadequate ⁽⁶⁾. Furthermore, there are not always standard procedures for the selection of the auditors ⁽⁷⁾.

⁽³⁾ Court Special Report No 10/2001, paragraph 20 (OJ C 314, 8.11.2001).

⁽⁴⁾ For example see paragraph 4.51 of the Court's Annual Report for the financial year 2002.

⁽⁵⁾ For example see paragraphs 4.27 and 5.32 of the Court's Annual Report for the financial year 2002.

⁽⁶⁾ Court's Annual Report for the financial year 2002, paragraphs 7.24, 7.27 and 8.11; Court Special Report No 1/2004, paragraphs 44 and 45 (OJ C 99, 23.4.2004); Court Special Report No 11/2003, paragraphs 76 and 77 (OJ C 292, 2.12.2003); Court's Annual Report for the financial year 2001, paragraphs 3.57 and 3.58 (OJ C 295, 28.11.2002).

⁽⁷⁾ Court's Annual Report for the financial year 2002, paragraphs 7.24 and 7.25.

⁽¹⁾ Court's Annual Report for the financial year 2002, paragraph 4.23.

⁽²⁾ The requirement for IACS checks to be increased over the regulatory minimum when a certain level of error is detected illustrates the need for the balance between cost and benefits to take into account the different inherent risks of the various budgetary areas.

30. Publicity about checks varies between different schemes and Member States, and beneficiaries often have little perception of the possibility of being checked or its consequences. This reduces the deterrent effect of the system. Penalties to deter beneficiaries from making incorrect applications are used within agricultural expenditure, and in internal policies starting with the Sixth Framework Programme for Research and Technological Development (RTD) ⁽¹⁾, but not in the other budgetary areas ⁽²⁾.

Impact of Commission's administrative reform

31. The Commission's wide-ranging administrative reform programme ⁽³⁾ is focused on implementing improvements in management in general, and financial management in particular. The key principles of the reform are simplification, decentralisation and the assumption of greater responsibility by department heads ⁽⁴⁾. A central internal audit service has been created together with internal audit capabilities within each directorate-general. A revised Financial Regulation has been issued and fundamental accounting reform is ongoing.

32. Along with these measures, significant efforts have been made to improve the systems of internal control within the Commission, taking into account the extent and quality of the control procedures themselves as well as instilling a control culture throughout the organisation. This process has been centred on a set of 24 internal control standards ⁽⁵⁾ intended to provide a framework for the control environment and internal control systems. The standards are general in nature and are only applicable at Commission level.

33. Key elements of the reform process in terms of the control framework are the annual activity reports and director-general declarations, produced since 2001 for each directorate-general. These include a self-assessment about the implementation of the internal control standards, and are intended to provide reasonable assurance that the control procedures put in place give the necessary guarantees concerning the legality and regularity of the underlying transactions and resources have been used for their intended purpose. The Court has found when examining the first two years of this procedure that while directors-general are mostly

in a position to arrive at an opinion on the systems within the Commission, they are unable to do so for systems in Member States in areas of shared management ⁽⁶⁾. Furthermore, the Commission has experienced difficulties in employing staff with the necessary financial experience, and instilling an adequate control culture within the organisation ⁽⁷⁾.

CHARACTERISTICS OF AN EFFECTIVE AND EFFICIENT INTERNAL CONTROL FRAMEWORK FOR THE EUROPEAN UNION

34. In order that the citizens of the Union have assurance that the European Union budget is subject to effective and efficient internal control, the Court proposes the development of a Community internal control framework for developing new and existing internal control systems ⁽⁸⁾, based on common concepts aiming for a transparent and optimum use of resources.

Objectives

35. *It is essential that the objectives of internal control systems are clearly and comprehensively defined and disseminated. General objectives will be common to all internal control systems, whereas more detailed objectives will depend on the characteristics of the particular area. The objectives should define: the scope (the budgetary area); the purpose (legality and regularity, and/or sound financial management ⁽⁹⁾); those involved (the levels of administration from the Commission through to those paying the final recipients); what it comprises (control procedures based on common principles and standards); to what end (to ensure a cost-effective control over the area); with what constraints (that zero risk of irregularity is neither realistic nor economic); to what extent (type and intensity of checking set by an acceptable balance between cost and benefit); and how (open and transparent, exchange of information, control chain).*

36. *The internal control systems should actively contribute to improving the management of the EU budget by including safeguards that remedial action is taken and recoveries made. Control procedures are only effective at improving financial management if complete and timely corrective action is taken on errors in transactions and weaknesses in the systems themselves.*

⁽¹⁾ Court Special Report No 1/2004, paragraph 43.

⁽²⁾ With no penalties, and interest only payable from the date of the recovery order, beneficiaries required to repay Community aid benefit from interest-free funds. This increases the risk of irregular claims.

⁽³⁾ COM(2000) 200.

⁽⁴⁾ Rules governing expenditure have been simplified, making them easier to administer, and the centralisation of the *ex ante* financial control authorisation has been replaced by those authorising expenditure and payments becoming responsible for their actions.

⁽⁵⁾ SEC(2001) 2037/4 sets out the internal control standards which were inspired by the COSO (see glossary) framework. An important element of this framework is that it recognises that internal controls provide reasonable, and not absolute, assurance on the reliability of financial statements, the legality and regularity of transactions and the soundness of financial management.

⁽⁶⁾ Court's Annual Report for the financial year 2002, paragraph 1.97.

⁽⁷⁾ Court's Annual Report for the financial year 2002, paragraph 0.8.

⁽⁸⁾ The CICF relates to internal control over the Community budget, even if some of the procedures may be called audits, and are undertaken by auditors (e.g. the audit of cost claims by independent auditors — see paragraph 43).

⁽⁹⁾ See paragraph 5.

Conditions

37. *Controls should be undertaken in an open and transparent way, allowing the results to be used and relied upon by all parts of the system. The 'owner' of the checks should be the European Union, not the individual control organisations.* Controls should be undertaken to an adequate standard, and the work done, results and supporting documents made available for quality review. This is a basic requirement for an effective chain system, and emphasises the Community nature of the systems, rather than the work of individual control units or organisations.

38. *For the internal control systems to be effective and efficient, legislation underlying policy and processes should be clear and unambiguous and sufficient to secure the proper use of funds, but not unnecessarily complex.* The purpose of controls over legality and regularity is to ensure that rules and regulations covering EU revenue and expenditure are complied with. The rules and regulations should minimise the scope for differing interpretations and not impose requirements that cannot be subsequently verified by controllers or auditors. The more demanding and difficult the requirements are, the greater is the risk that they will not be followed either by design or accident. Well designed rules and regulations contribute to the achievement of the policy objectives set, decrease the risk of error, simplify the controls required and reduce the number and cost of controls necessary for a defined level of 'acceptable risk'. Furthermore, legislation should include an incentive for beneficiaries to make accurate claims by strengthening penalties and sanctions and extending their use to all areas of the budget.

Structure

39. *In order to optimise the use of resources the internal control systems should have, as their basis, an effective chain of controls operating to common standards, with each level having specific defined objectives which take into account the work of the others.* Within Member States someone should be responsible for providing assurance that the control work undertaken at the local level is to the required standard and quality, and thereby allows reliance to be placed on that work ⁽¹⁾. The Commission supervisory level should ensure that

Member State levels are operating effectively and as intended. An example of a chain-based model is given in Annex III.

40. The structure of individual systems will need to take into account the specific characteristics of the budgetary area and Member State organisations. However, all systems and structures should follow the common concepts of checks undertaken to a consistent minimum standard, reliance on checks done by other levels, transparency and availability of results and appropriate balance between costs and benefits.

41. The internal control systems should recognise that a key part of the system is the controls that apply at the level of the beneficiary and provide evidence on the physical existence and accuracy of underlying actions and costs. For expenditure, payments are made to final beneficiaries based on compliance with a number of conditions which can be physical (e.g. numbers, sizes, amounts) or monetary (costs incurred). The critical aspect for checking the legality and regularity of the transactions is the existence and accuracy of the conditions declared by beneficiaries, many of which can only be verified by physical inspection at the final beneficiary level.

42. The internal control systems should recognise the difficulties of compensating for ineffective control at the final beneficiary level with checks undertaken at a more central level. For example, a review of a list of claims by a central ministry is unlikely to identify all material errors caused by inaccurate or misleading claims. Some may be identified through the use of desk checks based on data, although many can only be discovered on the spot. The key to a soundly managed system is therefore through effective primary on-the-spot checks when the payment is made, and secondary controls also directed at this level. The cost of checking claims in detail on-the-spot is often relatively high compared to the value of the average payment, but the overall effectiveness of control procedures is largely proportional to the number of checks done at this level.

43. *Claims for reimbursement of expenditure or costs over a defined threshold should be accompanied by an audit certificate established by an independent external auditor or, in the case of public bodies, by a competent public officer.* Beneficiaries should be required to provide a certificate attesting to the reality, accuracy and compliance with relevant rules and regulations of cost claims ⁽²⁾. Audit certificates should be used for all claims, or periodic sequences of claims, by a beneficiary, over a certain threshold. The threshold should be specific to the different intervention mechanisms and be defined by the Commission based on cost and benefit considerations.

⁽¹⁾ Examples of organisations in the current systems which perform this function include: specific departments established in each Member State to coordinate, monitor and report on the checks required by Council Regulation (EEC) No 4045/89 (OJ L 388, 30.12.1989) as last amended by Council Regulation (EC) No 2154/2002 (OJ L 328, 5.12.2002); certifying authorities in each Member State for each Structural Fund intervention established by Council Regulation (EC) No 1260/1999 (OJ L 161, 26.6.1999).

⁽²⁾ As currently applied in the internal policies area for the Sixth RTD Framework Programme.

44. Management of the process needs to take into account the fact that the auditors are selected, engaged and paid by the beneficiary, but report to the Commission either directly or indirectly (i.e. through Member States). The scope and extent of the audit work as well as minimal requirements for materiality and confidence levels, documentation of audit testing, form and content of audit report and right of access to working papers should be defined and standardised.

Application

45. *The Commission should define the minimum requirements for control systems at all levels within the process, which take into account the specific characteristics of the different budgetary areas.* This will require an analysis and common definition of the basic building-block components of systems and control procedures. For the legality and regularity of transactions, aspects to be taken into account include administrative checks, segregation of duties, record keeping, checking of input, control accounts, reconciliations and on-the-spot checks.

46. *Control procedures should be implemented to an adequate common standard, and the work done and results documented in a common format and recorded in a database with access for others in the control chain as a basis for placing reliance.* An efficient system requires that checks on transactions and systems are undertaken to adequate common standards of method, coverage and quality no matter who undertakes them, and at whatever location. Controls to a common standard should allow reliance to be placed by central-level controllers on controls undertaken by others in the control chain.

47. The common standard should be applied through the use of a common approach to documenting, evidencing and reporting all aspects of the process including: reason for selection of the transaction or system; objective of the checks; description of the checks undertaken; supporting documentation; results; reaction of controllee; and follow-up. This information should be maintained in central databases, with access available to all participants in the control process subject to appropriate security safeguards.

48. *Control systems should use sampling for clearly defined purposes: risk-based samples should be used to identify and correct irregularities; representative sampling should be used to confirm the effectiveness of the systems.* Sampling is a widely used technique for auditing large populations of transactions, particularly when the auditor wishes to estimate characteristics such as the average level of irregularity. Sampling recognises that resources are not available to audit (or control) every item and can be applied at a number of different levels, including the selection of transactions within a population, and the selection of items for detailed audit within a

transaction. Sampling can be split into two main categories — risk-based and representative — with different objectives and purposes.

49. *The internal control systems should be accompanied by an effective and coordinated information approach.* The more beneficiaries are aware of the existence of an effective system of controls and its consequences, the greater the efforts they may make to ensure that claims are legal and regular. Information should be provided to all beneficiaries on the control system in a coordinated and coherent way, emphasising the common Community purpose of the checks rather than the bodies undertaking them.

Costs and benefits

50. *The type and intensity of checking within internal control systems would be set with reference to the cost and benefits.* Any control system is a trade-off between the cost of operating the defined intensity of checks on the one hand, and the benefit these procedures bring on the other. In the Community context the benefit involves reducing the risk that funds are wasted and containing the risk of error to a tolerable level. It is likely that the level of tolerable error or irregularity would vary between different budgetary areas, depending on both the cost of controls as well as the inherent risk of transactions containing errors or irregularities.

51. In practical terms the tolerable risk of error would be defined together with the intensity of checking at the final beneficiary level considered necessary to achieve this result ⁽¹⁾. The results of the checking would be monitored and the intensity of the checks adjusted accordingly for the following year or period. In practice it is highly unlikely that the desired cost/benefit balance would be achieved immediately, but would require fine-tuning over a number of years taking into account information on costs, and the results and effectiveness of different types and intensities of checking.

52. *The system should record information on the cost of operating controls as well as the benefit in terms of the residual risk of irregularity.* The cost of controls should be relatively easy to define and the introduction of activity-based management will facilitate the provision of this information at the Commission. An accurate estimate of costs incurred by Member States is likely to be more difficult to obtain. One alternative would be for the cost of the checks to be financed by the EU budget, thus allowing the costs to be known and provide an adequate degree of transparency in the process.

⁽¹⁾ For example, the tolerable risk could be set by reference to an acceptable error rate and the intensity of checking, defined in terms of the proportion of transactions necessary to be checked to reach that level of residual risk.

53. One way of measuring and monitoring the *benefit* of the control procedures would be through random representative sampling to estimate the residual level of illegality and irregularity, in order to compare it with the tolerable risk set for the area.

Roles and responsibilities

54. *The Commission should be responsible for promoting the improvement in internal control systems in partnership with Member States, and subsequently providing assurance that they are operating effectively.* The Commission would be required to define the common characteristics of the systems for the different budgetary areas and to take appropriate measures to monitor the cost of controls and evaluate the benefits they bring.

55. *The budgetary authorities (Parliament and Council) should be responsible for approving the cost/benefit balance for the different policy areas.* The trade-off between the costs of controls against the benefits they bring is a critical aspect of control strategy, and should be open and transparent. Given its key importance, the desired balance should be approved by the political authorities of the Union, based on a detailed proposal of the Commission, taking into consideration the costs to be devoted to checking revenue and expenditure, and the risks to be tolerated. It is likely that different budgetary areas will be subject to different levels of balance, based on the type and risks of the transactions concerned.

56. *The Court of Auditors, as the EU's external auditor, audits the internal control systems.* International auditing standards require auditors to assess the reliability of internal control when determining the approach and extent of testing ⁽¹⁾, and cover the process of making use of the work of other auditors ⁽²⁾. This latter aspect requires the other auditor's work to have been undertaken to an acceptable professional standard and be available for review and scrutiny. Clearly defined standards and objectives of internal control systems would provide an objective basis against which the Court could assess their design and operation when auditing them, thereby increasing the effectiveness of its work.

CONCLUSION

57. The Court encourages the establishment of coherent and comprehensive systems of internal controls over the EU budget, based on a logical framework using common principles and standards (Community internal control framework) to be applied at all levels of administration in the institutions and Member States alike. The Court considers that the internal controls should provide reasonable assurance on the legality and regularity of transactions, and compliance with the principles of economy, efficiency and effectiveness. The cost of the controls should be in proportion to the benefits they bring in both monetary and political terms. The system should be based around a logical chain structure where controls are undertaken, recorded and reported to a common standard, allowing reliance to be placed on them by all participants. Many of the building blocks for implementing such a framework are fully or partially in place in the current systems, whereas others would need to be introduced.

58. The existence of an efficient and effective system of internal controls over EU revenue and expenditure would be significant in helping the Court in fulfil its role of external auditor of the European Union, as conferred on it by the Treaty. By placing reliance on well developed and implemented control systems the Court will be able to make the best use of its own resources and so improve the accomplishment of its tasks.

59. The EU budget is a complex instrument, involving many different aspects and layers of administration. To define and implement a system of common controls will demand considerable commitment from both the European institutions and Member and beneficiary States. It will require the active participation of all parties involved in the financial control of the EU budget, changes in both legislation and work practices, and a level of openness and transparency over the management of the EU budget not yet achieved. By working together to ensure an efficient and effective control of the EU budget, the institutions and Member States of the European Union would demonstrate their commitment to a common purpose for the benefit of the citizens.

⁽¹⁾ INTOSAI auditing standard 3.3.1

⁽²⁾ International Standard on Auditing 600 issued by the International Federation of Accountants (IFAC).

GLOSSARY OF TERMS AND CONCEPTS

Control procedures: Those procedures which check or verify that transactions or systems are accurate and comply with the necessary rules and regulations. Controls may be *administrative* (e.g. on the coherence and apparent accuracy of claims) or *on-the-spot* (e.g. on the physical reality of the costs or aspects claimed).

COSO: Committee of Sponsoring Organisations of the Treadway Commission — a voluntary private-sector organisation established by professional accounting and audit bodies dedicated to improving the quality of financial reporting through business ethics, effective internal controls and corporate governance. See www.coso.org.

Direct management: Where the Commission is solely responsible for the management, administration and control of certain areas of the EU budget.

External audit: An independent oversight of financial management of an organisation which reports to stakeholders on the completeness and accuracy of financial statements and produces objective reports on aspects of management. The European Court of Auditors is the external auditor of the European Union.

Indirect or shared management: Where the Commission is responsible for the management, administration and control of areas of the EU budget in partnership with Member States.

Internal audit: An independent function within an organisation which helps management ensure that systems are in place and working effectively. Internal audit is part of internal control.

Internal control: The whole system of financial and other controls, including the organisational structure, methods, procedures and internal audit, established by management to assist in conducting the business of the entity in a regular, economic, efficient and effective manner, ensuring adherence to management policies, safeguarding assets and resources, securing the accuracy and completeness of accounting records and producing timely and reliable financial and management information.

Internal control system: A system of control procedures established by management in order to prevent or detect and correct errors and irregularities and ensure that the entities' objectives are met.

INTOSAI: International Organisation of Supreme Audit Institutions — an international and independent body which aims at promoting the exchange of ideas and experience between supreme audit institutions in the sphere of public control. See www.intosai.org.

National audit institution (NAI): The public body of a State which reports to the national parliament and provides an independent external audit of the State budget.

Random representative sampling: Statistically based sampling technique designed to provide an estimate of a given characteristic of a population of transactions, such as the average level of irregularity. The technique is not appropriate for identifying and correcting individual errors, although it can be used to identify areas of particular risk.

Regulatory controls: Those control systems and procedures established by regulation.

Reliance on controls: A concept by which an auditor or controller relies on the work of other auditors or controllers in arriving at an opinion. The auditor or controller must obtain evidence that the work of the other has been undertaken to an adequate standard.

Risk analysis: Technique used to identify transactions that are likely to contain errors.

Risk-based sampling: Samples based on risk analysis.

System: A collection of management, administrative and/or control procedures and processes applied in an organised and uniform manner to a defined class of transactions or budgetary area.

ANNEX I

SINGLE AUDIT IN THE USA AND THE NETHERLANDS

The term (and concept) 'single audit' is used in the United States of America (the Single Audit Act), and the Netherlands (single audit approach). This Annex provides an overview of both of these examples and identifies parallels that can be drawn with the European Union context.

United States of America

Around one sixth (or USD 300 billion) of the United States *federal budget* is expended by non-federal (and non-State) organisations. Such organisations may receive multiple grants for different subjects. In the past this resulted in a number of audits of the same organisation, sometimes overlapping in time, and often covering the same material. This inflated the overall audit cost and placed an unnecessary burden on auditees. The Single Audit Act of 1984 tackled the problem by providing that only one audit need be undertaken on the organisation as a whole (e.g. its annual financial statements) — replacing the need for individual audits of individual funds — and established uniform audit standards.

'Single audit is intended to provide a cost-effective audit of NFEs [non-Federal entities]. Efficiencies can be considerable when an organization-wide, or single audit, is conducted in lieu of multiple audits of individual Federal programs. The parties involved in the audit process know beforehand what is expected and what the products of the audit will be. Furthermore, repeated exposures to a structured audit process promote discipline in an auditee's accounting practices.'

The auditor provides an opinion as to whether the auditee's financial statements are presented fairly, thus providing a tool to assess the financial condition of the auditee.

A risk-based audit approach assures audit coverage to high-dollar, high-risk Federal programs and provides opportunities for the auditing of small-dollar, high-risk programs.'

'Single audit reports are not intended to provide detailed audit coverage of all the Federal awards or provide detailed financial information for individual awards. To do so would be cost prohibitive.' ⁽¹⁾

Characteristics of the application of the US single audit are:

- A single audit is required for a recipient organisation which expends more than USD 300 000 in a financial year. Organisations with annual expenditure of less than this threshold are required to make their records available for review or audit.
- Recipient organisations are required to maintain effective internal controls and comply with all applicable rules and regulations.
- It is the recipient organisation's responsibility to arrange for an audit (including selection of auditor), ensure it is properly completed, submit the report when required and take corrective action on audit findings.
- The cost of the single audit is funded by the federal grant.
- The audit is conducted in accordance with Government auditing standards and the auditor must: (i) provide an opinion on the financial statements and schedule of expenditure of the federal grant; (ii) gain an understanding of the internal controls over federal programmes and test them; and (iii) provide an opinion on compliance with programme requirements.

⁽¹⁾ Extract from 'Highlights of the Single Audit Process' of October 2001, produced by the Grants Management Committee of the Chief Financial Officers Council.

- Upon receipt of the Single Audit Report the federal awarding agency has six months to issue a management decision on each audit finding. This specifies the corrective action needed including repayment of funds. The auditee has the right to appeal.
- To ensure that single audits are carried out to the required standard, the workpapers can be subject to a quality-control review by federal agencies.

In terms of relevance to the European Union context the following should be noted:

- The US structure is simpler than that of the Union. Federal departments deal directly with the implementing organisations, making a much flatter management and control structure (no real 'cascade'). Single audit is therefore more restricted and easier to define and operate, as no intermediary organisations are involved.
- The US approach includes no common standards on the *internal controls* to be applied, although examination of these is an integral part of the single auditor's remit. The scale (in terms of number of beneficiaries and relatively low value of claims) in the EU context requires specific consideration of this aspect.
- There is no specific consideration made of the work of *internal auditors* (other than presumably an evaluation of their place within the internal control structure as a whole).
- For much of the EU budget (e.g. agriculture) there are many *more individual beneficiaries*, very few of which will receive significant grants. For Structural Funds there are more individually significant beneficiaries, although not many manage multiple grants.
- The US experience is more akin to the EU *directly managed expenditure*. The use of a standardised audit approach and particularly standard reporting document would be of specific interest, as would the system of 'management decision'.
- *Selection* of auditor by the auditee introduces an element of risk (underqualified or insufficiently independent auditors), although this risk can be managed by comprehensive terms of reference, detailed reporting and the review of working papers.
- The particular attention paid to *corrective action* indicates the positive and dynamic nature of the process.
- *Funding* of the audit through the federal grant significantly adds to the transparency and control over the process.

The Netherlands

The definition and application of single audit within the Netherlands is somewhat different and rather more wide-ranging than in the US. The first phase concerned the audit of Government ministries by the external auditor, the Netherlands Court of Audit (NCOA). This involved reliance by the NCOA on the work of the internal auditors of the ministries, having first set up common standards and guidance for their operation. The second phase covers a lower level within the control chain whereby the ministry auditors rely on the work of the auditors of local authorities over the use of Government funds managed by them. The ministry issues terms of reference indicating the issues the regional or local auditor should cover in his/her opinion.

The *first phase* was introduced as part of a wide-ranging improvement in the quality of financial control and audit of ministries, including the implementation of an adequate system of internal control procedures. The central audit service of the Ministry of Finance played a key role in monitoring the ministries and regularly informing the Parliament about the progress made. Because of political pressure and thanks to the support of the NCOA, it was possible to bring about considerable improvements. The improvements included provision of timely and efficient information flows and adequate compatible computerised accounting and information systems. Particular attention was paid to establishing strong and effective internal audit units in each ministry and the requirement to provide an annual audit opinion was formalised. The opinions are based on financial audits, which themselves are based on risk analysis. Internal audit standards were established and promulgated which were compatible with the standards of the NCOA. And the NCOA established standards for the review of the work of the internal audit department.

The *second phase* concerned the lower tier of public financial management in the Netherlands, namely regional and local authorities. These organisations have their own accountability structures, including local audit and discharge procedures. The aspect concerning single audit was the central government funds managed by these bodies, such as specific-purpose grants which represent around 20 % of the national budget. The previous arrangement was for audit certificates to be obtained for all grants; however, as for the US experience, this resulted in a multitude of uncoordinated reporting and audit requirements by the various ministries responsible for the various grants, with the associated burden on the auditees.

A Cabinet decision of 1989 set the *objectives* of the Dutch single audit policy on lower-tier levels as follows:

- streamlining of audit activities,
- establishing efficient and effective information flows,
- obtaining a sufficient view about legality/regularity and effectiveness of financial management for shared management tasks,
- removing the impediments to decentralisation and deregulation.

Single audit at this level revolves around the need for the local authority or other body to produce only one set of financial statements annually, and for the audit certificate provided on these financial statements to include a verification of the compliance of the central government grants with the respective obligations. The audit at the lower level is done in a way to also meet the requirements of those at a higher level.

An important finding and result of single audit in the Netherlands was to highlight the need for *legislation* governing the use of national funds that is coherent, practical and applicable. Compliance with inadequate or inappropriate legislation cannot be audited effectively, whether through single audit or otherwise. As such the single audit had a corresponding effect of stimulating an improvement in the clarity, effectiveness and relevance of legislation. A further recent development has been the move towards financial statements that concentrate on achievement of policy objectives and performance indicators, in addition to presenting basic financial accounting data.

In terms of *relevance* to the European Union context the following should be noted:

- The single audit concept is just that — an audit concept — and, as such, doesn't directly cover the definition and application of control procedures.
- The administrative structure is somewhat more complex than for the USA, although less so than for EU revenue and expenditure.
- The Dutch single audit concept places the Dutch NCOA above and outside the process. The NCOA has taken effective steps for reviewing the work of other auditors in terms of reliance.
- Implementing the Dutch single audit has not been a quick or easy process, despite being introduced in a relatively small national context.

The Dutch single audit concept requires considerable responsibility and workload to be placed on the internal audit capabilities of the ministries, and the availability of sufficient resources to perform the corresponding tasks.

ANNEX II

INTERNAL CONTROL ARRANGEMENTS IN THE DIFFERENT AREAS OF THE EU BUDGET

Own resources are the revenues by which the EU budget is financed. Over 80 % of own resources derives from GNP and VAT bases involving monthly transfers from Member States. The remainder of own resources represent customs duties and agricultural and sugar levies. These are collected by Member State administrations (e.g. customs) who are required to operate appropriate controls to ensure completeness and accuracy of collection. The Commission DGs operate supervisory controls to check that Member States are meeting their obligations. The joint audit arrangement (JAA) has been developed within the traditional own resources field since 1994, and covers cooperation between the Commission and internal audit functions in the majority of Member States. The JAA has resulted in the preparation of common audit plans and tools, with particular emphasis on assessing the adequacy of control systems covering the identification and payment of own resources. Three Member States (Austria, Denmark and the Netherlands) have fully adopted this methodology, involving the internal audit service of the national customs authority undertaking audit procedures agreed between itself and the Commission. *The cost of the checks is borne by the Member State. 25 % of customs duties collected are retained by Member State administrations.*

Agricultural expenditure, with payments of 43 521 million euro in 2002, represents over 50 % of EU expenditure. The expenditure involves many millions of relatively small payments to millions of individual farmers through a wide range of schemes. Payments are made by paying agencies, established and financed by Member States following rules established by the Commission. Paying agencies are subject to an independent audit each year by a certifying body, which certifies whether the financial claims to the Commission are accurate, and if the required control systems are in place and the necessary checks have been carried out. The paying agencies are required to undertake a number of checks within the integrated administrative and control system (IACS) which covers the payments based on declared area or numbers of animals. IACS comprises both administrative checks of claims and on-the-spot inspections of beneficiaries. Expenditure not subject to IACS, such as production and processing aid and export refunds, is subject to checks ⁽¹⁾ by a Member State coordinating body based on risk analysis and subject to the monetary amounts involved. *The cost of the checks is borne by the Member State.*

Structural measures expenditure, with payments of 23 499 million euro in 2002, represents 28 % of EU expenditure. The expenditure involves payments for eligible projects within the framework of operational programmes, and often involves reimbursement of costs to public bodies engaged in construction or training projects. The expenditure is managed by Member State administrations (managing and paying authorities ⁽²⁾) that select projects and make payments to beneficiaries. Member States are responsible in the first instance for ensuring the financial control of EU expenditure. In the second half of the 1990s the Commission issued a regulation ⁽³⁾ defining the administrative and control requirements on structural measures expenditure in order to address criticisms about the quality of management. These introduced the requirement for an independent body to provide a closure statement on the accuracy and legality and regularity of expenditure presented to the Commission for reimbursement. Such statements are largely based on an inspection of a defined value (5 %) of underlying expenditure intended to verify the effectiveness of the management and control systems, as well as the transactions themselves. In November 2002 the Commission made a proposal to the Structural Funds Technical Group entitled '*Contrat de confiance*'. The *contrat de confiance* does not add new regulatory requirements but is based on effective coordination of EU and national controls, the presentation by the Member States of an adequate control strategy and provision of annual reports detailing the results of control activities. As a counterparty the Member States are promised less checking by the Commission. *The cost of the checks is borne by the Member State.*

Pre-accession aid is the other budgetary area which is largely co-managed with the beneficiary States. Expenditure, which totalled 1 752 million euro in 2002, is aimed at helping the countries prepare for accession to the Union, and comprises three main funds — Sapard, which relates to rural development, and Phare and ISPA which concern structural development. The expenditure finances investment projects as well as institution-building measures such as twinning, and is undertaken by agencies within the countries concerned which are homologated by the Commission. *The cost of the checks is borne by the Member State.*

⁽¹⁾ Council Regulation (EEC) No 4045/89 (OJ L 388, 30.12.1989), as last amended by Regulation (EC) No 2154/2002 (OJ L 328, 5.12.2002).

⁽²⁾ Article 9 of Council Regulation (EC) No 1260/1999 (OJ L 161, 26.6.1999).

⁽³⁾ Commission Regulation (EC) No 2064/1997, superseded by Commission Regulation (EC) No 438/2001 (OJ L 63, 3.3.2001).

For expenditure in the field of '**internal policies**' the Commission partly reimburses costs incurred by private or public legal entities participating in Community actions. Payments in 2002 amounted to 6 567 million euro. The co-financing takes place through the reimbursement of eligible expenditure or costs incurred and substantiated by the final beneficiary. The Commission makes financial and non-financial checks, including *ex post* financial audits, at the level of the final beneficiary. For the RTD framework programmes, which represent over half of internal policies expenditure, the Commission mandates independent auditors to carry out part of these audits on its behalf, based on standardised guidelines. In 1999 the Commission set the objective to audit 10 % of contractors participating in the RTD framework programmes for the Fifth Framework Programme (1998-2002). From the Sixth Framework Programme (2002-2006) the financial statements for indirect RTD actions have to be accompanied by an audit certificate certifying the eligibility and reality of the costs claimed. However, the Commission remains responsible for assessing whether these costs were necessary for undertaking the action. *The cost of providing audit certificates is considered an eligible cost and, up to a certain ceiling, is fully reimbursed by the EU.*

External actions are directly managed by the Commission and comprise payments made to finance eligible development aid projects outside the Union, mostly in the developing world. Payments in 2002 amounted to 4 424 million euro. In the context of decentralisation, much of the expenditure is increasingly managed by the Commission delegations that are responsible for making payments and checking projects. Other expenditure is channelled through NGOs and some expenditure is paid directly by the Commission central services (who also perform checks). Some projects are subject to independent audit of the expenditure declarations. *The cost of the controls is borne by the EU budget.*

Administrative expenditure is for the running of the EU institutions and is managed directly by the Commission (or other institution involved). The expenditure, some 5 212 million euro in 2002, largely comprises payment of salaries and other staff costs, as well as accommodation costs. The expenditure is checked by the institutions' services involved, *and the cost is borne by the EU budget.*

ANNEX III

EXAMPLE OF A CHAIN-BASED CONTROL MODEL FOR SHARED MANAGEMENT EXPENDITURE

This example shows how a chain-based control model could be applied to shared management expenditure. The structures would need to be adapted to specific budgetary areas and Member State organisational structures.

Primary controls would be those undertaken by the paying organisation on the grant application or claim (local level). They generally comprise administrative checks, together with checks of reality on the spot for claims considered at risk.

Secondary controls would also be undertaken at a local level, but by a functionally separate control unit or organisation, and would obtain evidence that the primary systems and controls are operating effectively, and then undertake risk-based checking of transactions in line with the tolerable risk.

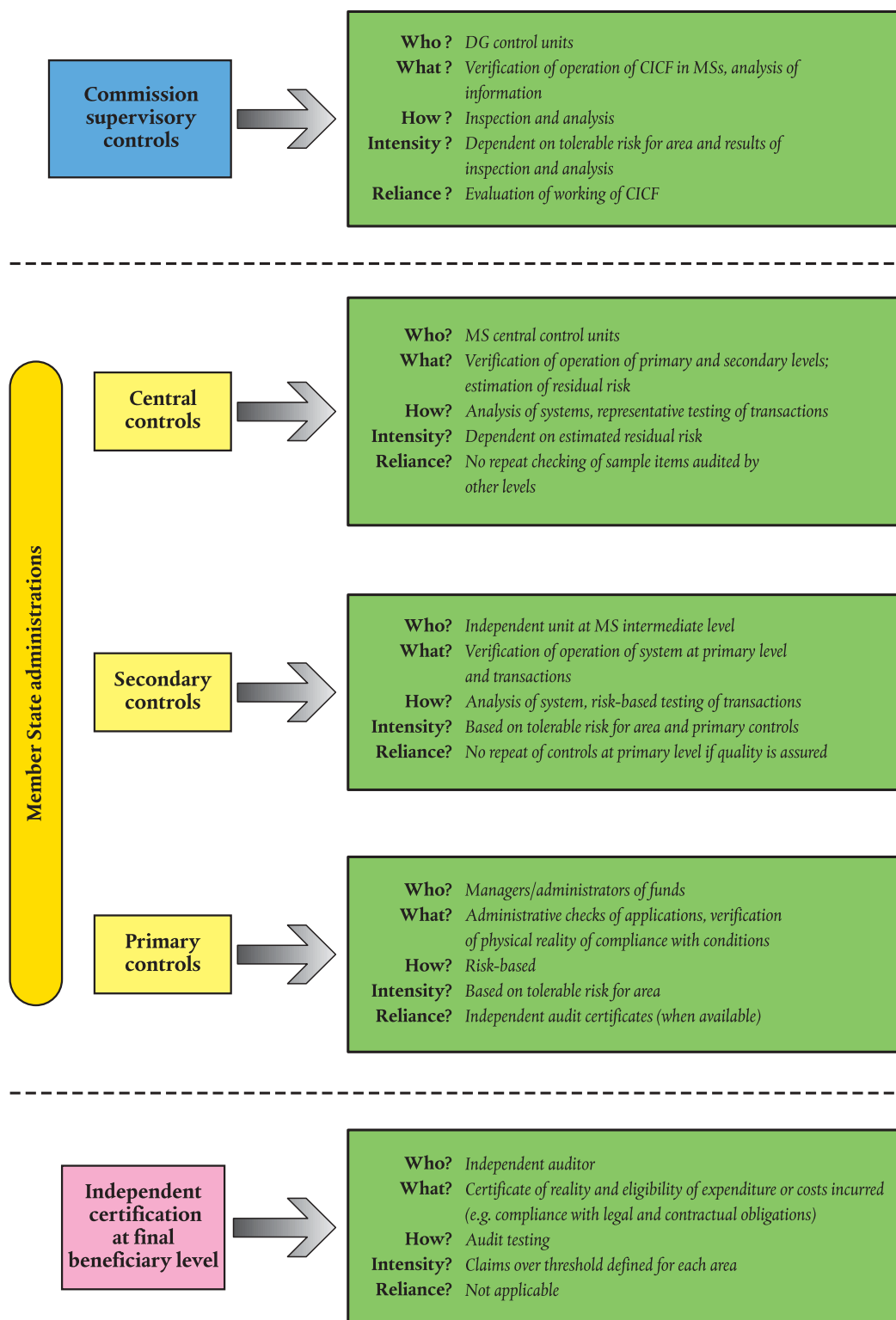
Central controls would be undertaken by Member State central or regional level and would examine the operation of the primary and secondary controls, and undertake testing of a representative sample of transactions to estimate the residual level of risk in the population.

Commission **supervisory** controls would oversee the process in the Member State to ensure that it was being implemented correctly and monitor the cost/benefit balance.

See diagrams II and III.

Diagram II

CICF: internal control levels for chain-based model



NB: Structure to be adapted to needs of specific budgetary areas and Member State organisation.

Diagram III

CICF: overview of responsibilities and tasks

