**Institut Européen des Hautes Etudes International**

# The Auditing Mechanism and Working Procedures of the Financial Aids in the European Union

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# INTRODUCTION

Historically by the creation of the Marshall Plan, the idea of aid was created by the United States of America which was not devastated in World War II when compared to the European countries. After the Marshall Plan was decided to transfer funds from the United States through the countries of Europe, it was the first attempt to boost growth and stability which targeted the regimes of European countries against Union of Soviet Socialist Republics (USSR). The Plan amounted on average to around 3% of the beneficiary countries' GDP during the 1949-1952 periods. Although a large portion went directly to consumption needs to bandage the injuries of war, private and public investments were primary targets of the Plan. More importantly, the Marshall Plan leaded to provisions on *national co-financing* by beneficiary governments: For every dollar of Marshall Plan aid received, the beneficiary country was required to take a position with the matching amount of domestic currency in a counterpart fund to be used only for purposes approved by the United States government.

"Stimulating growth in poorer countries has been the primary goal of aid policy since World War II. However, despite earlier optimistic expectations on the growth impact of aid within the governments of European countries, the success of aid programs among beneficiaries has been unsatisfactory because of the system: few countries have managed to experience large growth rates and increase their productivity, while in most cases aid has failed to boost growth rates in recipient countries"[1] which was foreseen by the economists. The Marshall Plan will be the exemplary for the aid programs of the future. Meanwhile, in 1951 the European Coal and Steel Community (ECSC) was founded (*Treaty of Paris*), by France, West Germany, Italy, Belgium, Luxembourg and the Netherlands to control the steel and coal resources of its member states. Steel had played an important part in armaments production in World War II and was a fundamental resource of the western European states. The aim was therefore a common program of post war production and consumption of steel and coal. The project was also intended to show some cooperation and reconciliation between France and Germany in the aftermath of the war. There was a desire to unite the countries of Europe by controlling steel and coal which were fundamental resources to war industries. The European Coal and Steel Community was the fulfillment of a plan developed by a French economist Jean Monnet, publicized by the French foreign minister Robert Schuman. It was the first step through a united Europe also strongly supported by the United States[2]. The words in quotation mark could explain the idea behind the ECSC clearly.

"Through the consolidation of basic production and the institution of a new High Authority, whose decisions will bind France, Germany and the other countries that join; this proposal represents the first concrete step towards a European federation, imperative for the preservation of peace."[3]

In the following years the same member states tried to build a common defense and political union, European Defense Community (EDC) and European Political Community (EPC) but failed because it was too early for a united Europe, so six founding member states tried again in building an economic union which has succeeded this time. The European Economic

[1] Mosley P., J. Hudson and S. Horrell, 1987, 'Aid, the public sector and the market in less developed countries', *Economic Journal*, 97, 387, 616-641

[2] Winston Churchill gave a speech at the University of Zurich on September 19, 1946 calling for a "United States of Europe", similar to the United States of America

[3] The Schuman Declaration of 9 may 1950; the proposal on the creation of an organised Europe

Community (ECC) brought in four new perspectives among themselves in terms of establishing a custom union between each other: “the four freedoms” which are free movement of capital, goods, services and people and the European Atomic Energy Community (Euratom) which aimed to control the non-military nuclear resources of the states. This union established by the Treaty of Rome of 1957 and entered into force in January 1, 1958 and called European Community (EC). These Communities which gathered under the name of the European Community turned into the European Union. The steps through this metamorphosis obtained by two processes: deepening, structural evolution and institutional changes within the supranational level, and widening, enlargement of the European Community, the number of member states. The growth was foreseeable when two processes were applied correctly and the European Union was established by the successive step of these processes.

After the construction of the European Union the idea of “*enlargement*” gained importance among the member states. The increased numbers of member states will give Europe, its own voice and authority in the global arena. However the enlargement procedure was not easy for every country in Europe, there are criterias and conditions to implement to get a full membership and not all the candidate countries were enthusiastic about the reconstruction. The Phare programme was established in 1989 to encourage the applicant countries and assist them in terms of economic reconstruction and political changes. The programme started its activities and successively expended from Poland and Hungary to eight new countries; Czech Republic, Estonia, Latvia, Lithuania, Slovakia, Bulgaria and Romania. Especially, the new member countries, which receive financial aid from the European Union through the Structural Funds to enhance convergence with more developed European Union member states. They have basically aimed to achieve a growth in terms of income expansion. Although the growth rates of these countries are reaching higher ratios than the average European Union growth rate, managing a convergence through European Union financial assistance is a high priority target for both recipient and donor European Union countries. Hence the income in these countries is substantially smaller than the average European Union income; an additional resource will affect the growth rates artificially. The Copenhagen Council influenced the programme in two ways the first one is in 1993, shifting the flow of the resources, and in 1997 the focus of the aid programme entirely changed to an instrument of pre-accession. Although the range of the programme where Central and Eastern European countries is beneficiary did not change, the support of the infrastructural investment gained an importance. Mainly the aid has been leaning over the public investment and is often implemented according to a co-financing model where the beneficiary country co-finances the investment project by use of domestic resources. This mechanism is considered to act as a motivation device in some cases, where information about the selection and monitoring of projects provokes the typical moral hazard situation. As a result an internal control units and auditing system created by the European Union to prevent fraud. Although the creation of the institution was reaching the date of 1975; European Court of Auditors, was appointed the enlargement cases when the need of controlling and auditing occurred. The liaison offices were built to obtain the association within the ECA and the Supreme Audit Institutions (National Audit Offices) / (SAIs) of the countries. After strengthening the bond within the national authorities and European Union institutions, now the Union is ready for creating new types of funds and programs in accordance with the requirements of the countries (i.e., such as SAPARD structural funds for agriculture). As the paper includes the European Union funds the example of SAPARD is given in terms of the efficiency of the funds.

The paper is structured as follows; the first chapter expresses the European Union budget in a view of financial perspectives of 2007 -2013 which is a proposal for carrying European Union into the future, and also the budget procedures; in terms of transferring the resources in national

budgets, identifying the resources and the expenditure for budget which forms the assets/liabilities relation. Afterwards the budget auditing will be observed which is a crucial aspect in terms of DAS; conducted by the European Court of Auditors and the aspects of the budget in central and eastern European countries. In order to underline the importance of the implementing agencies, the projects and the entire procurement process will be observed.

Chapter two, expresses the European Union aid programs. The mechanism of pre-accession instruments will be analysed in details of commitment and transfer of funds, implementation structures in candidate countries and finally the monitoring and evaluation of the financial assistance. Also organisational coordination of the existing instances of the Union are discussed. Contracting, procurement (tender) awarding process and their assessment in terms of technical, financial and composite evaluation is treated in this chapter.

The last chapter treats the auditing in the European Union with its institutions and mechanisms. Especially examines the working procedure of these financial controls in terms of aid programs.

Finally the last pages express the future of auditing structure in European Union and some newly discussed thoughts concerning these establishments and aid efficiency.

# 1. THE BUDGET AND FINANCIAL PERSPECTIVE OF EUROPEAN UNION FUNDS IN CANDIDATE COUNTRIES

## 1.1. Instruments of the Future: "Financial Perspective 2007-2013" in European Union

The period of 2000-2006 financial perspective was agreed in 1999 and the next one is for the period 2007-2013 was agreed in July 2004, taking into accounts the possible impact of a future enlargement of the budget. Some changes were set out in the framework for a new and simplified political and administrative structure for the delivery of the Community's assistance and cooperation programs. Only four of these six instruments are new, two already existed before, and do not needed any further modification. Therefore this communication renewed by four new legal instruments needed to put the new frameworks and structure into effect. These new instruments are: Instrument for Pre-Accession Assistance, European Neighborhood and Partnership instrument, Development Cooperation and Economic Cooperation instrument, and instrument for stability. In this context the instrument for pre-accession assistance will be focused.

Enlargement has given the European Union with even greater responsibilities in the field of external actions. These responsibilities channeled towards *three main objectives*:

a) providing stability and development by the assistance of aids and grants while the new candidate countries taking their first steps towards the Union,
b) ensuring strategic and civilian security in and outside the Union with the initiatives of a global player and,
c) prosperity in its neighborhood

These ambitious goals will give a chance to express and provide a stronger voice for the European Union which is supported by more efficient tools.

The European Union is with more than 450 million inhabitants and a quarter of world production, and as one of the biggest aid donor in the world. The Union of 25 and which will soon 27 members could manipulate or influence the political and economic choices in the global arena. However this potential is waiting to be discovered. There is a *gap between the European Union's economic weight and its political power*. This costs Europe in the field of external relations, whether in politically or financially, the world is growing with a crooked way and this is testing the Union's abilities to act or react in the events happening around us like war in Iraq or energy prices in globe. More examples can be given in the sense that the Union did not do much about, but the cost is numerous. By the 2007 – 2013 agenda the ideas will be transformed into actions. The Union will provide a common voice into the international scene and will use it to promote a real common strategy if the agenda succeeds also the citizens are into it. This could be proven by the strong demand from citizens for more Europe on the international scene even where the Community's policies are not currently in the lead. It should strengthen its capacity to make global governance more effective, to promote sustainable development and political stability through its multilateral and bilateral policies.

In the beginning the European Union must improve its capacity to outline substantial external policies by overcoming the division into pillars that contradicts the reliability of its action; it also has to make sure that, once adopted, these policies are supported by all the resources of Community and national instruments, subject to their respective decision-making procedures. Enlargement is a good example where action at the Community level is the rational way to express its opinion. The Union intervention which is focused on helping candidate countries to fulfill accession criterias and to prepare for the management of European Union funds is a clear action of the European Union. This policy covers the candidate countries (*Turkey and Croatia*) and the potential candidate countries (*the Western Balkans*) and is driven by the accession and pre-accession framework, namely the Strategy Papers, Regular Reports, the European and Accession Partnerships and the negotiations. The instrument for Pre-Accession will replace a range of existing instruments (*PHARE, ISPA, SAPARD, CARDS etc*.) and will cover Institution Building, Regional and Cross-border cooperation, Regional Development, Rural Development and Human Resources Development and will address the need for a flexible approach in order to accommodate new priorities quickly. Beneficiary countries will be divided into two categories, depending on their status as either candidate countries or potential candidate countries (as recognised by the Council). Potential candidate countries will continue to receive assistance within the lines currently specified in the CARDS Regulation: Institution Building and Democratisation, Economic and Social Development, Regional and Cross-Border Co-operation and some alignment with the acquis communautaire, in particular where this is in the mutual interest of the European Union and the beneficiary countries. Candidate countries will receive the same kind of assistance but will additionally receive assistance aimed at

a) helping countries to fulfill the political, economic and all acquis related criterias for the membership in the accession criterias and to build up administrative and judicial capacity for its implementation;
b) helping countries prepare for European Union Structural, Cohesion and Rural Development Funds (European Union Funds) after accession both by preparing the necessary structures and systems and by financing projects

## 1.2. The European Budget

The development of the European Union's budgeting system has been the result of a long, difficult and at times noisy process; the result forms a set of rules and procedures that differs in many respects from that found in the budgeting systems of other organisations, national or multinational. The origin of the system can be traced back to 1951 the year in which the European Coal and Steel Community (ECSC) was created by the six States that initiated the process of European integration: Germany, France, Italy, Belgium, the Netherlands and Luxembourg. Until 1970, this system, which had been preserved under the Treaty of Rome that formed the Common Market in 1958, was financed by contributions from the Member States, as calculated using percentages laid down by treaty. Accordingly, France, Germany and Italy each had to finance 28% of the budget. In fact, this is *how most multinational organisations* are funded because European Union is one of them: the organisations' treaties and conventions instruct fixed scales of contributions for calculating the annual contribution that each participating country must pay the organisation. In 1970, when the "*own resources decision*" was adopted, the budgeting system of the European Community changed radically, since the decision provided the Community with resources of its own and ended its dependence on direct contributions from the Member States. Along with the direct allocation of customs duties and agricultural levies, the European budget benefited from a portion of value added tax (VAT) revenues which were allocated for spending on Community policies.

While it represented an important step towards the Community's budgetary autonomy, the decision on own resources did not succeed to prevent the budget crisis which lasted from the mid-1970s until the late 1980s. This crisis was created by a combination of three factors. First, expenditure increased rapidly due to the strong growth in the agricultural sector and the development of new Community policies. At the same time, traditional own resources were declining and revenue from the VAT resource was limited by the low level of economic activity. In addition, some Member States, especially United Kingdom, challenged the way in which the budgetary burden was apportioned among the members. Lastly, the Community had yet to find its own internal institutional balance, particularly as regards the relationship between the role of the Parliament, Council and Commission in the budget-making process. This difficult period in the Community's budgetary history came to an end in 1988 with the adoption, as part of an Interinstitutional agreement, which was between the three budgetary institutions of the Community: the Parliament, Council and Commission, of a multi-annual financial framework and the reform of the own resources system. These changes helped to normalise the Community's budget position in the following years and bring spending under stronger control. In the following years the budgetary institution added a new member among themselves which is the European Court of Auditors. These four institutions (Commission, Parliament, Council and Court of Auditors) established a plan or a medium-term financial framework "*financial perspective*" by the leading of the Commission.

### *1.2.1. Budget preparation process*

The present annual budgetary procedure of the European Union is set out in Article 272 of the EC Treaty, which stipulates the sequence of stages and the time limits which must be respected by the two arms of the "budgetary authority": the Council of Ministers (acting by qualified majority) and the European Parliament, which together establish the annual budget.

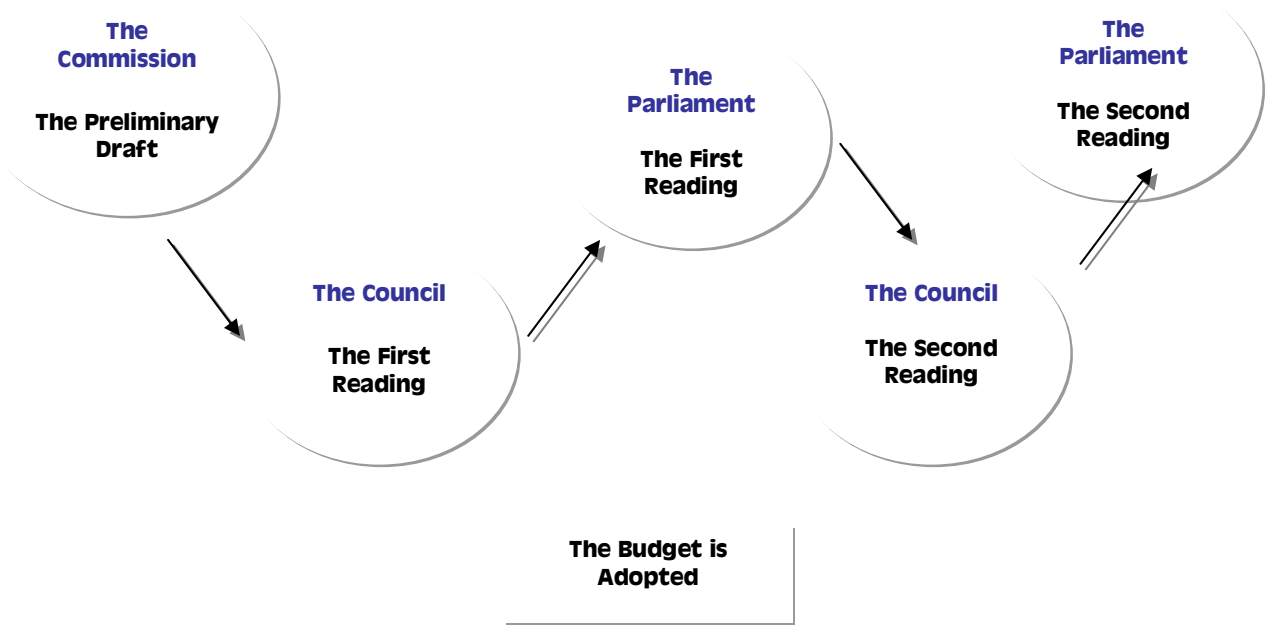
Stages of the annual EC Budget procedure;

a) The Commission draws up a Preliminary Draft Budget (PDB) in May;
b) The Council conducts its first reading of the PDB in July and establishes a Draft Budget;
c) The European Parliament conducts its first reading in October on the basis of the Council's Draft Budget;
d) In November, the Council conducts a second reading on the Draft Budget to consider any amendments or proposed modifications by the European Parliament; and
e) In December the European Parliament reviews the Council's proposals
f) and adopts the Budget

The Council conducts its second reading in early November, after a conciliation meeting with delegation from the European Parliament. The Draft Budget is amended in the light of the European Parliament's amendments (for non–compulsory expenditure) or proposed modifications (for compulsory expenditure). As a general rule, the Council's decisions on second reading determine the final amount of compulsory expenditure. Unless the entire Budget is subsequently rejected by the European Parliament, the Council has the 'last word' on this category of expenditure. The Draft Budget as amended is then returned to the European Parliament. In December the European Parliament reviews non–compulsory expenditure, for which it can accept or refuse the Council's proposals.

The President of the European Parliament then declares the Budget adopted and it can be implemented. Under the present budgetary procedure, the Council has the final say on 'compulsory expenditure'. This is spending that is a direct result of Treaty application or of acts adopted on the basis of the Treaties. In practice this mainly means spending on agriculture. The European Parliament has the final say on all other categories of spending, defined as 'non-compulsory' expenditure. Non-compulsory expenditure includes spending on regional policy, research policy and energy policy.

**The Budgetary Procedure in European Union:**



### *1.2.2. Including European Union funds in the national budget*

In many of the candidate countries, the external grant based resources are not part of the annual national budgeting process. This tends to reduce the scope for priority setting and can lead to overlapping and no optimal resource allocation. As a result, the total resources available for a given area or ministry are not known accurately and the process is not transparent and difficult to control and monitor. In order for a country to include external resources in the national budget process it is necessary to have an estimate of the amount of funds likely to be made available. With the guideline of assistance which is issued in 1999 by the Community[4] however, it is now possible to include priorities and target schedules within the multi-annual Accession Partnerships. It has become possible for each country to include both the assistance and the co-financing for particular activities in the budget either under a specific budget line or as an overall line for external grant-based resources.

#### 1.2.2.1. Resources of the European Union budget

The revenue of the general budget of the European Union can be divided into two main categories: *own resources* and *other revenue*.[5] The main body of budgetary expenditure is financed by own resources. Other revenue represents only a minor part of total financing. There are three categories of own resources: *traditional own resources, the value added tax (VAT resource* and *the Gross National Income (GNI) resource.*

Traditional own resources; comprise agricultural levies and customs duties.

a) Agricultural levies[6] are charged on imports of agricultural products coming under a common organisation of the market and originating from non-member countries, For certain products for which the world market price is generally below the European price, the rules of the Common Agricultural Policy impose a tax (levy) when such products are imported into the Community. In agriculture products the levy is especially imposed on sugar production.

b) Revenue from customs duties[7] corresponds to common customs tariff duties and other duties (including antidumping and countervailing duties) established or to be established by the institutions of the Communities in respect of trade with nonmember countries;

Other own resources; Revenue from traditional own resources is not sufficient to cover Community expenditure. This is why the own resources established by the decision of 21 April 1970 a third own resource, based on value added tax (VAT), to finance the Community budget. The VAT resource consists of payments by the Member States of an amount equal to the VAT "uniform rate" times the calculated VAT base. The calculated VAT base is equal to

[4] Commission Decision (SEC (1999) 1596 final: Guidelines for Phare Programme Implementation in Candidate Countries for the Period 2000-2006 in Application of Article 8 of Regulation 3906/89).

[5] This is laid down in Article 269 of the Treaty establishing the European Community, which states that: "Without prejudice to other revenue, the budget shall be financed wholly from own resources".

[6] Agricultural tax: (Council Regulation 94/3290 of 22 December 1994 (1)). They are entered in Chapter 10 of the general statement of revenue of the EU budget.

[7] The European Coal and Steel Community (Article 2(1)(b) of the Council decision of 29 September 2000)

the VAT taxable base, harmonised to take national exceptions into account. The resource based on (VAT) is a uniform percentage rate (0.31 %) that is applied to each Member State's VAT assessment base, which has been harmonised according to EU rules. The VAT-resource accounts for 14.4 % of total revenue, or some 15.3 billion euros.

Revenue from this resource gradually became the main source of Community financing until the end of the 1990s, when it was overtaken by the resource based on gross national income. The "GNI" resource, which was created in 1988 to offset the reduction in the "VAT" resource, is designed to ensure that budget revenue and expenditure are in balance. Beginning in 1999, the ceiling limits the Member States' total contributions to the European Union to 1.24% of their GNI. The amount paid by each Member State is in general directly proportional to its share of the total GNI of the Community. The resource based on gross national income (GNI) is a uniform percentage rate (0.73 %) applied to the GNI of each Member State. Though it is a balancing item, it is nowadays the largest source of revenue and accounts for 73.0 % of total revenue or 77.6 billion euros. In each enlargement of the Community, the new Member States have always benefited from transitional measures which reduce their contributions to the Community budget. The rationale for such arrangements is that, while the full amount of own resources payments is due immediately upon accession, Community expenditure in favour of the new Member States only reaches its normal level after a number of years. [8]

#### 1.2.2.2. Expenditure of the European Union budget

The European Union budget expenditures concentrated on mainly two categories of *agriculture, which consist common agriculture policy (CAP) plus rural development and accompanying measures,* and the *structural operations, which contain structural and cohesion funds*. While it has been declining significantly for a number of years, agricultural expenditure still accounts for about 40% of the Community budget. The Common Agricultural Policy was initially successful in encouraging the development of agricultural production, the growth of export markets, efficient use of agricultural land and self-sufficiency for many farmers. The subventions of agriculture caused artificially high prices and led to a growth in budgetary costs in many member states which, after more than 15 years of attempted reforms and experiences, combined with pressures from outside competitors, have barely begun to ease in the last few years, and (unless the rules are substantially changed) will increase with the further enlargement of the European Union. The others are the internal policy, external action, administrative expenditures, reserves, pre-accession aid and enlargement. When the pre-accession and enlargement issues are concerned, SAPARD (Agriculture), Instrument for Structural Policies for Pre-accession (ISPA - Enlargement), PHARE (Enlargement) instruments have to be taken into consideration which successively gaining importance daily lives of the Europeans. Maybe the enlargement issue is a bit painful for the Member States but it is for sure that the more seed you have the more harvest you will get. However every candidate country has its own problems, so these problems are trying to be solved by the European Union funds. Before moving into these funds, the flow of the budget, the implementations and the auditing of budget will be observed.

[8] The stats have been taken from the European Commission Official web site, Financial Programs and Budget, European Budget at a glance

## 1.3. Choosing a Model for the Financial Management of European Union Funds

With regard to budget execution, countries vary in terms of the system they have established and the degree of financial independence given to each ministry. Many candidate countries have established a treasury system through which all national budget funds are managed. Others have delegated this responsibility to line ministries[9] and other state institutions. When it comes to the management of external resources, it is generally recommended to follow the existing system of the administration. There is no single "standard" solution for establishing a National Fund system; each country will have to develop its own system, which matches the administrative structure and culture of that country. In some countries, the possibility of establishing a separate institution for the management of Community assistance has been discussed. So far as possible, countries should use existing structures of the administration and upgrade these structures, if necessary, to comply with the requirements of the National Fund system. The main issue is to determine the division of responsibilities between the National Fund and the Implementing Agencies in particular with regard to payments. In general, the Memorandum of Understanding between a candidate country and the European Commission foresees a division of responsibility between the National Fund and the Implementing Agencies. Under this arrangement, the National Fund takes responsibility for the overall financial management of the Community assistance and the Implementing Agencies are responsible for financial and technical implementation of specific funds/grants. Payments may be executed in the two ways;

### *1.3.1. The usage of the treasury*

In countries with a developed treasury system responsible for managing the national budget, it is logical for the National Fund system to be placed inside the treasury. Under this approach, the treasury's main responsibility in relation to the National Fund would be the financial management and execution of payments for the contracts concluded by the Implementing Agencies. The treasury/National Fund would also make requests for funds to the European Commission, run the accounting system and prepare financial reports. As most treasuries are not banks themselves, the treasury would need to open bank accounts with commercial banks or the central bank of the country concerned.

### *1.3.2. Using a separate national fund institution*

For countries that do not have a state treasury but where the individual ministries are responsible for financial management and hold their own bank accounts, a separate National Fund organisation/agency should be established under the ministry of finance. The National Fund will then act as a treasury for managing Community assistance. In designing the system, a decision is required about who is authorised to make payments on the relevant accounts (which according to the Memorandum have to be opened by the National Fund). The payments can either be made by the National Fund or the Implementing Agencies. Responsibility for ensuring that financial management procedures are carried out correctly should be with the National Fund. Some countries with a treasury system, however, may

[9] Budget management and control is, of course, not the exclusive responsibility of the ministry of finance. Line ministries are responsible for planning, managing and controlling their own budgets. They are accountable for defining and implementing government policies in their sector. Therefore, they should be responsible for developing sectoral policies and their sectoral budgets as well, but within the framework of policies, regulations and procedures laid down by the government.

choose to establish a separate organisation for implementing the National Fund system, i.e., a parallel treasury. Under this approach, the accounts may still be run through the treasury or it may also be decided to establish separate accounts for European Union funds outside the treasury. The main disadvantage with this approach is that there may be a duplication of functions with the treasury. According to a financial control, it has to be determined whether the institution is under the authority of an existing internal audit unit (e.g. within the ministry of finance) or whether a new internal audit function needs to be established.

## 1.4. Auditing Budget

The European Court of Auditors (ECA) performs an ex post audit of all budgetary and financial operations, including both revenues and expenditures, and has broad powers of inspecting documents and performing on-site investigations. Its analysis and recommendations are summarized in an annual report which is circulated to all Community institutions by 15 July each year and published by 15 November, along with the responses of the Member States and the Commission. Each year it is invited to certify the reliability of the Commission's accounts through the so-called "*Statement of Assurance*" (DAS)[10] to the Parliament. The Court performs two main types of function:

a) To *conduct an audit* if the management operations have been conducted properly, in terms of formal budgetary and accounting procedures.
b) To *evaluate the quality of the Community's financial management systems* in terms of economy, efficiency and effectiveness. The Court focuses more specifically on the analysis and evaluation of decision-making and internal auditing systems than on operations themselves so that is why it maintains close ties with the supreme audit institutions (SAI) of all Member States.

The audit departments and institutions of the Member States, which are needed to co-operate in various auditing operations and procedures employing funds that the Member States manage by delegation from the Commission. These activities account for some 80% of the Community's budget. The Member States' involvement in such audits differs according to the category of expenditure concerned.

Agricultural expenditure (EAGGF) is managed within the Member States by agencies that are certified by the Commission, which ensures and regularly checks that the agencies have effective audit departments and procedures.

The effectiveness of such controls is one of the major criteria guiding the Commission in its "*clearing the accounts*" procedure. With regard to Structural Funds, which are co-financed by the Community, the Member States and sub national authorities, each Member State is bound by a number of obligations that determine the nature of the control regime:

[10] The Treaty of Maastricht of 7 February 1992 made the European Court of Auditors an institution of the European Communities, enhancing its independence and authority. It introduced the requirement for the Court to publish an annual Statement of Assurance (known as DAS, from the French term déclaration d'assurance) on the reliability of the Communities' accounts, and the legality and regularity of the transactions underlying those accounts.

a) assign appropriate agencies (in many cases the respective ministries – i.e., Ministry of Finance that are responsible for managing the funds or programs concerned) to check the validity of requests for payment
b) provide the Commission with a description of the management and control system it uses
c) make all audit reports and control documents concerning the management of funds available to the Commission

Commission directorates may conduct on-site audits or request that their national counterparts do so within the Commission, DG Internal Audit Service has been assigned responsibility for coordinating the work on financial control. In this connection, it has signed agreements with a number of Member States regarding the harmonization of methods, co-ordination of programs and exchange of data. Similar procedures have been developed in relation to the control of own resources. Recent years have brought growing concerns within the Community, and the Commission, about the problems of combating fraud in the area of agricultural spending and other Community programme. The Commission's Unit for the Co-ordination of Fraud Prevention (UCLAF) was set up in 1987. An effort was also made to strengthen co-operation between the Commission and Member States in the anti-fraud area. In April 1999, following financial scandals in the Commission and the resignation of the Commission itself, UCLAF was replaced by OLAF (Office de Lutte Anti-Fraud), with enhanced powers and resources. The financial management arrangements within the Commission are also being strengthened. This issue will be examined under the OLAF headline.

## 1.5. The Approach of Budget in Central and Eastern European Countries

In most of the Central - Eastern European countries that have received grant-based assistance "non-refundable technical assistance" from the European Union and a number of bilateral and multilateral donors has been not to include such assistance in either budget planning or the budget execution process. Since it was hardly ever within the power of the governments to decide on priorities for the use of such funds, and planning often took place outside the normal budget process, it made little sense to try and include the funds in the budget. In the case of aid received from bilateral donors, the amounts received are often not known by the recipient government so the aid just bypasses normal controls by the state treasury. In addition to this the procurement of services, supplies and works using the funds made available is generally the responsibility of the donor and not the recipient. Some of the multilateral donors have already begun introducing greater responsibility to the recipient countries for the use of funds provided through loans or grants. The European Union, introduced the Decentralised Implementation System (DIS) several years ago, which gradually has shifted more and more of the responsibility for managing funds to the recipient country.[11] The National Fund system is a decentralisation and the "Memorandum of Understanding on Establishment of the National Fund" signed by the Commission and candidate countries to define the National Fund as "the central treasury entity within the Ministry of Finance through which the Community funds are channeled towards the recipient". The recipient country is responsible

[11] The DIS Manual—prepared by the European Commission is applicable to the implementation of decentralised Phare Programmes. The Manual defines the standard procedures which must be respected by all bodies implementing a Phare Programme unless other provisions have been formally agreed in writing with the Commission. The Manual is based on Phare and Financing Regulations—Framework Agreements concluded with each country—as well as on previous Phare Manuals. European Commission, September 1997

for the overall financial management of Union funds received during the period leading up to full membership of the European Union (i.e. the "pre-accession funds") including procurement through the Commission's DIS system.

When the National Fund system transfers more of the management and control functions to the national administrations the overall responsibility and accountability for managing the system will be placed with the national senior officials (CFCU)[12] in charge. In the case of mismanagement or misuse of funds the European Commission can require that the funds be reimbursed. As a result of the introduction of the National Fund system, candidate countries need to adapt and strengthen their procedures for managing and controlling public funds. In particular, internal control and internal audit functions have to be introduced or improved. Accounting and public procurement systems also need upgrading in order to comply with European Union standards. Strengthening public expenditure management systems is a pre-accession requirement and a pre-requisite for effective management of European Union funds. Candidate countries are generally encouraged not to establish two separate systems for management of Community assistance and the national budget. A double or parallel system will require more resources than operating one system and may prove less efficient.

When designing a National Fund system a country evaluate its existing administrative system and procedures and determine whether these are in compliance with European Union requirements. Many structures and procedures may only need limited adaptation in order to satisfy European Union requirements. Other structures and procedures may have to be restructured or newly established in order to fulfill the requirements. "The Commission proposes commitments of €2.48 billion and payments of €3.15 billion. These represent an increase of €0.4 billion, or 19.2% for commitments, and a decrease of €0.14 billion, or 4.1% for payments. This leaves a margin for commitments of €1.09 billion below the ceiling. The margin is so large because no further commitments can be made to newly acceded Member States. Notable changes in commitment levels relative to 2005 include: a 10% increase to funding for Romania and Bulgaria to a total of €1.65 billion; an increase of €200 million for Turkey, taking the total to €500 million; an increase of €35 million for Croatia, taking the total to €140 million. The comparatively high level of payments is explained by the ongoing implementation of outstanding commitments to former accession countries from the SAPARD and ISPA programs, although the decrease related to 2005 owes to the end of the PHARE programme in the new Member States".[13] (Table 1)

### *1.5.1. Implementing agencies*

The administration, and the financial and technical management, of programs and projects funded by European Union pre-accession aid (ISPA and SAPARD) and the Phare programme is carried out by Implementing Agencies. The Implementing Agencies are responsible for the design of projects and the entire procurement process according to the Phare Decentralised Implementation System together with the supervision of projects. Payments on the appropriate contracts are either made by the Implementing Agencies themselves or the National Fund depending on which model has been selected. If payments are made by the National Fund, the Implementing Agencies verify that they have received the required supplies or services and request that payment be made. The National Fund should conclude an

[12] Central Finance and Contracts Unit (CFCU) is an implementing body within the national administration in charge of tendering, contracting and making payments for Phare-funded projects. A Senior Programme Officer is responsible for technical implementation of the programme of these projects.

[13] European Union Committee 5th Report of Session 2005–06 The 2006 EC Budget

agreement with each of the Implementing Agencies. This agreement sets out the responsibilities of the Implementing Agencies. Additional secondary legislation may be needed depending on a country's administrative system. The Implementing Agencies can be either departments of ministries or dedicated procurement units. In some cases, Implementing Agencies have been created out of units that were involved with the implementation of Phare projects in previous years. Some experience with procurement under the decentralised implementation system is valuable.

# 2. EUROPEAN UNION EXTERNAL AID PROGRAMS - (Table 2)

European Commission external aid programs offer opportunities for businesses from European Union Member States and countries eligible for individual programme to participate in their implementation. There are strict rules conducting the way in which contracts are awarded. These rules will help to ensure the most suitable and qualified contractors which are chosen without bias and for the best value obtained, with the full transparency. The European Commission provides an opportunity to obtain funds for launching new activities to commence partnership relations within Union and in third countries (MEDA and CARDS countries and candidate countries PHARE SAPARD IPA). Each European Commission Directorate-General (DG) has funding programs covering different themes.

The contracts for services, supplies, works and also grants financed by the European Community in the course of co-operation with third countries are awarded by a contracting authority of the beneficiary country, award procedures are governed by the Financial Regulation applicable to the General Budget of the European Communities, which lays down the basic rules, methods and procedures for the award of contracts from EC funds and regulations and other specific instruments relating to the various co-operation programs. The rules for applying the standard procurement is divided between those for services (e.g., technical assistance, studies, provision of know-how, and training), supplies (i.e., equipment and materials) works (i.e., infrastructure and other engineering works) and grants (i.e., non commercial actions). Once approval for an activity has been granted by the European Commission within a Financing agreement, the Contracting authority can proceed with tendering and contracting following the standard procedures. The Commission publishes the date, requirements and details about the funding programs by issuing calls for proposals. The frequency of publication depends on the programs' utility. Calls are published once a year. In particular cases, if the annual budget of the programme has not entirely been distributed, the Commission may publish a new call for proposals without any previous announcement. The calls for proposal will outline the criterias needed, for applying the proposal. The applicants, who are interested, have to send their proposals to the Commission before there specified deadline, which should be respected for every tender.

Once the requests have been received by the proper services of the Commission, the applications will follow three stages:

a) First Stage is *the Evaluation* by the service in charge of the programme (*Evaluation Committee*) and by another service selected by the Commission. The decision for whether the project is eligible or not. If it is eligible;

b) Second one is *Financial Control* which will be undertaken by the Directorate-General which evaluates the financial aspects. (i.e., if it is a work contract lower price tender will take the awarding contract)
c) Third and the final stage is the *Agreement which* will be signed by both parties.

These procedures can take between 2 to 6 months. The Commission guarantees confidentiality until the final decision has been taken. All requests for funding will be followed by a written answer, negative or positive. After the decision to award a Community grant, the selected

beneficiary or applicant has to sign an agreement between his organisation and the European Commission.

"*In general the payment of the grant is made in three stages. First instalment will be made right after the signature of the convention. The receipt of the first instalment often means the starting date of the project. Amount: between 30% and 40% of the total grant awarded. Second instalment: paid upon receipt and approval of the intermediary activity report, that sets out and accounts for the progress of the project to that point. Amount: around 30% of the total grant. Third and final instalment: paid after the completion of the project actions and the approval of the final report evaluating the activities during the whole project duration*"[14]. The observation procedure of projects and contracts has to be emphasized to widen and deepen the study. There are three pre-accession instruments:

PHARE (Poland and Hungary Assistance to the Reconstruction of the Economy) which addresses priority measures concerning the adoption of the acquis communautaire, whether through improving administrative capacity or supporting related investment. It also has an element for Economic and Social Cohesion. "Originally created in 1989 to assist Poland and Hungary, the PHARE programme currently covers 10 countries : the 8 new Member States: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, as well as Bulgaria and Romania, assisting them in a period of massive economic restructuring and political change. Phare has two priorities. The first is institution building with twinning projects involving the European Union experts to national ministries for at least one year the purpose was to strengthen public administrations and prepare for the adoption of European Union legislation. The second priority is economic and social cohesion to be achieved via a comprehensive National Development Plan that each country was required to draw up. This plan constituted the key document for programming Phare and foreshadowed the requirements inside the European Union to obtain assistance in the framework of "*Structural Funds Objective 1*"[15].

Until 2000 the countries of the Western Balkans (Albania, Bosnia-Herzegovina and the Former Yugoslav Republic of Macedonia) were also beneficiaries of Phare. However, as of 2001 the CARDS *programme (Community Assistance for Reconstruction, Development and Stability in the Balkans)* has provided financial assistance to these countries."[16] Which is a key external relations' priority for the European Union is to promote stability and peace in the Western Balkans, not only on humanitarian grounds but also because the region's conflicts are at odds with the wider objective of security and prosperity across the continent of Europe. Since 1991 the European Union has committed, through various assistance programs, € 6.8 billion to the Western Balkans. In 2000 aid to the region was streamlined through a new programme called CARDS (Community Assistance for Reconstruction, Development and Stabilisation) adopted with the Council Regulation (EC) No 2666/2000 of 5 December 2000. Through the programme € 4.6 billion will be provided to this region in the period 2000 to 2006 for investment, institution-building, and other measures to achieve four main objectives:

a) reconstruction, democratic stabilization, reconciliation and the return of refugees

[14] South East Partners Brussels Office - Guide to EU Funding, Brussels , 31 October 2005

[15] is to promote structural adjustment in regions with GDP/capita less than 75 % of the EU average

[16] The text has been taken from the offical site of the European Commission, ec.europa.eu/comm/enlargement/pas/phare/

b) institutional and legislative development, including harmonization with European Union norms and approaches, to underpin democracy and the rule of law, human rights, civil society and the media, and the operation of a free market economy
c) sustainable economic and social development, including structural reform
d) promotion of closer relations and regional cooperation among countries and between them, the EU and the candidate countries of central Europe

Since early 2005 the Directorate-General Enlargement has been responsible for managing all relations with the countries of the Western Balkans. This includes political relations and the development and management of the CARDS programme.

*ISPA (Instrument for Structural Policies for Pre-Accession)* which finances major environmental and transport infrastructure projects. ISPA was designed to address environmental and transport infrastructure priorities identified in the Accession Partnerships with the 10 applicant countries of Central and Eastern Europe. ISPA was established by Council Regulation No. 1267/1999 in June 1999 on the basis of a Commission proposal in Agenda 2000 to enhance economic and social cohesion in the applicant countries of Central & Eastern Europe for the period 2000-2006.

Its main features are that it:
a) Only finances major environmental and transport infrastructure projects
b) Has a budget of € 452 million for Bulgaria and Romania in 2004. (Until 2003 the overall annual budget for the 10 countries of Central and Eastern Europe was € 1.1 Billion.)
c) Comes under the remit of the Directorate General for Regional Policy

Like the Phare programme, the ISPA programme has the aim of Economic & Social Cohesion. ISPA's exclusive focus on environmental and transport infrastructure measures has subsequently allowed the Phare programme to focus on other aspects of Economic & Social Cohesion, which avoids over-lapping of responsibilities in this field. For the countries that are Member States since May 2004, projects previously financed under ISPA are still under the responsibility of DG Regional Policy as part of its Cohesion Fund policy.

*SAPARD (Special Accession Programme for Agriculture and Rural Development)* finances agricultural and rural development. The aim of SAPARD is to help the 10 beneficiary countries of Central and Eastern Europe deal with the problems of the structural adjustment in their agricultural sectors and rural areas, as well as in the implementation of the acquis communautaire concerning the CAP (Common Agricultural Policy) and related legislation. It is designed to address priorities identified in the Accession Partnerships. SAPARD was established by Council Regulation 1268/1999 in June 1999, on the basis of a Commission proposal as part of the Agenda 2000 programme for increased pre-accession assistance in the period 2000 – 2006 and it is still in the financial framework of 2007 – 2013.

Its main features are that it:
a) Only finances agricultural and rural development measures
b) Has a budget of € 225.2 million for Bulgaria and Romania in 2004. (Until 2003 the overall annual budget for the 10 countries of Central and Eastern Europe was € 560 million.)
c) Comes under the remit of the Directorate General for Agriculture

The co-ordination of the three instruments is ensured by a division of responsibilities between the instruments. A committee at Directorate level ensures co-ordination between the

Commission services concerned. A 'General Assistance Document' covering all instruments was presented in June 2005 to the Phare Management Committee, the body assisting the Commission in coordinating the instruments. At country level, the Commission encouraged the applicant countries to enhance inter-ministerial co-ordination, which is seen as a key pre-condition for the successful future management of the Structural Funds.

## 2.1. Mechanisms of the Pre-accession Instruments

### *2.1.1. Commitments and transfer of funds - (Table 3)*

Before European Union funds can be transferred, they require: a Commission Decision, in order to be committed into the Budget; a Framework Agreement; and an annual bilateral Financing Agreement or Memorandum determining the financial commitment of the Community for the measure concerned towards the beneficiary country, (i.e., fixing rights and obligations for both parties). However, the procedures leading to decision making and commitment of funds differ for each instrument.

### *2.1.2. Implementation structures in candidate countries*

Funds from the pre-accession instruments are channeled through the National Fund, established in the Ministry of Finance in each country, under the responsibility of the National Authorising Officer. The concrete implementation of Phare and ISPA is carried out in Implementing Agencies (such as the Central Finance and Contracts Unit, CFCU) that receive the funds from the National Fund[17]. For SAPARD, the implementation is carried out by the dedicated SAPARD Agency that receives the funds from the National Fund.

Decentralisation of implementation under *Article 12 of the Co-ordination Regulation*[18] is the process by which management of European Union funds is devolved to candidate country administrations. In Bulgaria and Romania, for Phare and ISPA, this process was governed in 2004 by the Decentralised Implementation System (DIS). DIS means that the procedures for managing measures or projects financed by ISPA and Phare require *ex ante* control, (i.e., decisions concerning procurement and award of contracts are taken by the contracting authority and referred to the European Commission Delegation in the beneficiary country for endorsement). As a result the European Commission Delegations are responsible for endorsing procurement documents before tenders are launched or contracts signed.

On the other hand, SAPARD is implemented on a fully decentralised basis "*Extended Decentralisation Implementation System*" (EDIS). EDIS stands for full decentralisation of the management and implementation of European Union support, meaning the process by which management of European Union pre-accession funds is devolved to candidate country administrations, where the Commission exercises no systematic ex-ante control over individual transactions, but is limited to an ex-post control, whilst it retains the final responsibility for general budget execution. Such delegation of management responsibility requires each country to set up adequate management and control systems to be approved at national level by the National Authorising Officer. Once these conditions are met, the Commission carries out the

[17] Unless the National Fund acts as a paying agent on behalf of the Implementing Agency.

[18] Article 12 of the Co-ordination Regulation provides the legal basis to "waive the Commission's *ex ante* approval for project selection, tendering and contracting by applicant countries"

compliance verification prior to the Decision by the Commission conferring management of European Union support.

For both Bulgaria and Romania, the Commission is supporting the countries' efforts to move to EDIS in the first half of 2006. In addition, the obligation to have EDIS in place by the date of accession was included in the "*Act of Accession (Article 27)*" and provides a clear impetus for these countries to complete the final preparations for this to be achieved. Nevertheless, the process has suffered from delays. For Phare and ISPA, the move to EDIS is done through 4 stages described in the Commission Working document "Preparing for Extended Decentralisation" and the document "Roadmap to EDIS for ISPA and Phare". The Roadmap sets out the procedural stages leading to an EDIS decision. Stages 1 to 3 are the responsibility of the Candidate countries and contain a Gap assessment, a Gap Plugging and a Compliance assessment of the management and control systems. Stage 4 is the preparation for Commission decision and is the responsibility of the Commission. This decision is taken following an in depth review, including a verification audit on-the-spot, of the management and control systems as described in the EDIS application submitted to the Commission by the National Authorising Officer.

### *2.1.3. Monitoring and evaluation*

#### 2.1.3.1. Phare - (Poland and Hungary Assistance to the Reconstruction of the Economy)

Execution of the Phare programs is subject to a structured monitoring and evaluation process. A Joint Monitoring Committee in each country is supported by Sectoral Monitoring sub-Committees which meet twice a year. In 2004, a revised Joint Monitoring Committee (JMC) mandate came into force in the new Member States. The key purpose of it is to further reinforce the monitoring function, by the introduction of an Implementation Status Report, strengthening of the JMC operations as well as related reporting obligations to the Commission. The previous mandate still applies to Bulgaria and Romania. At the same time as the Interim Evaluation function remains centrally managed for Bulgaria and Romania, it has been decentralised to the new Member States. The external interim evaluation schemes generated 45 individual country, sectoral, ad-hoc or thematic evaluation reports covering Phare and other pre-accession financial instruments measures, as well as a Consolidated Summary Report of Phare support allocated in 1999-2002 and implemented until November 2003. On the whole, evaluation results concluded that Phare performance was rather mixed. Three shortfalls in performance account for a large part of those findings. First, there were substantial weaknesses in needs analysis and design. Second, achievement of programme/project objectives was only adequate. Third, although improving, implementation suffered from pervasive efficiency problems. Nevertheless, given the complexity of the pre-accession objectives and the constraint of the very limited implementation period, what has been achieved with Phare support is indeed remarkable.

#### 2.1.3.2. ISPA - (Instrument for Structural Policies for Pre-Accession)

All ISPA projects are subject to the ISPA Regulation and the Financing Agreement provisions of both monitoring and evaluation. Implementation progress is reviewed systematically twice a year and periodically by Commission services, in particular through the Monitoring Committees. The Financing Memorandum, which is concluded for each project between the Commission and the ISPA beneficiary state. This section states that after the completion of a

project, the Commission and the beneficiary countries will evaluate the project's impact and the manner in which the project has been carried out. Ex-post evaluation is not an issue yet, as no projects are completed at this stage.

#### 2.1.3.3. SAPARD - (Special Accession Programme for Agriculture and Rural Development)

Implementation of SAPARD programs is subject to the provisions of the "Multi Annual Financing Agreements" in respect of both monitoring and evaluation. Since 2001 SAPARD Monitoring Committees were established in each beneficiary country, and were largely operating under the Structural Funds rules, with the Commission assuming observer status. Although, eight out of the ten beneficiary countries became new Member States on 1 May 2004 they continued contracting SAPARD projects with the final beneficiaries until they were able to switch to post-accession programming. "As a consequence till the end of 2004 the Sapard agencies approved as many as over 37.000 projects involving €2.2 billion of Community contribution." [19] The Commission continued working closely with the beneficiary countries on adapting and running the monitoring and evaluation systems. The Monitoring Committee meetings provided a useful opportunity to discuss and decide on:

a) monitoring the implementation of the programs
b) approval of modifications to be introduced in the programs, namely those resulting from the mid-term evaluation exercises and
c) approval of the annual reports on progress achieved in relation to the implementation of the Sapard programs, before their official submission to the Commission

### *2.1.4. Co-ordination*

One of the most important roles of the Commission is to ensure close co-ordination between the three pre-accession instruments. The Accession Partnerships set the general framework for assistance under the three pre-accession instruments. They are harmonized, in the case of Phare, by the National Development Plans, and in the case of ISPA, by the national strategies for the environment and transport. SAPARD projects are selected on the basis of the Rural Development Programs, prepared on the basis of the Candidate countries' plans and approved for each of the countries by the Commission. The Phare Management Committee plays a key role in general coordination. *According to Article 9 of the Coordination Regulation, the Committee should assist the Commission in coordinating operations under the 3 instruments and the Commission should inform the Committee about the indicative financial allocations for each country and per pre-accession instrument about action it has taken as regards co-ordination with the (European Investment Bank) EIB, other Community instruments and International Financial Institutions (IFIs).*

#### 2.1.4.1. Co-ordination inside the Commission

The Phare programme and the co-ordination of the instruments come under the responsibility of DG Enlargement, supported by the Phare Management Committee. ISPA is under the responsibility of DG Regional Policy, and SAPARD under the responsibility of DG Agriculture. Programming is coordinated through extended inter-service consultations. In

[19] Report From The Commission To The European Parliament And The Council, General Report On Pre-Accession Assistance ( Phare – SAPARD – ISPA), Brussels, 24.3.2006

addition, a Co-ordination Committee at Directors level for the pre-accession instruments has been set up in the various Commission services involved. It pays particular attention to the preparation of EDIS of Phare and ISPA. To avoid duplication, the Commission has clarified the interface between Phare and SAPARD, taking into account the provisions of the Co-ordination Regulation. As regards project monitoring, co-ordination takes the form of the JMC. The Joint Monitoring Committee is responsible for coordinating the monitoring of each pre-accession instrument and for assessing the overall progress of EU–funded assistance in the beneficiary countries. The Committee issues recommendations to the ISPA Committee or to the Commission when relevant. Periodic meetings were organised by the Commission services (DGs Enlargement, External Relations and Regional Policy) with the experts in the Delegations responsible for Phare and ISPA to discuss programming and implementation issues, in particular those related to tendering and contracting.

#### 2.1.4.2. Co-ordination in the candidate countries

The Commission strongly encourages the candidate countries to enhance interministerial co-ordination, which is a key pre-condition for the candidate countries' successful future management of the Structural Funds and, in the short term, for implementing Phare. In several countries, such interministerial co-ordination still needs further improvement. As decentralised management is either provided for from the outset (for SAPARD), or will gradually increase (for Phare and ISPA), the responsibility of the candidate country for the proper co-ordination of operations receiving pre-accession support, and for avoiding overlaps, must be developed accordingly. Therefore, the Commission requires the countries to take the necessary steps for effective and efficient co-ordination.

#### 2.1.4.3. Co-ordination with the European Investment Bank (EIB) and International Financial Institutions (IFIs)

As in previous years, Co-operation with the EIB and other IFIs continued under the framework of the Memorandum of Understanding on co-operation in pre-accession assistance. The Commission Services periodically organise meetings with the EIB and other IFIs to co-ordinate issues related to programming and implementation, as well as procedural issues. In view of organising the transition from pre-accession support to full membership of the European Union for countries acceding in May 2004, the Commission also chaired the European Commission - IFI Working Group, as well as the European Commission - IFI High Level Group, which consist of meetings at senior management level between EC and all IFIs. Given the fact that large infrastructure projects which are commonly subject to international co-financing are now financed under ISPA, co-financing under Phare was limited. In terms of implementation, the main co-financing instrument was again the Small and Medium Entity (SME) Facility in which the EIB, the EBRD and the Council of Europe Development Bank are participating. The objective is to continue co-financing capacity building of the financial sector to develop financing for SMEs and municipalities. Given that major transport and environment projects are mainly carried out under ISPA, DG Regional Policy is the major partner for co-financing with the EIB and EBRD. The Municipal Lending Facility focuses on finance and capacity building measures to local banks in order to expand their lending operations to local municipalities. The EIB and the Commission have established a facility on border regions, as requested by the Nice European Council, and as outlined in the Commission Communication on Border Regions (of 25 July 2001 COM(2001)437final). The project concentrates on the implementation of small municipal infrastructure in border regions to promote integration with current European Union regions. The give a sense to the funds,

#### 2.1.4.4. Types of co-financing

"There are two types of co-financing: *parallel* and *joint co-financing*:

Under *parallel co-financing*, the project is *divided into identifiable subprojects which are funded by different co-financing partners each*. In parallel co-financing, the auditors must do some substantive testing of the parallel co-finance in order to form an opinion on the existence of the co-finance and the compliance of the co-finance spent in line with the legal documentation (i.e., Financing Memorandum)

Under *joint co-financing*, the total project cost is divided between the co-financing partners and all the funds are pooled such that the source of funding for a specific activity within the project cannot be identified where projects have been jointly co-financed the co-financing contribution should be checked by the auditors on the Phare funded contracts selected for testing;

Where projects have been co-financed, the auditors should:

a) obtain certified declarations of the co-financing provided and the declarations should be supported by a summary analysis of the nature of the co-financing;
b) the auditors should also review the data included in the declarations and summaries for internal consistency and compliance with the co-financing conditions in the Financing Memorandum as far as this is possible;
c) the auditors must check the co-financing amounts provided versus each co-financing subcomponent as stated in the co-financing budget in the Project Fiche, for each project under audit for this purpose, they should review the documentation supplied to them and check the information on:
    - the nature of the co-financing provided (joint or parallel),
    - on types of expenditure (e.g. purchase of equipment or land, works, provision of services, etc);
    - the co-financing provided 'in kind' (financial value of in-kind contribution, information on what was provided "in kind", etc);
    - the amounts of VAT included within the co-financing contribution
    - any audit reports prepared by your State's Supreme Court of Auditors (or SAIs - National Audit Offices) covering these co-financing arrangements"[20]

## 2.2. The Procedures to be observed in Centralised and Decentralised Management

There are three procurement procedures to be observed for the contracts and projects, financed under the external aid programs of the European Commission:

[20] Audits Of Contracts Implemented Under A Decentralised Implementation System - Multiple Framework-Contract In The Field Of External Audit Of Programmes And Projects Of External Aid Managed By The European Commission, DG Elargement

### 2.2.1. Centralised perspective:

The procedures to be followed under a centralised programme; the contracts are concluded directly and only by the European Commission which is acting for and on behalf of the beneficiary country. In this case The European is responsible for issuing invitations to tender (Annex 1), receiving to tender, chairing tender Evaluation Committees, deciding on the results of tender procedures and signing contracts.

### 2.2.2. Decentralised Perspective:

#### a) Ex-ante

The procedures followed under a decentralised programme with ex-ante controls. Contracts are concluded by the Contracting authority[21] designated in a financing agreement, (i.e., the government or an entity of the beneficiary country with legal personality with which the European Commission establishes the financing agreement.
There are five steps from submitting the tender dossiers to European Commission to signing the contracts which are:

The Contracting authority will draw up shortlists (restricted procedures[22]). Before the procedure is launched, the Contracting authority must submit tender dossiers[23] to the European Commission for approval. On the basis of decisions thus approved, the Contracting authority is responsible for issuing invitations to tender, receiving tenders, chairing tender Evaluation Committees and deciding on the results of tender procedures.

The Contracting authority then submits the result of the evaluation for approval and at a second step-after having notified the contractor[24], received and analysed the proofs regarding exclusion and selection criteria the contract award[25] proposal to the European Commission for endorsement. Once it has received this endorsement, it signs the contracts and awards the contract. As general rule, the European Commission will be represented when tenders are opened and evaluated and must always be invited. The Contracting authority must submit procurement notices and award notices to the European Commission for publication.

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[21] The Practical guide for contracting procedures in EC external actions, European Commission Brussels, February 2006 the European Commission, acting for and on behalf of the beneficiary country, in the case of centralised approach. The Contracting authority appointed by the government of the beneficiary country, in the case of decentralised approach.

[22] The glossary of terminology used in the common texts for Budget and EDF. Brussels 2006. Calls for tender are restricted where all economic operators may ask to take part but only candidates satisfying the selection criteria and invited simultaneously and in writing by the Contracting Authorities may submit a tender.

[23] The glossary of terminology used in the common texts for Budget and EDF. Brussels 2006. The dossier compiled by the Contracting authority and containing all the documents needed to prepare and submit a tender.

[24] The glossary of terminology used in the common texts for Budget and EDF. Brussels 2006. Any natural or legal person or public entity or consortium of such persons and/or bodies offering to execute works.

[25] The glossary of terminology used in the common texts for Budget and EDF. Brussels 2006. The procedure followed by a Contracting authority to identify, and conclude a contract with, a suitable contractor to provide defined goods or services.

In order to assist the countries that have applied to become members of the European Union, funds on accession is develop to carry out the reforms required for membership and to equip themselves to benefit this funds. As a pre-accession strategy the Union provides financial assistance to candidate countries. The Phare programme applies to the acceding and candidate countries from Central and Eastern Europe, and principally involves Institution Building measures in order to promote Economic and Social Cohesion. Cyprus and Malta have received pre-accession assistance although under a different instrument, budget line and procedures, as well as Turkey is receiving the funds of pre-accession form the European Union.

8 of the 10 countries which were previously eligible for the Phare programme are new Member States since May 2004. As a result, 2003 was the final programming year for pre-accession assistance to these countries, though contracting is envisaged to continue till 2005 and payment of funds till 2006 (and ex-post control of payments for some time thereafter). Article 34 of the Act of Accession has set up a post-accession Transition Facility to provide continued financial assistance to the new Member States in a number of core areas requiring further reinforcement, which were identified in the 2003 Comprehensive Monitoring Reports. Besides the pre-accession instrument the EU has adopted a special system of financial support for the Western Balkan countries. Before 2000 support to this region was provided by the Phare and Obnova financial instrument, which was replaced in December 2000 by the so called CARDS (Community Assistance for Reconstruction, Development and Stabilisation) Programme. This programme underpins the objectives and mechanisms of the Stabilisation and Association process, which is the EU policy framework for the Western Balkan countries until their eventual accession: Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia and Serbia and Montenegro, including Kosovo (as defined by the UN Security Council Resolution 1244). Also Croatia, which has now been granted candidate country status, has received support from this instrument. Besides the CARDS programme the Commission is also providing Humanitarian aid to this region1, falling outside the objectives of the CARDS instrument.

The responsibility for the above mentioned programs lies with the Directorate-General for Enlargement. The external assistance to Central and Eastern Europe and the Western Balkan is implemented through various management methods. The audits carried out within the framework of this lot will be mainly on projects and programs implemented through a Decentralised Implementation System (DIS) with and without ex-ante control on procurement by the Commission. Under a “decentralised” implementation system the management and implementation of the external aid is decentralised to the national implementing bodies, while the EC Delegation is still involved in at least some ex-ante control during the procurement process. Where ex-ante control is fully removed it is called ‘Extended Decentralised Implementation System” (EDIS). Both implementation systems have been used for implementation of most of the financial support in the 10 Phare eligible countries, Turkey, Malta, and Cyprus. In addition, some of the CARDS support has also been implemented through DIS. In 2004 and the beginning of 2005, each of the Implementing Agencies for the precession support and the Transition Facility in the 10 new Members States were accredited to move to an implementation system of Extended Decentralisation (EDIS) removing the ex-ante control involvement of the European Commission Delegation during tendering and implementation. Also the Implementing Agencies in Romania and Bulgaria are currently preparing for the accreditation for EDIS. Under a DIS and EDIS system, Implementing Agencies in the candidate countries undertake the tendering and contracting for the specific programs concerned. They record the financial transactions in a reporting system named PERSEUS. This system is shared with the Commission. Since the start of the Phare assistance

in 1992, the Obnova assistance in 1996 and the CARDS assistance in 2000, basic rules have been the same, nevertheless implementation systems, manuals, guidelines and procedures have undergone changes. Although this tender will be based on a "*standard audit approach*" the tenderer should be flexible and capable of addressing different financial audit requirements. In this respect it must also be noted that after European Union accession the member states are required to use procurement rules in line with the European Union Public Procurement Directives (PPD). Therefore, procurement rules used for the implementation of the pre-accession aid in these countries will no longer follow "*the Standard Practical Guide*" to contract procedures financed from the European Commission general budget in the context of external actions" but their own national procurement rules.

### b) Ex-post

The procedures followed under a decentralised programme with ex-post controls. Contracts are concluded directly by the Contracting authority designated in a financing agreement, i.e., the government or an entity of the beneficiary country with legal personality with which the European Commission establishes the financing agreement. The Contracting authority will draw up shortlists[26] (restricted procedures) and is responsible for issuing invitations to tender, receiving tenders, chairing tender Evaluation Committees, deciding on the results of tender procedures and signing the contracts *without the prior approval* of the European Commission. The Contracting authority must submit procurement notices and award notices to the European Commission for publication.

## *2.2.3. Eligibility Criterias: The rules on nationality, origin and exceptions*

### 2.2.3.1. The Rule of nationality for contracts

Participation in tendering procedures is open on equal terms to all persons coming within the scope of the Community Treaties and, to all such natural and legal persons who are nationals of the beneficiary third countries or of any other third country as are expressly mentioned in those instruments. See (Annex A2) for the list of countries for each aid programme or instrument.

1) The rules for the procurement procedures are open on equal terms to all legal persons who are established in:

a) member State of the *European Union*, in an official *candidate country* as recognised by the European Union or in a Member State of the *European Economic Area*(EEA);

b) developing countries specified in the OECD Development Assistance list (Annex A3) with *thematic scope*[27] defined in developed country (Annex A4), in addition to those legal persons already eligible by the instrument concerned;

[26] The Programmes Supported by European Union in Turkey, Turkey, Report of 2004-2005, Hansjörg Kretschmer. The list formed by the proper applicants attest their interest over the awarding.

[27] Official Journal of the European Union on access to Community external assistance, Council Regulation (EC) of 21 November 2005 (i.e., 23 July 2001 concerning action against anti-personnel landmines in third countries other than developing countries)

c) and also developing countries specified in the OECD Development Assistance list (Annex A3) with *geographical scope*[28] defined in developed countries (Annex A4), which are expressly mentioned as eligible and those already started to be eligible by the instrument
d) any country other than those referred in a), b) and c), where reciprocal access (Annex A5) to their external assistance has been established in conformity to Article 6 of the Regulations on access to Community external assistance

Participation is also opened to international organisations.

2) Community funding covers an operation *implemented through an international organisation,* participation in the appropriate contractual procedures shall be open to all legal persons who are eligible for the above-mentioned rules as well as to all legal persons who are eligible pursuant to the rules of that *organisation,* care being taken to ensure that equal treatment is afforded to *all donors.*

3) Community funding covers an operation *co-financed with a third country,* or *with a regional organisation,* or with a *Member State,* participation in the appropriate contractual procedures shall be open to all legal persons who are eligible for the rules of that organisation as well as to all legal persons who are eligible under the rules of such *third country, regional organisation* or *Member State.*

4) As far as food aid operations are concerned, the application of points two and three shall be limited to emergency operations. Without prejudice to the qualitative and financial requirements set out in the Community's procurement rules and in conformity with the Regulations on access to Community external assistance, all experts engaged by tenderers may be of any nationality.

However the relevant beneficiary countries for the application of PHARE and IPA should not be considered anymore for Estonia, Hungary, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Slovenia, Malta and Cyprus, are covered by a separate regulations[29], because they became member States since first of May 2004.

Where an agreement on widening the market for procurement of goods or services to which the Community is party applies, the contracts for procurement financed by the budget are also open to third-country nationals. This nationality rule also applies to the experts proposed by service providers taking part in tender procedures for service contracts financed by the European Union. For the purposes of verifying compliance with the nationality rule, the tender dossier requires tenderers to state the country of which they are nationals by presenting the documents usual under that country's law.

If the Contracting authority suspects that a candidate/tenderer has only a registered office in an eligible country or state and that the nationality of the candidate/tenderer is ineligible, the candidate/tenderer is responsible for demonstrating effective and continuous links with that country's economy. This will avoid *awarding contracts* to firms whose nationalities are ineligible but which have set up companies in an eligible country to go around the rules on

[28] Official Journal of the European Union on access to Community external assistance, Council Regulation (EC) of 21 November 2005. (i.e., 17 December 2001 concerning pre-accession financial assistance for Turkey)

[29] Guide On Grants And Public Procurement Under Pre-Accession Instruments, Brussels, May 2004 - (Council Regulation (EC) No 555/2000 of 13 March 2000) as amended by Council Regulation (EC) No 2500/2001 of 17 December 2001)

nationality. The nationality rule also applies to the experts proposed by service providers taking part in tender procedures for *service contracts* financed by the European Community. For the purposes of verifying compliance with the nationality rule, the tender dossier requires tenderers to state the country of which they are nationals by presenting the documents usual under that country's law.

#### 2.2.3.2. The rule of origin for contracts

"*All supplies and materials purchased under any contract financed under a Community instrument must originate from the Community or from an eligible country as defined in Articles 3 and 7 herein. The term 'origin' for the purpose of this Regulation is defined in the relevant Community legislation on rules of origin for customs purposes*".[30] Therefore in its tender, a tenderer must state the origin of supplies. Contractors must present a *certificate of origin* to the contracting authority when bringing supplies into the beneficiary country, when provisional acceptance of the supplies takes place or when the invoice is presented. The contract will specify the options which are applicable. Furthermore, the country of origin is not necessarily the country from which the goods have been shipped and supplied. Where there is *only one country* of production, the origin of the finished product is easily established. However, in cases where *more than one country* is involved in the production of goods it is necessary to determine which of those countries confers origin on the finished goods.

The same goes for supplies and equipment purchased by a contractor for works or service contracts if the supplies and equipment are intended to become the property of the beneficiary country once the contract is completed. Certificates of origin must be made out by the competent authorities of the supplies' or supplier's country of origin and comply with the international agreements to which that country is a signatory.

The official Certificates of Origin must then be submitted, failing this, the contracting authority cannot release any funds to the contractor but it is up to the contracting authority to check that there is a certificate of origin. If there are serious doubts about origin, it will be up to the European Commission's services in Brussels to decide on the course of action. More significantly, perhaps, the eligibility rules could be considered to constitute an inconsistency with the Directives' requirement to award contracts on the basis of either lowest price or most economically advantageous tender. By applying the eligibility rules in relation to third country goods in free circulation in the EU, and third country experts engaged by eligible service-providers, care will be needed to ensure compatibility with the Treaty.

#### 2.2.3.3. Exceptions for contracts

Exceptions for the nationality and origin cases are rare. The award of such derogation is decided on a case-by-case basis by the Commission before the procedure is launched.

In conformity with the Regulations on access to Community external assistance, in duly substantiated exceptional cases, the Commission:
- may extend eligibility to legal persons from a country not eligible.
- may allow the purchase of supplies and materials originating from a country not eligible.

[30] Article 5 - Rules of origin, Council Regulation (EC) No 2112/2005 of 21 November 2005 on access to Community external assistance.

Derogations may be justified on the basis of the unavailability of products and services in the markets of the countries concerned, for reasons of extreme urgency, or if the eligibility rules would make the realisation of a project, a programme or an action impossible or exceedingly difficult. Note, however, that the frequently used argument that a product of ineligible origin is cheaper than the Community or local product does not constitute grounds for awarding derogation. Where an agreement on widening the market for procurement of goods, works or services to which the Community is party applies, the contracts for procurement financed by the budget are also open to third-country nationals other than those referred to in the previous two paragraphs, under the conditions laid down in this agreement.

*a)* "*With regard to nationality, the European Commission may exceptionally allow nationals of countries other than those stipulated in the applicable Regulation to participate in tenders and contracts, on a case-by-case basis.*

b) *With regard to the origin of supplies, the same exception applies as under (a). Note, however, that the frequently used argument that a product of ineligible origin is cheaper than the Community or local product does not constitute grounds for awarding derogation. If the award of contract is preceded by a tender procedure, the derogation must be in mentioned in the procurement notice*"[31].

### 2.2.3.4. Ineligibility criterias of contracts

The implication of the Commission for the decentralised contracts consists simply on its authorisation to the financing of the contracts. In case of non-respect of the procedures especially on the expenditure related to the operations involved are *ineligible* in terms of Community financing.

The interventions of the Commissions' representatives, in the process of concluding or the implementing the contracts are to see whether or not the conditions for the Community financing are met in the context of external assistance. They will not take action against the principle by which the decentralised contracts become national contracts that are only prepared, elaborated and concluded by the decentralised Contracting authority. The tenders and candidates for these contracts cannot be considered as beneficiaries by the Commissions' representatives in the process of concluding or the implementing the contracts. They must only hold a legal bound with the decentralised Contracting authority and the Commissions' representatives because the acts *may not cause a shift* within the Contracting authority's decision and which is taken by the Community.

The Contracting authority assumes fully responsible for its actions and will be accountable for any successive audit or other investigation. There are strict rules governing the way in which contracts are awarded. These rules help to ensure that qualified contractors are chosen without bias and that the best value for money is obtained, with the full transparency appropriate to the use of public funds.

[31] Guide On Grants And Public Procurement Under Pre-Accession Instruments, Final version May 2004

## 2.3. Grounds for Exclusion

A tenderer or a candidate will be excluded from participation in the cases found to fall within any of the categories of exclusion which is given, in the meanwhile the Directives, by using the term "may", do not make the exclusion of tenderers obligatory for each category of exclusion. The Directives provide a choice to be made as to which exclusion categories are to be applied (i.e., those which are necessary or appropriate in light of the object of the procurement). According to the contract procedures the candidates or tenderers will be excluded from participating if:

a) *"they are bankrupt or being wound up, are having their affairs administered by the courts, have entered into an arrangement with creditors, have suspended business activities, are the subject of proceedings concerning those matters, or are in any analogous situation arising from a similar procedure provided for in national legislation or regulations;*

b) *they have been convicted of an offence concerning their professional conduct by a judgment which has the force of res judicata;* (for fraud, corruption, involvement in a criminal organisation or any other illegal activity detrimental to the Communities' financial interests.)

c) *they have been guilty of grave professional misconduct proven by any means which the Contracting authority can justify;*

d) *they have not fulfilled obligations relating to the payment of social security contributions or the payment of taxes in accordance with the legal provisions of the country in which they are established or with those of the country of the Contracting authority or those of the country where the contract is to be performed;*

e) *they have been the subject of a judgment which has the force of res judicata for fraud, corruption, involvement in a criminal organisation or any other illegal activity detrimental to the Communities' financial interests;*

f) *following another procurement procedure or grant financed by the Community budget, they have been declared to be in serious breach of contract for failure to comply with their contractual obligations"*[32].

### *2.3.1. Exclusion for work, supply and service contracts*

Depending on the national legislation of the country in which the tenderer or candidate is established, the above documents relate to legal persons and/or natural persons including, where considered necessary by the Contracting authority, company directors or any person with powers of representation, decision-making or control in relation to the candidate or tenderer. Where they have doubts concerning the personal situation of candidates or tenderers, Contracting Authorities may themselves apply to the competent authorities referred to above to

[32] Guide On Grants And Public Procurement Under Pre-Accession Instruments, Final version May 2004

obtain any information they consider necessary about that situation. Candidates (first stage of a restricted procedure) and tenderers (second stage of a restricted procedure for service contracts or the single stage of an open procedure for works and supply contracts) must sign their applications including the declaration that they do not fall into any of the categories cited above Tenderers who have been notified the award of a contract must supply the proof usual under the law of the country in which they are established that they do not fall into the categories listed above. The date on the evidence or documents provided must be no earlier than 1 year (BUDGET)/180 days (EDF) before the date of the notification of award. Tenderers must, in addition, provide a grave statement that their situations have not altered in the period that has elapsed since the evidence in question was drawn up. If the supporting documents are written in a language other than the language(s) of the call for tenders, a translation into one of those languages must be attached which will apply for the purposes of interpreting the application or the bid.

For contracts with a value of less than EUR 50.000, the Contracting authority may, depending on its analysis of risks, ask candidates or tenderers to provide only a signed declaration that they do not fall into the categories listed above. In that case no pre-financing or interim payment may be made.

The decentralised Contracting Authorities can consult the relevant services of the European Commission in order to appreciate the situation of the candidates or tenders. Contracts may not be awarded to candidates or tenderers who, during the procurement procedure:

a) are subject to a conflict of interest;
b) are guilty of misrepresentation in supplying the information required by the Contracting authority as a condition of participation in the contract procedure or fail to supply this information.

### *2.3.2. Misleading, False Declaration of the Beneficiaries and Penalties*

Without prejudice to the application of penalties laid down in the contract, candidates or tenderers and contractors who have been guilty of making false declarations or have been found to have seriously failed to meet their contractual obligations in an earlier procurement procedure will be excluded from the award of all contracts and grants financed by the Community budget for a maximum of two years from the time when the infringement is established, as confirmed after an adversarial procedure with the contractor. That period may be extended to three years in the event of a repeat offence within five years of the first infringement.

Tenderers or candidates who have been guilty of making false declarations will also receive financial penalties representing 2% - 10% of the total value of the contract being awarded. Contractors who have been found to have seriously failed to meet their contractual obligations will receive financial penalties representing 2% - 10% of the total value of the contract in question. That rate may be increased to 4% - 20% in the event of a repeat offence within five years of the first infringement.

## 2.4. Procurement Process in the European Union Funds (Tender Procedure)

Basic principle is governing the award of contracts is competitive tendering. The purpose is;

a) to ensure transparency in operations
b) to obtain the best prince possible for the desired contracts

There are different procurement procedures, once the European Commission give approval to the activities, contracting authority can proceed with tendering and contracting the following principles of standard procedures which will be taken into consideration by a graphic.

The thresholds given in this table (Annex A6) are based on the maximum budget for the contract (including any co-financing).

For the best result in the procurement process, there are early steps have to be taken by the tenderer: the first step is to define the needs, second one is to identify the parties, thirdly the determination of the feasibility in the project and the last one is deciding on acquisition.

*a) Defining the needs is an essential, in the procurement process. A proper definition of the needs will help determining the scope of the goods, works or services, and identifying the inputs to be provided by the client, and set standards and requirements against which future performance delivery to evaluate. At this process, it is useful to consider the need, not in terms of the characteristics of the goods, works or services supposedly required but it has to be dealt with only, in the feasibility. As an alternative, in order to allow the optimum solution to be found, the needs should be defined in terms of the objectives to be reached: the benefits and advantages to be obtained, the performance or service level to be reached, the functions to be carried out, or the knowledge, skills or insight to be gained.*

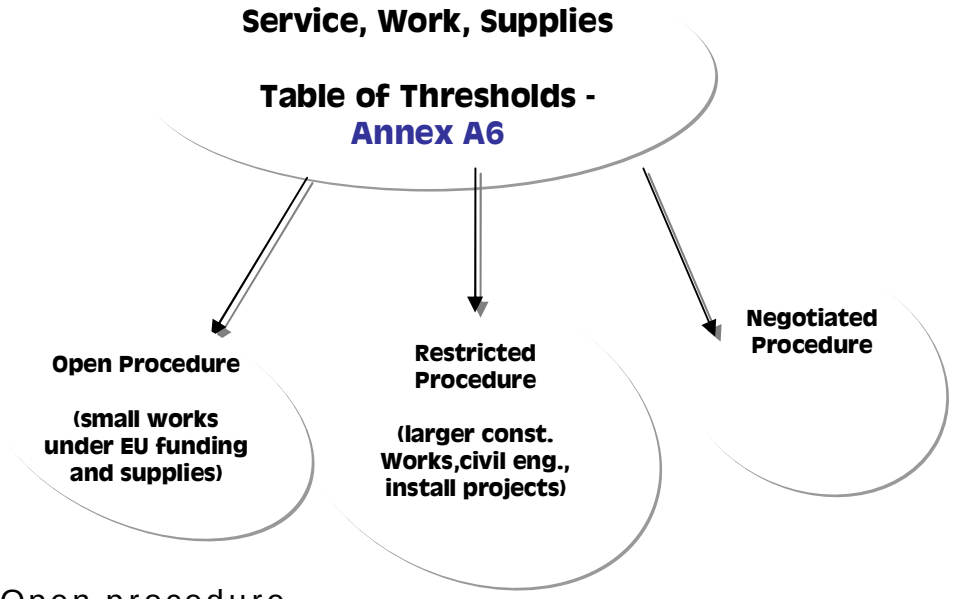
*b) Identifying the parties and interests concerned in the project. They will all have different interests, roles and responsibilities. Many will have rights to interfere in the preparation or implementation process. Ignoring any of the interested parties at the beginning may upset project implementation and cause unnecessary delays and cost increases as a financial perspective.*

*c) Once the needs have been identified, it is necessary to determine in rather greater detail; the feasibility of meeting them by various means possible, so that an informed decision can be taken on which solution and approach to select for the implementation of the project. This is often done in the form of a feasibility study carried out for this purpose by experts in the field concerned, in close consultation with the parties concerned. If sufficient internal resources are available, the contracting authority may prefer to carry out the study in-house, otherwise a suitably qualified external consultant should be engaged. It is important to start out by considering a sufficiently wide range of possible solutions, and to narrow down the choice only little by little. Each step taken in this process must be clearly described and suitably documented.*

d) *After having determined the needs, identified the parties concerned, studied the feasibility of various approaches and estimated their economic implications, and carried out appropriate consultations, the contracting authority should be in a position to decide which goods, works and services will be procured. It is important to formulate this decision in terms which are not very limitative or restrictive. For the contracts, best value for money is obtained when suppliers, contractors and consultants have a certain freedom to propose the goods, works and services which best serve the needs identified and best meet the contracting authority's requirements. In particular, specifications or designs must not be more detailed than appropriate in view of the project delivery strategy chosen; terms of reference would typically put more emphasis on the results to be achieved than on the precise activities to be carried out. The time frame for implementation will be given.*

### 2.4.1. The choice of procurement Procedure

The choice of procurement procedure should be determined by the complexity and nature of the contract by taking into account the need of efficiency and cost-effective procurement processes, including the optimal use of the competitiveness in the market.




#### 2.4.1.1. Open procedure

Calls for tender are open to all interested economic operators where they can submit a tender. For supporting transparency principle, maximum publications will be done in order to attract any natural or legal person who wishes to tender receives upon request the *tender dossier*[33]. When the tenders received are examined, the contract is awarded by conducting the selection procedure and the procurement procedure.

[33] (a)Invitation to Tender; (b) Instructions to Tenderers; (c) General and Special Conditions of Contract; (d) Technical Specifications; (e) Tender Form; (f) Contract Form; (g) Appendices (model financial offers, forms for guarantees, etc., as applicable). Tender Procedure - Decentralised Contracting authority, February 2004

#### 2.4.1.2. Restricted procedure

Calls for tender are restricted where all economic operators ask to take part but only candidates satisfying the selection criteria may submit a tender. The Contracting authority invites a limited number of candidates to tender, before procedure will draw up a shortlist of suitable candidates determined to perform a contract with the contracting authority. The selection procedure, is to cut down the longlist to a shortlist form, by examining responses to procurement notice in which the selection criteria and general description of the tasks to be undertaken.

In the second stage of the procedure, the Contracting authority invites the shortlisted candidates and sends them the tender dossier. In order to ensure fair competition, tenders must be submitted by the same service provider or consortium.

#### 2.4.1.3. Negotiated procedures

Under the competitive negotiated procedure, the Contracting authority invites tenders from candidates of its choice. At the end of the procedure, it selects the most economically advantageous tender in case of service tenders and the cheapest compliant offer in case of supplies or works tenders.

### *2.4.2. Framework contracts*

A contract concluded between a contracting authority and an economic operator for the purpose of agreeing on the essential terms governing a series of specific contracts to be awarded during a limited timeline, especially regarding *the duration, subject, prices, conditions of performance and the quantities foreseen.* Only specific contracts concluded under framework contracts are proceeded by a budget commitment. For each individual assignment, the contracting authority invites contractors drawn from the list to submit an offer within the bounds of the framework contract. *It then selects the most economically advantageous tender.*

The contracting authority may also conclude multiple framework contracts, which are separate contracts with identical terms awarded to a number of suppliers or service providers which is explained with an example under this topic. The specifications will then specify the maximum number of operators with whom the contracting authority will conclude contracts. The duration of such contracts may not exceed four years, save in exceptional cases justified in particular by the subject of the framework contract. Contracting authorities may not make unjustified use of framework contracts or use them in such a way that the purpose or effect is to prevent, restrict or distort competition which is against the fair competition.

*For short-term, technical assistance contracts under €200,000 and with a performance period (i.e., duration of actual services to be provided) of under 12 months, the Contracting Authority must use the Framework Contract. The duration of such contracts may not exceed four years, save in exceptional cases justified in particular by the subject of the framework contract. Contracting authorities may not use framework contracts in such a way that the purpose or effect is to prevent, restrict or distort competition. Detailed information including templates for the Framework Contracts can be found on the Europeaid website.*

*For sectors which are not covered by the Framework Contract or where such a procedure has been unsuccessful, the competitive negotiated procedure/simplified procedure should be used.*

### 2.4.3. Transparency and fair competition

In 1996 the Commission launched an initiative to improve the transparency and efficiency of tendering and contracting under the external assistance programs, particularly with regard to service contracts. The companies and organisations submit their expressions of interest and are taken into consideration in a fully standardised and official pre-qualification procedure. The improvements have not only increased the overall transparency of the tendering process, but also ensure that only companies that have indicated specific interest will be invited to tender. Supply and works contracts have always been published in the official journal (OJ) of the EU. General project and contract information (programme summaries, budgets still available for contracting, etc.) relating to services and technical cooperation has also been published in the Official Journal. Finally, a list of awarded contracts is published in the OJ on a regular basis. In 2003, the European Commission worked to improve the rules on advertising, tendering, technical evaluation, participation and contract awards, and produced a new European Commission External Aid Contract Procedures to ensure the easier implementation of the principles such as equal treatment, non-discrimination and proportionality.

Any company wishing to participate in a tender is thus assured of complete equality and transparency from the time of the tender announcement on the internet and-or in the official journal right through to the award of the contract to the successful tenderer. The arrangements for competitive tendering and publicising contracts for works, supplies and services depend on the contract value. The contract depends on which of the components (works, supplies or services) overcome an assessment which must be made on the basis of the value and strategic importance of each component relative to the contract as a whole. No contract may be split simply to avoid compliance with the rules. If there is any doubt about how to estimate the value of the contract, the Contracting authority must consult the European Commission on the matter before embarking on the procurement procedure. Whatever the procedure used, the Contracting authority must ensure that conditions are such as to allow fair competition. Wherever there is an obvious and significant inequality between the prices proposed and the services offered by a tenderer, or a significant difference in the prices proposed by the various tenderers (i.e., in cases in which publicly-owned companies, non-profit associations or non-governmental organisations are taking part in a tender procedure alongside private companies), the Contracting authority must carry out checks and request any additional information necessary. The Contracting authority must keep such additional information confidential.

## 2.5. Award Criteria

*As it is indicated in the procurement procedure, contracts are awarded in one of the following two ways:*

a) *under the procurement procedure, in which the contract is awarded, in order to satisfy the conditions, and the lowest price given; by taking into account e.g. quality, technical advantage, functional and environmental characteristics, service, delivery dates, price*

b) *under the best-value-for-money procedure. The criteria should be precise, non-discriminatory and not prejudicial to fair competition and transparency.*[34]

[34] SIGMA, Support for Improvement in Governance and Management, A joint initiative of the OECD and the European Union, principally financed by the European Union, December 2004

It is very important to select award criteria which match the specifications and requirements and correspond to the nature and purpose of the goods, works or services to be procured. Typically, quality and technical advantage are dominating importance for consulting services. It may also be important criteria for works and equipment. For routine goods, where quality, delivery time and other factors are less significant, lowest price may be adequate.

The selection, qualification and award criteria must be determined and made known to tenderers in advance of the respective procurement proceedings. This is typically done by including information in notices and in the tender documents.

Where the criterion is most economically-advantageous-tender, in addition to price, the following factors, as examples, may be considered, as applicable:

- delivery and completion date;
- running costs;
- cost-effectiveness;
- quality;
- economical, aesthetic and functional characteristics;
- technical merit;
- after-sales service; and
- technical assistance.

When the Directives in the acquis communautaire examined for the award criteria, the results are exceptionally strange:

In the awarding criterias, competitive tendering is the principle governing the award of contracts to ensure the transparency of operations and to obtain the desired quality of the services, supplies or works at the best possible price. It also states that the applicable regulations oblige the Commission and the contracting authority to guarantee the widest possible participation on equal terms in tenders subject to Community financing and that there are several different award procedures, each allowing for a different degree of competition but the Directives do not specify "*best tender*" or "*desired quality at best possible price*" in the European Union law, so it leaves the decision to member states to design their national policy in this respect while allowing award on the basis of "*lowest price*" or "*most economically advantageous tender*", in which aspects of the quality of the offer are related to the price or cost.

However, the principles of the awarding consistent with the fundamental rules of the Treaty and the Directives, except for imposing eligibility rules that may have an impact on the economic advantage achievable. In fact it is not clear that the procedures foreseen do not allow any differing point of competition.

The principal *automatic award procedures*[35] of open and restricted tendering on the one hand and the negotiated procedure on the other, are either open to all eligible undertakings or do not

[35] A Clause-by-Clause Analysis in comparison with the EC Directives, December 2003**,** the term "automatic award procedure" used as the equivalent of the lowest price criterion seems to be both inappropriate as well as indicative of a procedure of an electronic nature, which is not the case. The same lack of precision could be said to apply to the best value-for-money procedure, where no factors are mentioned, giving the incorrect impression that the automatic procedure would not produce best- value for- money and vice versa.

involve a call for competition. Open and restricted tendering are clearly compatible with the principle of competitive procurement on which the Directives are based, but it is questionable whether the procedures foreseen for usage in the thresholds (Annex A6) of the Directives are sufficient to meet the principle of transparency.

Moreover, the award criterias does not make condition for usage of the Directives' in which negotiated procedure with a call for competition, even in circumstances in which the open or restricted procedure would not be considered appropriate. The principles are incompatible with the Directives in this respect and in the effect of limiting a Contracting Authority's ability to secure a satisfactory economic outcome for the Community funding provided. Compatibility could readily be achieved by adopting the Directives' criteria for the use of the various procedures above their thresholds together with a requirement for transparency and an appropriate form of competition for contracts below the threshold, unless there is a compelling justification to the contrary.

## 2.6. The Evaluation Committee

### *2.6.1. Composition*

Where an evaluation committee is used, the contracting authority appointed the members on a personal basis. The membership consists from an observer, a non-voting Chairman, a non-voting Secretary and a minimum of 3 (three) voting members. Each member should demonstrate a working proficiency of the language and should have equal voting rights in which the tenders are submitted. The voting members have to be capable of the technical and administrative capacities and information necessary to give an informed opinion on the tenders. The reports must be held by the committee in every meeting. Any absence should be recorded and explained in this report which is called tender evaluation report. (i.e., the names and functions of all those involved in the evaluation process must be recorded in the tender evaluation report).

### *2.6.2. Impartiality and confidentiality*

All members of the evaluation committee, including the observer, must sign a Declaration of Impartiality and Confidentiality (Annex A7). Any tender committee member or observer who has a potential conflict of interest due to a link with any tenderer must declare it and immediately withdraw from the tender committee. No information about the examination, clarification, evaluation or comparison of tenders or decisions about the contract award can be disclosed before the conclusion of the contract by the contracting authority and the successful tenderer. Any attempt by a tenderer to influence the process in any way (whether by initiating contact with members of the tender committee or otherwise) will result in the immediate exclusion of its tender from further consideration:

- Apart from any tender opening session, the proceedings of the tender committee are conducted in camera and are confidential.
- In order to maintain the confidentiality of the proceedings, participation in the tender committee meetings should strictly limited to the members of the tender committee, including the observer.

- The tenders should not leave the room/building in which the committee meetings take place before the conclusion of the work of the tender committee. They should be kept in a safe place when not in use.

### 2.6.3. Responsibilities of the Evaluation Committee members

The Chairman is responsible for coordinating the evaluation process and for ensuring its impartiality and transparency. The voting members of the evaluation committee have collective responsibility for the recommendations made by the Committee. *The Secretary to the Committee is responsible for carrying out all administrative tasks connected with the evaluation procedure. These will include:*

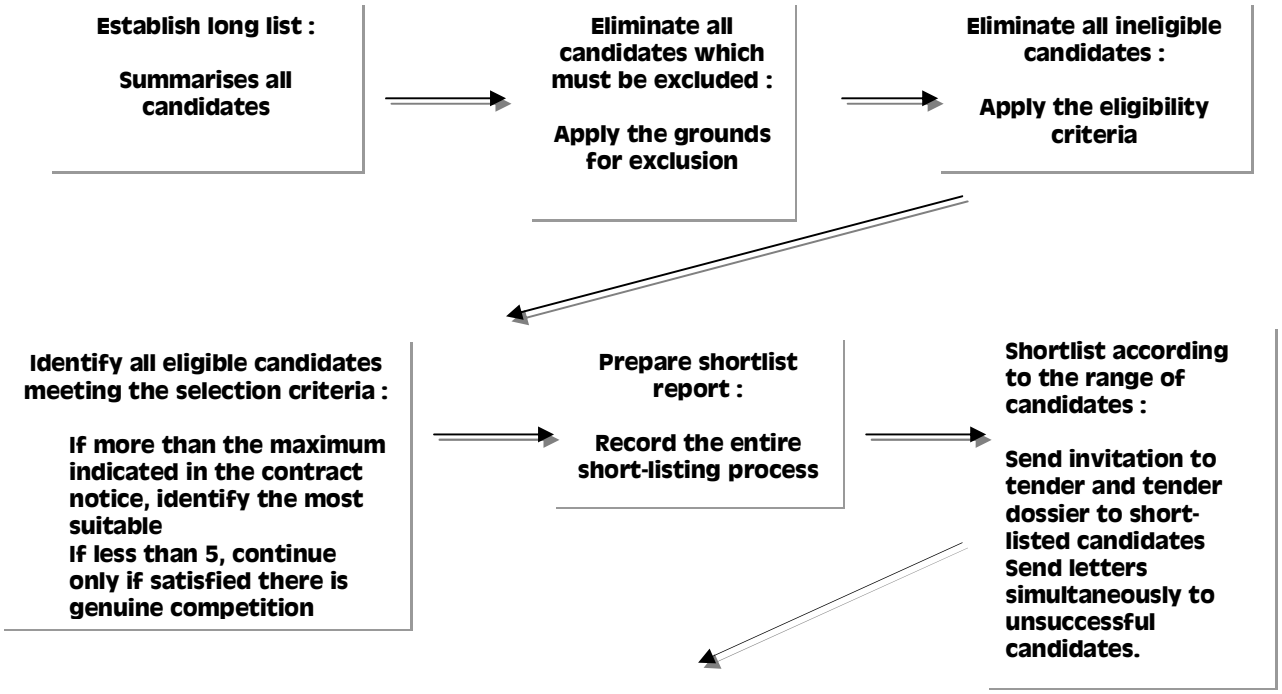
*a) circulating and collecting the Declarations of Impartiality and Confidentiality;*
*b) keeping the minutes of all meetings of the tender committee and the relevant records and documents;*
*c) registering attendance at meetings and compiling the Tender Evaluation Report and its supporting annexes*

### 2.6.4. Timetable

The evaluation committee should be formed early enough to ensure the availability of the designated members during the period necessary to prepare and conduct the evaluation process. The tender evaluation should start and be completed as soon as possible. The duration of the evaluation process should be agreed between the tender committee and the contracting authority. The evaluation process should take as long as necessary having regard to the need to notify the successful tenderer within the tender validity period specified in the tender dossier. *The Directives do not contain any provisions on the organisation of the tender proceedings except to require tenders to be opened after the deadline and to make provision for confidentiality; otherwise it is entirely a national concern to elaborate these procedures.*[36]

[36] A Clause-by-Clause Analysis in comparison with the EC Directives, December 2003

**Evaluation committee meets to establishment of shortlist:**




## 2.7. Tender Opening Procedure

The purpose of the tender-opening session is to check that the tenders are complete, that the *tender guarantee*, whenever required, has been provided, that the documents have been duly signed and that the tenders are generally in order.

The receipt and opening of tenders must be done in a manner to ensure the regularity of the proceedings. The tender opening session may be done by a public opening or by a non-public opening.

*Public opening of tenders is recommended by the European Commission under Community funding for all supply and works contracts governed by the Directives under the application of the open or restricted procedures, except for tenders submitted by electronic means where special procedures may be used.*[37]

*Non-public opening of tenders at a formal meeting is acceptable, particularly for consultant services contracts, including other services, and in general for low value contracts, which normally implies contracts below the EC thresholds or as otherwise determined by the contracting authority or national legislation. The opening should be conducted by a tender committee or alternatively by a panel of at least two persons appointed by the contracting authority.*

Here is a stage by stage explanation of the tender opening meeting. (Where held in **non-public**)

[37] Guide On Grants And Public Procurement Under Pre-Accession Instruments, Final version May 2004

## a) Part 1: Preparatory phase

- *First meeting of Evaluation Committee:*

    a) *to be held before starting the actual evaluation;*
    b) *the tender dossier should have been circulated in advance to the members of the Evaluation Committee.*

- *The Chairman presents the purpose of the tender procedure in general terms.*

- *The Chairman reminds the Committee of the award criteria and weightings specified in the tender dossier, stating that these must be respected without modification. (The selection criteria used in the short-listing of candidates should not be used during the tender evaluation).*

- *The Chairman explains the procedures to be followed by the Evaluation Committee.*

- *Before the tenders are opened, the Chairman of the Committee checks that all members are familiar with the technical evaluation grid (Annex 8) set out in the tender dossier to make sure that the tenders will be evaluated by the different members of the Committee in a consistent manner.*

- *The Chairman reminds the Committee of the Contracting Authority's minimum technical requirements, of the criteria for technical evaluation (80 points), that the financial evaluation will be carried out later as per the tender dossier, and that the weightings given to the technical and financial evaluations will be 0.80 and 0.20 respectively. Other weighting that might have been duly authorised by the EC should be explained if necessary.*[38]

## b) Part 2: Compliance with formal requirements

*Chairmen and Secretary's tasks are carried out by the tender opening checklist in (Annex A10):*

- *Examine and state the condition of outer envelopes before opening them in order of receipt, announcing the name of the tenderer and whether separate envelopes have been used for technical and financial offers. Only tenders contained in envelopes received by the date and time indicated in the tender dossier are considered for evaluation.*

- *Require all members of the Evaluation Committee and any observer(s) to read and sign a Declaration of Impartiality and Confidentiality (Annex A7).*

- *Open the inner envelope containing the technical offer and mark the tender envelope number on each copy of the technical offer. The front page of each copy of the technical offer must be initialed by the Chairman and the Secretary.*

- *The Chairman and the Secretary must initial the inner envelope containing the financial offer across the seal, marking the tender envelope number on the envelope. This is not*

[38] Practical Guide to contract procedures for EC external actions (Budget and EDF), Instruction Note from Mr. Richelle, 01/02/2006

*opened and must be locked away in a safe place until the financial evaluation takes place, after completion of the technical evaluation.*

The Committee must decide whether or not tenders comply with the formal requirements at this stage (i.e., following the opening of the outer envelope and the opening of the technical offer).

The Summary of tenders received, which is attached to the Tender Opening Report must be used to record the compliance of each of the tenders with the formal requirements. Non-compliant tenders may be rejected. The evaluation committee may decide to ask for missing documents or formal corrections. This decision has to be applied equally to all tenders.

## c) Part 3: Administrative compliance

The Committee checks the compliance of tenders with the instructions given in the tender dossier. The evaluation committee may decide to ask for missing documents or formal corrections. This decision has to be applied equally to all tenders.

- *Copies of the technical offers are distributed to the Committee members. The originals are locked away for safe keeping.*

- *Each technical offer is examined for compliance with the tender dossier, in particular that:*

  - *the documentation is complete*

  - *the language required by the tender dossier has been used*

  - *a declaration of intent, accepting the terms of reference and general conditions, has been signed by the tenderer (i.e., leader and all consortium partners, in the case of a consortium)*

  - *each of the key personnel proposed have signed a statement of availability and exclusivity for this tender*

  - *for consortia: the confirmation of association and designation of a lead company has been signed by all consortium members*

  - *for tenderers intending to subcontract tasks (if permitted by the tender dossier):*

  *the tenderer has included a statement regarding the content and extent of subcontracting envisaged, which must be within the limit stated in the tender dossier, and the identity of the sub-contractor with the agreement of the other Evaluation Committee members, the Chairman may communicate in writing with tenderers whose submissions require clarification. The evaluation committee may decide to ask for missing documents or formal corrections. This decision has to be applied equally to all tenderers.*[39]

[39] Practical Guide to contract procedures for EC external actions (Budget and EDF), Instruction Note from Mr. Richelle, 01/02/2006

Where the tender opening is public, the minutes of the tender opening should be sent to the participants promptly after the opening of the tenders. Where appropriate, the minutes might also be published on the website of the contracting authority. The following are usually announced at a public tender-opening session: the names of the tenderers, the unevaluated tender prices, provision of any requisite tender guarantee and fulfillment of any other formality or condition that the contracting authority thinks appropriate. A Tender Opening Report should be prepared for all tenders, irrespective of value. It should comprise a summary of the tenders submitted and the minutes of the tender opening session. A simplified version may be used for low-value contracts.

The Tender Opening Report should state:

*a) the date, time and place of the session;*

*b) the persons present;*

*c) the names of the tenderers who have responded within the deadline;*

*d) whether the originals of the tenders were duly signed, and whether the tenders were sent in the requisite number of copies.*

## 2.8. Evaluation of Offers

### a) Part 1: Administrative compliance

The Committee checks the fulfillment of tenders with the instructions given in the tender dossier and in particular the administrative compliance grid (Annex A11). Any major formal errors or major restrictions affecting performance of the contract or distorting competition result in the rejection of the tender concerned. Nationality of experts (European Development Fund) and subcontractors: the evaluation committee must check at this stage that the nationalities of any experts and/or subcontractors identified in the technical offers satisfy *the nationality rule* which is mentioned before. If the service provider is required by the terms of reference to provide supplies in accordance with detailed technical *specifications* agreed on *in the terms of reference, the Evaluation Committee must verify that the planned supplies must satisfy* the rule of origin. With the agreement of the other evaluation committee members, the chairperson may communicate in writing with tenderers for the submissions which require clarification, and offering them the possibility to respond within a rational time period to be fixed by the Committee. The administrative compliance grid included in the tender dossier, and it must be used to record the administrative compliance of each of the tenders.

### b) Part 2: Technical compliance

The Committee then examines the technical offers, the financial offers remaining sealed. When evaluating technical offers, each member awards has a score out of a maximum 100 point in accordance with the technical evaluation grid laid down in the tender dossier. Whatever the circumstances are, the Committee and its members may not change the technical evaluation grid communicated to the tenderers in the tender dossier however in practice, it is recommended that tenders score for a given criteria on one after another, rather than scoring each tender for all criteria before moving on to the next. If the content of a tender is incomplete or mistaken substantially from one or more of the technical award criteria lay

down in the tender dossier (i.e., the required profile of a certain expert or the lack of information), **the tender should be automatically rejected, without being given a score**, but this should be justified in the evaluation report. If the tender dossier specifically permits variations, such variations are scored separately. All the variation solutions in the tenders must be evaluated on the basis of the points awarded to the criteria in the evaluation grid concerning such variants. Each voting member of the Committee completes an evaluation grid (Annex A8) to record his assessment of each technical offer in order to establish a general appreciation of strengths and weaknesses of the individual technical offers.

## 2.8. The Scoring Procedure

On conclusion of the technical evaluation, the points awarded by each member are compared at the Committee's session. Besides the numerical score, a member must explain the reasons for his choice and defend his scores in front of the Committee. The Committee discusses each technical offer and each member awards it a final score. The committee members may modify their individual evaluation grids as a result of the general discussion on the merits of each offer. Once discussed, each evaluation committee member finalises his evaluation grid on each of the technical offers and signs it before handing it over to the Secretary of the Evaluation Committee.

The Secretary must then gather a summary of the comments of the Committee members as part of the evaluation report. In the case of major disagreements, a full justification has to be provided by nonconforming members during a meeting of the Evaluation Committee. The format of the summary as part of the evaluation report (Annex A9) indicates the level of detail expected. The Secretary calculates the aggregate final score, which is the arithmetical average (the sum of numbers divided by into the dividend) of the individual final scores. If interviews were provided for in the tender dossier, the Committee may, after writing up its provisional conclusions and before definitively concluding its evaluation of the technical offers, decide to interview the key members of the team of experts proposed in technically compliant tenders *(i.e., those which have achieved an average score of 80 points or more in the technical evaluation).* It is recommended that tenderers which have scored close to the technical threshold also be invited for the interview. In the case of interviews, the experts are interviewed by the Committee, preferably collectively in the case of a team, at intervals close enough to permit comparison. Interviews must follow a standard format agreed beforehand by the Committee and applied to all experts or teams called to interview.

*Tenderers must be given at least 10 days advance notice of the date and time of the interview. If a tenderer is prevented from attending an interview by "forcé majeure", a mutually convenient alternative appointment is arranged with the tenderer. If the tenderer is unable to attend this second appointment, its tender will be eliminated from the evaluation process. On completion of these interviews, the Evaluation Committee, without modifying either the composition or the weighting of the criteria laid down in the technical evaluation grid, decides whether it is necessary to adjust the scores of the experts who have been interviewed. Any adjustments must be substantiated.*[40] This procedure requires considerable costs both for tenderers and the Contracting Authority; therefore the restraint should be used. The indicative timetable for these interviews must be specified in the tender dossier. Once the Committee has established each technical offer's average score (the mathematical average of the final scores

[40] Practical Guide to contract procedures for EC external actions (Budget and EDF), Instruction Note from Mr. Richelle, 01/02/2006

awarded by each voting member), any tender falling short of the 80-point threshold is automatically rejected. *If no tender achieves 80 points or more, the tender procedure will be cancelled.* Out of the tenders reaching the 80-point threshold, the best technical offer is awarded 100 points.
The others receive points calculated using the following formula: Technical score = (final score of the technical offer in question/final score of the best technical offer) x 100.

**Tenderer 1 is automaticly elminated**

**Tenderer 2 and Tenderer 3 are qualified for the financial evaluation**

## a) Part 1: Technical evaluation

| | Maximum possible | Tenderer 1 | Tenderer 2 | Tenderer 3 |
|---|---|---|---|---|
| Evaluator A | 100 | 93 | 88 | 84 |
| Evaluator B | 100 | 80 | 84 | 82 |
| Evaluator C | 100 | 99 | 82 | 90 |
| Total | 300 | 174 | 254 | 256 |
| Average score (mathematical average) | | 174/3=58.00 | 254/3=84.67 | 256/3=85.33 |
| Technical score (actual final score/highest final score) | | Eliminated* | 84.67/85.33=99.22 | 100.00 |

* Only tenderers with average score of at least 80 points qualify for the financial evaluation

## b) Part 2: Financial evaluation *

| | Maximum possible score | Tenderer 1 | Tenderer 2 | Tenderer 3 |
|---|---|---|---|---|
| Total fees (EDF fees, direct/lump-sum costs etc) | | Eliminated following technical evaluation | € 951 322 | € 1 060 452 |
| Financial score (lowest total fee/actual total fees x 100) | | | 100 | 951 322/1 060 452 x100 = 89.71 |

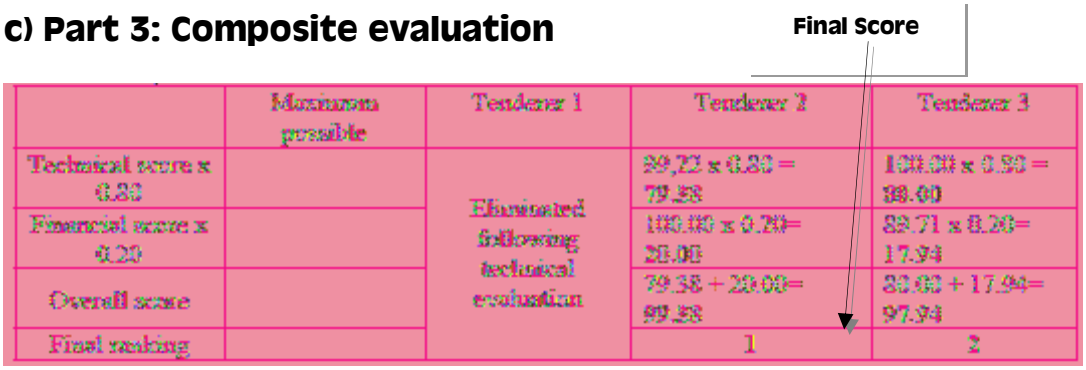
* Only tenderers with average scores of at least 80 points in the technical evaluation qualify for the financial evaluation.

**Tender2 / Tenderer 3 will give the ratio**

Evaluation Committee concludes with the most economically advantageous tender is established by weighing technical quality against price on an 80/20 basis. This is done by multiplying:

- the scores awarded to the technical offers by 0,80
- the scores awarded to the financial offers by 0,20

### c) Part 3: Composite evaluation




| | Maximum possible | Tenderer 1 | Tenderer 2 | Tenderer 3 |
|---|---|---|---|---|
| Technical score x 0.80 | | Eliminated following technical evaluation | 99.22 x 0.80 = 79.38 | 100.00 x 0.80 = 80.00 |
| Financial score x 0.20 | | | 100.00 x 0.20= 20.00 | 89.71 x 0.20= 17.94 |
| Overall score | | | 79.38 + 20.00= 99.38 | 80.00 + 17.94= 97.94 |
| Final ranking | | | 1 | 2 |

The resulting, weighted technical and financial scores are then added together and the contract is awarded to the tender achieving the highest overall score. Moreover this method is much more reliable because calculating only by the average method could lead into error.

## *2.8.1. Centralised;*

The entire procedure (technical and financial evaluation) is recorded in an Evaluation Report to be signed by the chairperson, the Secretary and all voting members of the Evaluation Committee. This must be submitted for approval to the relevant services of the European Commission, which must decide whether or not to accept its recommendations.

## *2.8.2. Decentralised - ex-ante;*

The entire procedure (technical and financial evaluation) is recorded in an Evaluation Report to be signed by the Chairperson, the Secretary and all voting members of the Evaluation Committee. This must be submitted for approval to the relevant services of the Contracting Authority, which must decide whether or not to accept its recommendations. The Contracting Authority must then submit the Evaluation Report together with its recommendation to the European Commission for approval. If there is an award proposal and the European Commission has not already received a copy of the tenders, these must be submitted.

If the European Commission does not accept the recommendation of the contracting authority, it must write to the contracting authority stating the reasons for its decision. The European Commission may also suggest how the Contracting Authority should proceed and give the conditions under which the Authority might endorse a proposed contract on the basis of the tender procedure.

If the European Commission approves the recommendation of the Contracting Authority will either commence awarding the contract or cancel the tender, as recommended.

### 2.8.3. Decentralised- ex-post;

No prior approval from the European Commission is required before the contracting authority acts on the recommendations of the Evaluation Committee.

The Evaluation Report is drawn up. The Contracting Authority will then take its decision. The entire evaluation procedure, including notification of the successful tenderer, must be completed while the tenders are still valid. It is important to bear in mind that the successful tenderer might be unable to maintain its tender (for example, because one or more of the key experts are no longer available) if the evaluation procedure takes too long.

Subject to the Contracting Authority's policy on access to documents, the entire tender procedure is confidential until the signature of the contract by both parties. The Evaluation Committee's decisions are collective and its deliberations must remain secret. The Committee members and any observers are bound to secrecy.

*The Evaluation Report, in particular, is for official use only and may be given away neither to tenderers nor to any party outside the authorised services of the Contracting Authority, the European Commission and the supervisory authorities (e.g., the Court of Auditors).*

### 2.8.4. Evaluation of financial offers

Upon completion of the technical evaluation, the envelopes containing the financial offers for tenders who were not eliminated during the technical evaluation (i.e., those which have achieved an average score of 80 points or more) are opened and all originals of these financial offers are initialed by the chairperson and the Secretary of the Evaluation Committee.

a) *The Evaluation Committee has to ensure that the financial offer satisfies all formal requirements. A financial offer not meeting these requirements may be rejected. Any rejection on these grounds will have to be fully justified in the Evaluation Report.*

b) *The Evaluation Committee checks that the financial offers contain no arithmetical errors. Any arithmetical errors are corrected without penalty to the tenderer. The envelopes containing the financial offers of rejected tenderers following the technical evaluation must remain unopened and retained.*[41]

#### a) Evaluation of financial offers in terms of the budget

The total contract value comprises the fees (including employment-related overheads), the incidental expenditure and the provision for expenditure verification, which are specified in the tender dossier. This total contract value is compared with the maximum budget available for the contract. Tenders exceeding the maximum budget allocated for the contract are eliminated. The Evaluation Committee then proceeds with the financial comparison of the fees between the different financial offers. The provisions for incidental expenditure, as well as the provision for expenditure verifications are excluded from the comparison of the financial offers as it was specified in the tender dossier.

[41] Guide On Grants And Public Procurement Under Pre-Accession Instruments, Final version May 2004

The tender with the lowest total fees receives 100 points. The others are awarded points by means of the following formula:

Financial score = (lowest total fees / total fees of the tender being considered) x 100.

When evaluating financial offers, the Evaluation Committee compares only the total fees.

### b) Evaluation of financial offers in terms of The European Development Fund (EDF)

Comparison of the financial proposals takes account of all contract expenses (fees, direct or lumpsum costs, etc.) with the exception of expenses repayable on presentation of proof of payment (i.e. reimbursable costs). The tender dossier, which includes a budget breakdown, requires the tenderer to classify these costs. The committee must nevertheless check the conformity of this classification and correct it where necessary. Fees are set by the tenderer alone. Financial offers exceeding the maximum budget allocated for the contract are eliminated. The lowest financial offer receives 100 points. The others are awarded points by means of the following formula:

Financial score = lowest financial proposal (excluding reimbursable)/the price of the bid under consideration (excluding reimbursable) x 100. When evaluating financial offers, the Evaluation Committee compares only the total fees and direct costs, (i.e., excluding expenses reimbursable on presentation of proof of payment.)

## 2.9. Preparation of Tender Dossiers

The tender dossier holds a *key position* in the tendering process and must provide all the information needed in a complete disciplinary way to obtain the contract. While the detail and complexity of the documents may vary with the size and nature of the contract, they generally should include:

a) The invitation to tender;
b) Instructions to tenderers;
c) General and Special Conditions of Contract;
d) Terms of Reference/Technical Specifications

*The tender dossier needs to be drafted so as to permit and encourage effective competition. The documents need to define as clearly as possible the scope of the works, goods or services to be procured, the minimum standards to be met by candidates and tenderers, the rights and obligations of the purchaser and the supplier, contractor or service provider, and any conditions to be met in order for a tender to be declared compliant, that is to say substantially responsive to the tender dossier.*[42] *If there needs to be a clarification meeting or site visit to clarify the tender dossier, including the scope of work and technical requirements, this should be specified in the instructions to tenderers, together with details of the arrangements.*

[42] Multiple Framework Contract in the field of audit of external aid programmes managed by the European Commission's Directorate – General for Enlargement, (ELARGE5FWCAudit2006)

## 2.9.1. Tender guarantees

A tender guarantee, which is precised in the tender opening procedure, is the amount specified in the tender documents, to afford the contracting authority and to protect against irresponsible tenders and may be acceptable for high value contracts in certain circumstances. However a tender guarantee should not be set so high as to discourage tenderers and the amount should normally fall within the range of 1-5 % of the estimated contract price. Eventhought the percentage, would be a burden or and obstacle for small and medium sized entities, so it should be used with moderation. The more measures get into the tender procedure the more Small and Medium Entities (SMEs) will get discouraged. A tender guarantee may be appropriate for works contracts and for complex supply contracts of significant value, not necessarily required for routine service contracts, framework agreements or low-value contracts. It represents financial costs as well as being an administrative burden for all participating firms so that is important issue to be discussed on, **"***the dilemma on the external aid***".** On one hand European Union is contributing to the country with external aid and new regulations to implement on the other hand this aid only contributes to the ones which are already develop and also the new implementation brings huge burdens to small and medium sized entities. Final step for the tender procedure is the awarding the tenderer by a contract.

## 2.9.2. Award of the contract

### 2.9.2.1. Informing the successful tenderer

*Centralised, decentralised - ex-post perspective;* before the period of validity of tenders expires, and on the basis of the evaluation report which is approved by the committee, the contracting authority notifies the successful tenderer in writing that its tender has been accepted (Annex A12) and draws attention to any errors which were corrected during the evaluation process.

*Decentralised - ex-ante;* in addition to centralised and decentralised ex-post perspective, the European Commission must give its formal *approval of award* prior to the submission of the notification letter. This notification is for the successful tenderer implies that the validity of the successful tender which is automatically extended for a period of 60 days. The further period is added to the initial period of 90 days irrespective of the date of notification. At the same time, the contracting authority requests the successful tenderer (i.e., to submit the evidence required by the tender dossier to confirm the declarations made in the tender submission form *within 15 days* of the date of the notification letter). The contracting authority must examine the evidence submitted by the successful tenderer before sending the contract to the tenderer for signature. In such circumstances as a contract is awarded under a financing agreement which had not been concluded at the time the tender procedure was launched, the contracting authority must not notify the successful tenderer before the financing agreement has been concluded.

### 2.9.2.2. Contract preparation and signature

In preparing the contract for signature, the Contracting Authority must proceed as follows:

Prepare a contract dossier using the following structure:

a) *Explanatory note (Annex A13)*
b) *Copy of the financing agreement authorising the project*

c) *Copy of the tender announcements (contract forecast, procurement notice and shortlist), Shortlist Report, Tender Opening Report, Evaluation Report, and any other relevant information*
d) *Three originals of the proposed contract, which is based on the standard contract template the standard contract annexes for the General conditions and Forms and other relevant documents must be reproduced without modification in every contract. Only the Special Conditions should need to be completed by the contracting authority.*[43]

*In the decentralised – ex-ante;* the approach is; the contracting authority sends the contract dossier to the Delegation of the European Commission for endorsement. The Delegation signs all originals of the contract for endorsement (and initials all pages of the Special Conditions) to confirm the Community financing and sends them back to the Contracting Authority and no approval by the Delegation.

a) *Sign and date all originals of the contract and initial all pages of the Special Conditions.*

b) *Send the three signed originals of the contract to the successful tenderer, who must countersign them within 30 days of receipt (and, in any case, before the expiry of the tender validity period)*

c) *Return two originals to the Contracting Authority together with the eventual financial guarantee(s) required in the contract. If the successful tenderer fails to do this within the* ***specified deadline or indicates at any stage that it is not willing or able to sign the contract, the tenderer cannot be awarded the contract****. The contract preparation process must be restarted from step with a new contract dossier prepared using the tender which has achieved the next highest score (provided that the tender passed the technical threshold and is within the maximum budget available for the contract).*[44]

*Centralised, decentralised - ex-post;* on receipt of the two signed originals from the successful tenderer, check that they correspond strictly to those sent originally, and send one original to the financial service in charge of payments and the other to the Project Manager.

*Decentralised - ex-ante;* on receipt of the two signed originals from the successful tenderer, the Contracting Authority sends one to the Delegation of the European Commission.

*The contract takes effect on the date of the later signature. The contract cannot cover earlier services or enter into force before this date.*

#### 2.9.2.3. Publishing the award of the contract

The contracting authority must informs candidates and tenderers in accordance with the decisions reached which concerning the award of the contract by including the grounds for any decision not to award a contract for which there has been competitive tendering or to recommence the procedure.

[43] The Practical Guide to contract procedures financed from the General Budget of the European Communities in the context of external actions, December 2003

[44] Guide On Grants And Public Procurement Under Pre-Accession Instruments, Final version May 2004

*Once the contract has been signed, the contracting authority must prepare contract award notice and send it to the European Commission, which publishes the results of the tender procedure in the Official Journal(OJ), on the Europeaid official website and in any other appropriate media.*

*In addition, the contracting authority must:*

a) *send the other tenderers a standard letter* (Annex A14) *within not more than 15 days from receipt of the countersigned contract;*
b) *record all statistical information concerning the procurement procedure including the contract value, the names of the other tenderers and the successful tenderer.*

The contracting authority is responsible for preparing the contract award notice and for submitting it for publication to the European Commission in electronic form without delay after having received the countersigned contract from the successful tenderer.

## 2.9.3 Modifying contracts

Contracts may need to be modified during their duration of awarding; if the circumstances affecting the project implementation have changed since the initial contract was signed. Contract modifications must be formalised through an administrative order or an addendum to the contract in accordance with the provisions of the General Conditions of the contract. Substantial modifications through the contract, including modifications to the total contract amount, must be made by means of an addendum.

*Such an addendum must be signed by the contracting parties (and, under a decentralised ex-ante system, approved and endorsed by the European Commission). Changes of address, changes of bank account and changes of auditor (in the case of service contracts) may simply be notified in writing by the contractor to the contracting authority, although this does not affect the right of the contracting authority to oppose the contractor's choice of bank account or auditor.*[45]

### 2.9.3.1. General principles of contracts

A contractor's request for contract modifications should not automatically be accepted by the contracting authority. The contracting authority must examine the reasons given and reject requests which have little or no verifications. If a contractor has a rejection or a modification needed, he/she can only do it within the execution period of the contract. The purpose of the addendum must be closely connected with the nature of the project covered by the initial contract. Major changes, such as a fundamental alteration of the terms of reference or technical specifications, cannot be made by means of an addendum. As the addendum must not change the competition conditions at the time the contract was awarded.

Requests for contract modifications must be made (by one contracting party to the other) well in advance and in any case before the end of the implementation period to allow for the addendum to be signed by both parties before the expiry of the execution period of the contract.

[45] On Grants And Public Procurement Under Pre-Accession Instruments, Final version May 2004

Any modification extending the period of implementation must be such that implementation and final payments can be completed before the expiry of the financing agreement under which the initial contract was financed.

### 2.9.3.2. Preparing an addendum for contracts

In preparing an addendum, the Contracting Authority must proceed as follows:

- Use the standard template for an addendum:

All references in the proposed addendum to article numbers and/or annexes to be modified must correspond to those in the initial contract.Any addendum modifying the budget must include a replacement budget showing how the full budget breakdown of the initial contract has been modified by this. If the budget is modified by the proposed addendum, the payment schedule must also be modified accordingly, taking into account any payments already made in the course of the contract. The payment schedule must not be modified unless either the budget is being modified or the contract is being extended.

- Prepare a dossier comprising the following items:
  - Explanatory note providing a technical and financial justification for making the modifications in the proposed addendum
  - Copy of the contractor's request for (or agreement to) the proposed modifications
  - Copy of the financing agreement authorising the project
  - Copy of the initial contract and any subsequent addenda
  - Copy of the initial tender announcements (contract forecast, procurement notice and shortlist), Shortlist Report, Tender Opening Report, Evaluation Report, and any other relevant information
  - Three originals of the proposed addendum, which is based on the standard addendum template and includes any revised annexes.

- *Centralised, decentralised - ex-post;*

Sign and date all the originals of the addendum and initial all pages of the Special Conditions.

*Decentralised: ex-ante;*
The Contracting Authority sends the addendum dossier to the Delegation of the European Commission for endorsement (and initials all pages of the Special Conditions) to confirm the Community financing. No endorsement by the Delegation is required in certain cases contemplated in the Practical Guide for Programme Estimates

- Send the three signed originals of the addendum to the contractor, who must countersign them within 30 days of receipt and return two originals to the contracting authority together with the eventual financial guarantee required in the addendum.
- *Centralised, decentralised - ex-post;* On receipt of the two signed originals from the contractor, send one original to the financial service in charge of payments and the other to the Project Manager.

*Decentralised: ex-ante;* on receipt of the two signed originals from the contractor, the contracting authority sends one to the Delegation of the European Commission. The addendum takes effect on the date of the later signature.

# 3. AUDITING IN EUROPEAN UNION: INSTITUTIONS and MECHANISMS

"*We have moved away from what I call high-altitude auditing, which means we no longer simply assess whether management has the right governance framework to manage controls. Instead, we are conducting substantive testing, auditing controls and sampling. In a sense, we've become auditors again, rather than high-level governance process consultants.*" [46]

Mark Carawan

Although these words enlighten the path to follow through the auditing mechanism in the European Union, initially let's take a look at the internal control and internal audit procedure and the link within the external audit to have an overall view of the Unions' approach to financial control in the public and private sector, furthermore the European Unions' external audit mechanism.

Even if European Union is a new born when compared to the history of Europe; the past was not so bright for the member states of present-day which structured the Union. In those times there was an interaction within the states willingly or unwillingly. These exchanges were made in all fields, in other words they were building up new methods with "the trial and error" to accomplish the goal of superior which resemble to a competition. One of these competitions brought a new knowledge to the control system in Europe.

## 3.1. The Milestones of Internal Control Methods in European Union

The main frame of auditing methods which is used in the European Union was established long time ago.

There were four types of audit model structured within order:

- the Westminster model;
- the Napoleon type;
- the Rechnungshof; and
- a transition type which is a mixture of three

In 1314 in England, posting the Comptroller of the Exchequer meant the beginning of an era of auditing. In France in 1318, King Philip V. founded a Chamber of Accounts; in 1807 Napoleon transformed it into the "Cour des Comptes (Court of Accounts)." The year 1761 was very important for the Habsburgs (frontiers of Austria and Hungary) when main and territorial or local audit offices were founded in what is today Slovenia, Croatia, Hungary, Slovakia and the Czech Republic.

[46] Mark Carawan - Barclay Internal Audit Group President, Internal Auditing Around the World Report, Profiles of Internal Audit Functions at Leading Organizations

In many countries, the constitution or legislation gives the Supreme Audit Institution (SAI) the right to undertake some form of performance audit. Cour des Comptes of France should serve as an example of Napoleon's court model. Rechnungshof of Germany is an office model, and the National Audit Office (NAO)[47], of the United Kingdom represents Westminster's model. As a matter of fact these methods combined and structured today's audit model of European Union.

With the creation of the European Union and the current process of enlargement it is possible to get clear view of the internal control (management) systems that will vary widely from country to country and will reflect administrative culture and tradition. A system that works well in one country may not be transplanted successfully to another. The way to understand in which financial control is practiced differ considerably from one European country to another. A broad approach which founded in France, Portugal, Spain and other continental European countries with a legal tradition based on the *Napoleonic Code*, puts emphasis on the controls that are exercised by a third party organisation, at the centre of government (i.e., an agency of the Ministry of Finance or the ministry itself). A second approach, Westminster approach, found in European countries such as the Netherlands, United Kingdom, and the Scandinavian countries which emphasises the responsibility for control issues with a view of decentralised to the head of line ministries and other budget entities (i.e., officials in the budget and finance departments of these organisations). However, this does not mean abandonment of productivity and effectiveness of the government's internal control system. In some countries, a mixture of elements of the three approaches may be found.

## 3.2. The Auditing History through European Union

The co-operation between Supreme Audit Institutions (SAIs) of Central and Eastern European Countries (CEEC) and European Court of Auditors (ECA) started in November 1993, when the court organised the first seminar of the heads of these SAIs in Berlin, with a goal of creating closer relations with the titles of "*Assessment of the Financial Assistance Granted*", "*Assessment of the Granting of EC Loans in Central and Eastern European Countries, Including EIB and EBRD Loan Operations*", "*The Internal Financial Control of European Commission Assistance*", "Audit Procedure and Methodology of the European Court of Auditors", "Assessment of the PHARE programme from the Commissions point of view". The titles are given in order to highlight the outlines of these two important institutions, are responsible of the auditing in the European Unions' external policies. The following seminar held in Luxembourg in 1996, to ensure the deepening of their relation within the SAIs and ECA.

During the meeting, which took place in Warsaw, in March 1998, the SAIs agreed on co-operation where *implemented in working groups, consisted of representatives of interested SAIs*, which prepared documentations and materials. The output of those groups required approval by the gathering of Liaison Officers representing all SAIs involved in co-operation, while final decisions were made by the Presidents. At the next meeting in Prague in 1999, co-operation was enlarging, parallel to the European Union's enlargement policies, towards two more candidate countries: Cyprus and Malta, while on the meeting in Cyprus in 2001 co-

[47] This functional link has grown in importance with the increasing decentralisation of Community management towards the SAIs—the United Kingdom's National Audit Office prominent among them. - Ms Mawhood, Assistant Auditor General (NAO), described the two main audit methods as the accountancy based approach which is followed in a number of Member States including the United Kingdom and the approach which would require auditors to be trained in the legal profession and is followed in a number of Member States including France., The United Kingdom Parliament, Committee on European Union Twelfth Report, London 2001.

operation was extended to Turkey as well. Today, this group has sixteen members: SAIs from Albania, Bulgaria, Croatia, the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia, Turkey and the ECA.

Since the establishment, group of mentioned countries, coordinated and assisted by the ECA and Support for Improvement in Governance and Management in Central and Eastern European Countries (SIGMA)[48,] was acting through different working groups which is a concrete outcome of the seminars and meetings. Reports of working groups were presented and further discussed on regular meetings of liaison officers, while their conclusions and recommendations for improvement based on the annual work and activities were presented on annual meetings of heads of SAIs and the ECA.

Even 10 years latter, members of SAIs were still showing the need for further, continuous developing and extending the exchange of experiences and practices in the field of their role in audit. All members of the working group expressed their interest on, is Internal Control Systems. The Presidents of the Supreme Audit Institutions of Central and Eastern European Countries, Cyprus, Malta, Turkey and the ECA, at the Meeting in Bucharest in December 2002, decided to extend the mandate of the working group on "Audit Manuals" by establishing the new sub-group on Internal Control Systems but the European Commission attaches a slightly different meaning to the term "financial control". Financial control covers both what the Commission terms "internal financial control" and "external financial control". The term internal financial control is synonymous with what is referred to as financial control, while the external financial control describes what is referred to as external audit. The key difference between the terms financial control and audit is that financial control includes both ex ante and ex post controls, whereas audit exclusively covers only ex post controls. After report has been presented and discussed on the Meeting of Liaison Officers in October 2003, in Luxembourg, European Commission renamed the sub-group as "Public Internal Financial Control Systems" (PIFCS)[49] to avoid confusion, when addressing the issue of financial control.

## 3.3. Objectives of the Public Internal Financial Control Group (PIFC)

*"The intention of the group is to support the working group on Audit Manuals in considering and developing the topic of common interest of all its members, through the following objectives:*

*a) providing an effective update on state of the development in external auditing of internal control systems (ICSs) in candidate countries with the purpose to identify most common problems and to find most appropriate solutions;*

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[48] SIGMA is a joint initiative of the OECD and the EU, principally financed by the EU to support SAIs.

[49] ***Public***, covering all control activities in the public sector.***Internal***, covering controls exercised by central and decentralised government agencies as opposed to external controls exercised by a body outside the government (e.g. the supreme audit institution). ***Financial***, to stress the financial (administrative, managerial or budgetary) character of the activities to be checked.***Control***, meaning all activities to oversee the entire field of financial management, enabling the government to be "in control" of its finances (therefore comprising all control tools such as ex ante control and ex post audit); and *Systems,* covering organisations, staff training, methodology, reporting, responsibilities,sanctions and penalties. European Commission, DG-Financial Control, April 2000.

*b) initiating discussions on how to get acquainted with and harmonising of the internal control/internal audit methodology established within the European Union (EU) and meeting the EU requirements; and*

*c) promoting the exchange of knowledge and experiences among SAIs within the Group but also with SAIs of EU Member States, with intention to ensure appropriate, timely and effective ICSs".* [50]

## 3.4. Methodology and Order of Activities in Auditing

After building a frame thought the history of audit, the methodology and the order of activities which is a wide and complex subject will be considered and focused on three major areas:

### *3.4.1. Internal control*[51]

The Commission has thirty-eight General Directorates responsible for carrying out the decisions taken by the Commission and delegated to them. Let's assume for a moment that the Commission is seen as the "government" and the Directorates may be seen as the ministries of this government.

In early 1999, the doubts about the European Commission has commenced in a sense of the "*government*" was incapable to deal with both, the growing acquisitions of mismanagement also irregularities may be a more dramatic way fraud inside and the management of the European Commission funds and administrative expenditures, in which consists of %35 of the European Union budget. This frame brought the inevitable scene; the appointment of a new Commission however a fundamental change is needed for restructuring the entire system in terms of financial management, control and audit to sustain development and more importantly recreate confidence ambience. Although the Union changed its financial management system, they have kept the external out which found out to be independent. Several explanations could be given to explain the failure of the system; most fundamental one is concentrating on centralised perspective with special institutions checking substantial part of the financial transactions in a way of "*watertight*" or by creating a non-responsibility field to managers which were appointed to carry on creating policies, activities, and operations. In addition, the system was too slow; carry many burdens of bureaucracy, and unidentified procedures. However the transition procedure was not painless for both the European Court of Auditors and the European Commission. In November 2004 the Court presented its 10th Annual Report for the financial year 2003. Although the annual statement of assurance (DAS) was carrying mostly positive impressions, the administrative expenditures of the European Union budget had no reasonable assurance for payments so that the Court is not able to give a positive statement of assurance.

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[50] Working Group on Audit Manuals, Prepared by the PIFC Expert Group, November 2004 – Internal Control System in Candidate Countries Volume I

[51] Internal control covers the globality of the policies and procedures conceived and put in place by an entity's management to ensure the economic, efficient and effective achievement of the entity's objectives; the adherence to external rules and to management policies and regulations; the safeguarding of assets and information; the prevention and detection of fraud and error, and the quality of accounting records and the timely production of reliable financial and management information. In case of shared management, internal control also covers the controls by the DG or Service on the management and control systems in the Member States.

Parliament and Council of the Union was disappointed about the negative concluded statement of assurance, so both institutions called the Barrosso Commission aid. Therefore the Commission made a strategic planning to achieve a positive statement of assurance of the Court of Auditors. The Commission is the only responsible for implementing the budget under the Treaty, but the resources are handled by the Member States so it is essential to give them an active role in the process. The Court of Auditors is inflexible about the statement of assurance, and the measures have to be stable to ensure the continuity of the objective. The transactions down to the level of the individual beneficiary must provide reasonable assurance that the risk of error is minimized and included an appropriate level of on the spot checks. In year 2004 the Court of Auditors published an opinion[52] on an effective and efficient internal control framework. Even there had been a significant progress in improving systems; current control framework in various areas of the budget is still open to discussion:

*Unclear and inconsistent objectives;* No clearly established control strategy leading to overall or specific objectives for the various systems. *Lack of coordination;* No formal requirement for control bodies to coordinate the planning of checks, or take into account the checks made by others. Information provided by Member States on the results of checks is sometimes inadequate or inconsistent. *No information on costs and benefits;* In the areas of shared management, the majority of the costs of undertaking controls are borne by the Member States/beneficiary States whereas the benefit accrues to the EU budget. Thus, Member States/beneficiary States have little incentive to devote sufficient resources to controlling EU funds. No information is currently available on the costs of controls borne by either Member States or the Commission, or on the benefit they bring. *Inconsistent application;* Random checks and risk-based checks have very different and mutually exclusive objectives. When rules do not sufficiently define the approach to be used, the result is confusion and reduced effectiveness. Control procedures are highly decentralised both in the Commission and in Member States. In practice, there is not always consistency in approach, extent, timing, follow-up etc. As a result, there are differences in the quality of checks. Independent audits are not required in all budgetary areas and, where required, there are sometimes inadequate terms of reference for the audit work, and there are not always standard procedures for the selection of the auditors. The option of penalties for irregular claims exists only within agriculture and internal policies.[53] The Commission and most of the Member states, 4 out of every 5 euros in the budget are handled by the Member States under the shared management, agrees with the Court's terms and share the idea of further improvement of the design of control systems by establishing clear objectives and responsibilities. In this context no sectors will be excluded, the Council interested with the Courts proposal for the development of the internal control framework with a new model "single audit"[54]. In this context Commission was requested to examine the feasibility of introducing a single audit model with each level of control building on the previous one, so improving the quality of audit activities without compromising the independence of the audit bodies concerned. The Court was requested to prepare an opinion on the same subject. In the absence of an official Commission reaction, the Court has found itself in a rather unique position for the first time; to be able to contribute to

[52] Opinion No 2/2004 of the Court of Auditors of the European Communities on the "single audit" model (and proposal for a Community internal control framework) – OJ C 107, 30.04.2004

[53] The Summary of control framework in various areas of the budget; not all the points are relevant to budgetary areas.

[54] The term 'single audit' originated in the mid-1980s in the US and the Netherlands. The approach in the two countries differ in detail but retain a strong point of commonality: bodies who receive more than one central or federal government grant are subject to an annual single audit of their complete financial statements, rather than being submitted to the cost and burden of multiple audits of the different grants by different auditors. This is single audit in its purest sense of the term.

the debate rather than simply reacting to proposals. The aim was to provide a useful, interesting and perhaps inspiring document, which also identify the growth and development of the Union.

The Court is the *external auditor* of the European Union and therefore not parts of the internal control system however in order to be able to audit efficiently and effectively the Court should rely, where possible, on the work of others(internal auditors) which means that work should be available and undertaken to an adequate standards. The Court also needs an effective basis against which to judge or audit the systems. The Opinion addresses both of these concerns. The Union faces some similar, but also many different and additional challenges. As the opinion states: "*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.*"

#### 3.4.1.1. Follow-up reports

Every time a management and internal control weakness is detected; the auditors will establish the consequences for the financial management of the programme and report the missing points. Each reported weakness should be the subject of an "*audit finding*" including an "*audit recommendation*" by highlighting the weaknesses. The auditor should give proper suggestions to it. If requested the auditors will issue an opinion on whether or not the management and internal control system is both adequate and in accordance with the contractual bases of the programs depending on the key areas indicated above. Each audit finding will identify the contractor, the contracted amount, the corresponding sub-project reference and the PERSEUS[55] reference.

*The description of the audit findings should include the following standard elements: "condition" (description of what the auditors find to be the actual situation), "criteria" (prescribed policies, procedures, rules etc to which the auditor should be adhering), "effect" (actual or potential impact or risk, including risk of a systemic error), cause (of the actual situation), auditor's comments, delegations comments, auditor's opinion and proposal for corrective action. Auditors will quantify each "financial audit finding" in order to allow for corrective actions.*

Rather than following the restricted understanding of single audit in the wider world the Court took the opportunity to be more precise in its *opinion* by considering the whole process of internal control and external audit over the European Union budget. Meanwhile the Commission is determining the gaps which exist between the control framework in place for each area of budgetary expenditure and general principles defined by the Court in its opinion No 2/004 but firstly the Commission ensure its own house by identifying the improvements necessary to control framework for budgetary management and centrally managed funds. By ensuring that the Directors-General's annual activity reports present clearly the basis for assurance on the underlying transactions, accompanied by appropriate indicators, and that the

[55] Under a decentralised implementation system (DIS) and extended decentralised implementation system (EDIS) where ex-ante control is fully removed during the procurement procedure, Implementation Agencies in the candidate countries undertake the tendering and contracting for the specific programmes concerned. They record the financial transactions in a reporting system named PERSUS. This system is shared with the Commission.

declaration of assurance covers the part of the accounts for which they are responsible, and, as much as possible, quantifies the effect of any reserves; and ensuring that the Accounting Officer signs off the Commission's accounts to certify that (s)he has made the checks that (s)he considers necessary and is satisfied that the accounts have been prepared in accordance with the accounting rules, methods and accounting systems established under his/her responsibility for the Commission's accounts, that (s)he has made any adjustments which are necessary for a true and fair presentation of the accounts in accordance with Article 136 of the Financial Regulation, and that they are therefore reliable.

In this respect, an amendment to Article 61 of the Financial Regulation has been proposed as part of the revision of this Regulation adopted on 3 May 2005; to assure in all Directorates General a clear definition of the role of the resource directors, in their support of their Director-General in daily financial and control matters, and as regards the annual activity report and its accompanying declaration; for further elaboration of the Commission's follow-up reports, making it possible for the Court to assess what steps have been taken to implement previous recommendations of the Court; to reinforce the role of the Commission-wide management assessment played by the annual Synthesis report, which takes stock of the situation in the services and addresses major crosscutting issues; by exploring the scope for greater simplification of the management of European Commission funds, and ensuring that the control requirements are proportionate to the risks; and introducing a common methodology for risk assessment, in particular to give assurance on the management of the risk of error in the underlying transactions; also providing guidelines for the services concerned by each family of expenditure on strategies for on-the-spot checks, including the methodology for the evaluation of supervisory systems and controls, the determination of sample sizes, the sampling techniques, the evaluation of the effect of errors on the EC budget and the level of acceptable risk; in the defining categories of errors, determining the rate of error found by on-the-spot checks on the basis of representative samples and reporting this, together with the corrective measures taken and/or planned, in the annual activity reports; by ensuring that the resources allocated to ex-ante and ex-post checks are sufficient to achieve an appropriate balance between the costs and benefits of controls.[56]

#### 3.4.1.2. Roles in managing internal control in terms of the Directorate General

##### *3.4.1.2.1. Role of Directors-General*

"Directors-General is responsible for the sound management of sufficient and efficient control systems in their DG, and for reporting annually through the Annual Activity Reports and Declarations to the institution on the state of these systems and the use made of the resources at their disposal. They retain overall responsibility. This responsibility is exercised through their supervision of the structures and processes which they establish within their DGs or Services in order to gain assurances that the systems under their control are operating properly. In the domain of financial management, this means that the Director General or Head of Service is in charge of delegating the Authorising Officers by Sub delegation (AOS) with their charter, responsibilities and reporting duties. In addition, the Director General or Head of Service will define the financial circuits and put in place the appropriate organisation

[56] Communication From The Commission To The Council, The European Parliament And The European Court Of Auditors On A Roadmap To An Integrated Internal Control Framework, Brussels, 15.6.2005

for executing ex-ante, on-the-spot and ex-post controls. Depending on the financial circuit, these functions can be carried out under direct control of the AOS or at a more centralised level in the DG. The adopted organisation will also respect the incompatibility between ex-ante and ex post controls as set out in the Financial Regulation (art. 60 § 4) and the Director General or Head of Service will also define the most appropriate organisation for executing the ex-post controls in their environment.

#### *3.4.1.2.2. Role of Directorates and units*

Directorates and units are responsible for the effectiveness of the control system in their environment. In the domain of financial management, the AOS takes overall responsibility for the sound execution of internal control as specified in his charter with his Director General or Head of Service. This means that they have to implement and supervise the effectiveness of the controls and establish the reporting to their Director-General of Head of Service as stated in art. 4.8 of their charter as AOS. According to the selected financial circuit, all ex-ante controls are executed in his directorate/unit or in a more centralised entity in the DG or Service. The Director-General or Head of Service designates, where relevant, the officials in charge of on-the-spot ex-post checks aiming to verify the functioning of the internal control system.

#### *3.4.1.2.3. Role of Resource Directors*[57]

In addition to their role under the directorates and units, Resource Directors oversee the implementation of internal control systems within their DG based on the overview of information received from all directorates responsible for implementing those systems. Being the recipient of all relevant information on the results of ex-ante and ex-post controls, of audits, and of management supervision controls given by operational directorates, he monitors the follow-up of action plans in this respect.

The Resource Directors should also co-ordinate the preparation of the DGs' annual activity report. In this context, Resource Directors will report to the Director-General or Head of Service their advice and recommendations on the overall state of internal control in their DG. This will apply fully in 2003; it will be applied to the 2002 exercise within limits which individual DGs may wish to explain. Due to the specificity of each DG or Service, the Director-General or Head of Service can decide to appoint another person in the Dg for the above-described tasks. He can also request the Resource Director (or his equivalent) to give guidance, promote best practice inside the DG or Service and to recommend improvements to the DG or Services internal control system and/or give additional tasks in the framework of supervision of internal control in the DG or Service, in line with standard 17 of the internal control standards[58].

[57] As there is no standard definition of the function of Resource Director across the Commission, the term 'resource director' will in this communication refer to the person of the management board in charge for resource management at DG-level including programming, human resources and financial resources management. If this function doesn't exist as such the Director General can designate the most appropriate person in this respect.

[58] Each DG shall establish appropriate supervision arrangements including, where appropriate, ex post control of a sample of transactions to ensure that the procedures set up by management are carried out effectively

### 3.4.1.3. Roles in managing internal control at commission level

#### *3.4.1.3.1. Role of the Commission*

Internal control and internal audit are cornerstones in the governance construct to protect adequately the Commission in the discharge of its duties as spelled out in the Treaty. Therefore, clear accountability in the role and definitions proposed for the different actors in the control and audit of Community. In the past, the control function in the Commission was centralised. Such a function exists in other organisations. However, in line with the reform and its determination to clearly assign responsibility for control to those who have the actual power to implement internal control on a day-to-day basis, the Commission has chosen a different model: while the responsibility for the implementation of internal control is decentralised to Directors General and Heads of Service, the definition of minimum control standards and oversight of their implementation is the task of a central service, the Central Financial Service (CFS).

#### *3.4.1.3.2. Role of Directorate General (DG) of Budget*

The responsibility of the Accountant in internal control is to ensure the integrity of the accounting system. Each DG is responsible for the data entered into the system and for ensuring the reliability and accuracy of the information entered. In this context, the Accountant is responsible for the subsequent processing and output of the information entered in the accounting system, including through local information systems which he has validated. The role of the Central Financial Service is to provide guidance, promote best practice, and recommend improvements to the Commission's overall internal control system and to the standards which underpin the basic control framework. In this context, as internal control embraces more than financial management and control, the CFS liaises with (Secretariat General) SG and DG Admin for issues of their respective field of competence, i.e. programming and human resources management.

The CFS is not responsible for verifying the reliability or adequacy of the overall system or for providing a "positive assurance" that it is functioning as intended. It will, however, review the state of internal control in the Commission on the basis of the contents of the individual annual activity reports, audits of Court of Auditors, IAS and executive summaries together with their action plan of completed audits and reviews by IACs. Transmission of these reports does not, however, involve any transfer of responsibility. On this basis, the CFS will provide an overview in the framework of the synthesis adopted by the Commission. The CFS will also co-ordinate internal control issues to promote a common understanding and implementation of methods, tools and techniques and to create a common reporting framework. In this respect, a special attention will be given to the specific needs of smaller DGs and Services.

#### *3.4.1.3.3. Role of the Secretariat General*

The SG prepares, in collaboration with the CFS, the synthesis of annual activity reports which will also bring to the attention of the College the key issues on which action is needed. They also prepare the common methodology for the annual activity reports. The synthesis of the annual activity reports constitutes a privileged moment for the College, because the synthesis

report allows it to take note of the overall activities and state of controls of the Institution, and to decide on remedial action, where considered necessary, in line with the specific provisions of this Communication. The Secretariat General has a key role in the co-ordination of the aspects of internal control related to the setting of policy priorities through the APS-cycle and the Commission's Work Program. In this context, they also promote a common understanding and implementation of methods, tools and techniques by the DGs and Services.

#### *3.4.1.3.4. Role of the Internal Audit Service*

The IAS is not itself responsible for the implementation and management of controls. In the framework of the Financial Regulation, it will assess the suitability and quality of the Commission's internal control systems and report yearly about its work in the annual internal audit report. In addition, on the basis of the work programme, it can undertake specific tasks to advice on an effective implementation of internal controls."[59]

#### *3.4.1.3.5. Role of the Court Of Auditors*

The Court of Auditors has developed the DAS methodology in recent years. It includes four elements: an examination of supervisory systems and controls, an examination of samples of transactions, an analysis of the annual activity reports and declarations of Directors-General, where necessary, an examination of the work of other auditors. The Commission as well as the Parliament and Council have supported this development. The Commission has taken note that the Court has stated in its 2005 work programme that it will work on "developing the DAS methodology in the context of new parameters" with the objective of answering "more and more closely to the needs of the users of the DAS". At the end of the meeting between the Commission and the Court of Auditors on 16 March 2005, Mr. Hubert Weber, President of the Court of Auditors stated that: "The Court of Auditors' aim is to maximize the impact and efficiency of its audit work through an approach which seeks to improve results rather than concentrate on listing errors. In order to help the Commission with its task to further improve the supervisory and control systems of the EU budget at all levels, the Court is committed to further developing its DAS approach. This allows the Court to even better measure progress and point out more precisely where improvements are needed." This Communication presents the actions envisaged to put into place an integrated control framework. A working document will present the control framework in place in 2004, and the actions which the Commission considers necessary to achieve the objectives set out in the Court's opinion n° 2/2004, including the 2007-2013 period.

Within the new the perspective of the control system, its focus have to change from taken action only upon individual cases of mismanagement, irregularities, corruption or fraud to be practical and make sure all parts of the prevention, detection and follow up the procedure and are strengthened them to take hasty actions. Some of the old control institutions were abolished and others are in the process to be closed down. New control institutions are replacing them equipped with new competences, resources and refined control/investigation tools. The legal framework, on which the different parts of the control system rest, has or is well in the process to be fundamentally renewed. It was underlined that the information

[59] A Report by Mrs. Schreyer and Mr. Kinnock in agreement with the President, Clarification of the responsibilities of the key actors in the domain of internal audit and internal control in the Commission Brussels, 21.1.2003

exchange between the different EC institutions and between these institutions and the relevant organisations in the Member States must become more efficient.

*"Internal control may be defined as the organisation, policies and procedures used to help ensure that government programs achieve their intended results; that the resources used to deliver these programs are consistent with the stated aims and objectives of the organisations concerned; that programs are protected from failure, fraud and mismanagement; and that reliable and timely information is obtained, maintained, reported and used for decision-making.*

*The essential features of control systems in the public sector and private sector are as follows:*

- *Identification of risk.*
- *The development of internal control systems and procedures to counter the perceived risk.*
- *The establishment of an internal audit procedure for checking that the systems of internal control are countering the perceived risk and of identifying risks not covered, or not adequately covered, by the existing systems and procedures.*

*The concept of risk covers the following elements:*

- *Misuse, including waste, of financial, human and technical resources, including external aid.*
- *Failure to execute budgetary and other policy decisions in a regular and efficient manner.*
- *Fraud and error.*
- *Unsatisfactory accounting records.*
- *Failure to produce timely and reliable financial and resource management information."*[60]

#### 3.4.1.4. Framework for establishing and maintaining an effective internal control

Any system of internal control has a number of components. Firstly the system that has been established through financial and procedural rules, the system must operate by responsible and appropriately trained personnel, and subjected to independent review to ensure and asses whether procedures are working as intended. In some cases this checking and monitoring role will be undertaken by an internal audit unit. Peoples attitude play a key role when operating an effective internal control for its operation. Management is responsible to establish and organize internal audit as a "supervisory function" within the organization's internal control system and connection between management, stakeholders and external audit. Internal audit also has a role in risk management, and can help in realization of the basic goals of an organization. In effect, internal audit is independent and objective, and provides assurance and consulting activity designed to add value and improve effectiveness of risk management, control and governance processes. The role of the external auditor will be to assess the work undertaken by internal audit and where possible rely on it. The external auditor may gain

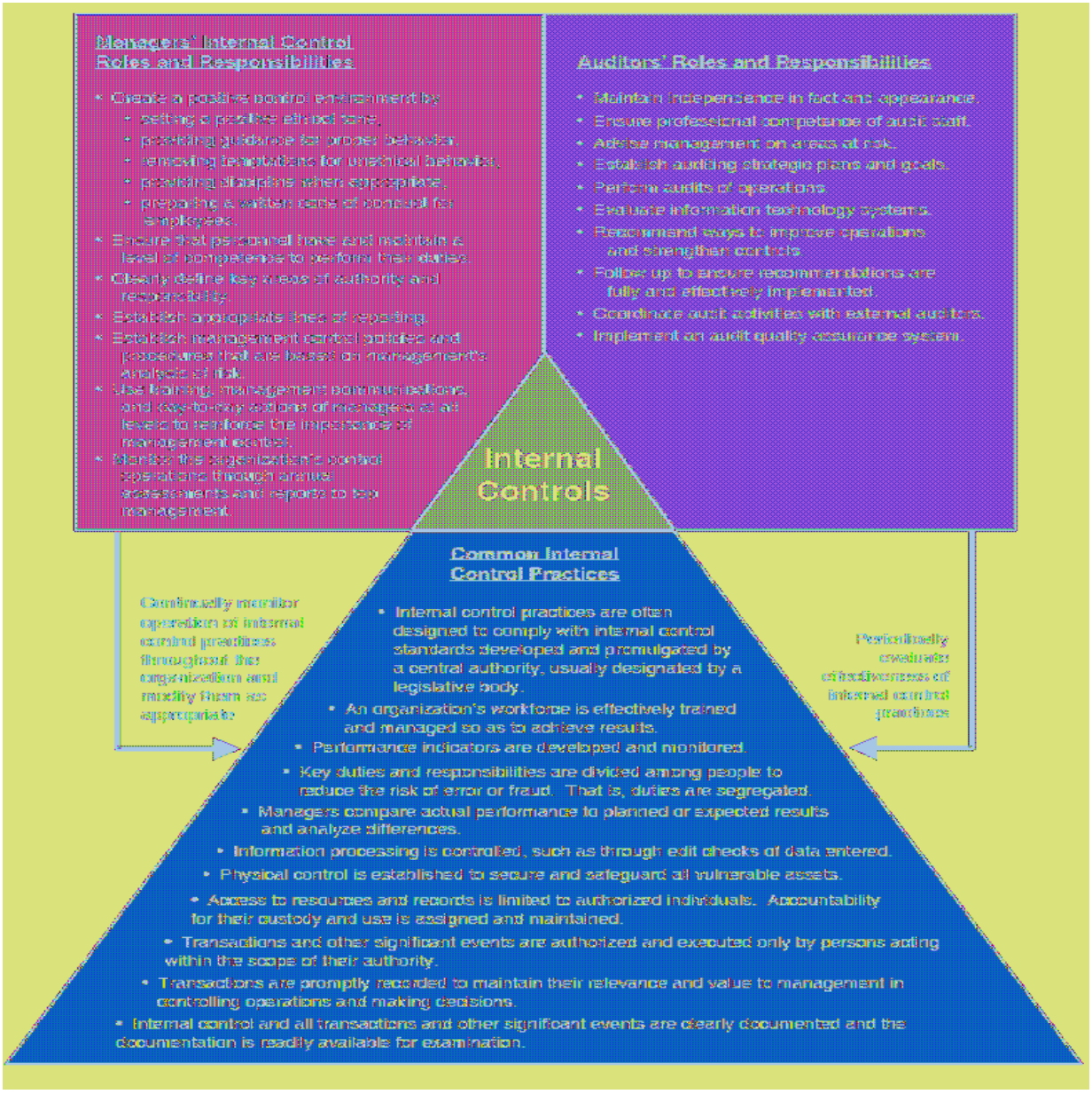
[60] Definition approved by the Board of Directors of the Institute of Internal Auditors in June 1999.

audit assurance from an effective internal control system, but to do so will need to ensure that it has operated correctly during the financial period. The external auditor will make a judgment on an assessment and on the effectiveness of the internal control system, and also an assessment of the reliance that can be placed in the work of internal audit. They will also be designed to mitigate no financial as well as financial risks, as it is important that an entity is both able to manage resources effectively, as well as implement an agreed programme. Once established internal control and risk management systems need to be regularly reviewed and updated to ensure their continuing effectiveness.

The auditors are playing a role in order to reach a decision about a management. Procedures and tests needed for a critical review of relevant procedures laid down in manuals, testing a sample of transactions to ensure that procedures have been complied with and reviewing internal control procedures to prevent fraud and irregularities.
*The following key areas should be reviewed to establish whether:*

- *the organisation set up is adequate for monitoring the external aid financed programme effectively (programming objectives, results and cash management);*
- *the recruitment and selection of personnel allows for a professional management of the external aid financed Programme;*
- *The number of staff is adequate;*
- *job descriptions have been set up and followed;*
- *An adequate separation of duties is ensured;*
- *There are adequate rules for the authorisation of signatures;*
- *the recruitment of the management is appropriate and establish whether there are any links between management and the contractors;*
- *adequate records and accounts have been maintained to record Programme transactions, in accordance with the (E)DIS manual;*
- *the system of internal control procedures allow a fair control over tendering, receipt and delivery of equipment, safeguarding of assets and security of transactions;*
- *the level of cash requested is in accordance with the level of disbursements, to avoid unnecessary cash balances;*
- *sound cash management procedures are operated;*
- *all bank accounts used have been declared to the Commission and identify any unexplained transfer of funds;*
- *controls regarding anti-corruption measures; the level of detail of the system check will depend on a number of factors such as:*
- *The extent to which the system concerned is still involved in the management of EC support.*
- *The extent to which the system functions under DIS or EDIS. In the last case the auditors are expected to give more attention to the functioning of the system.*[61]

[61] Multiple Framework-contract in the Field of External Audit of Programmes and Projects of External Aid managed by the European Commission, DG Enlargement - Audit Contracts Implemented Under a Decentralised Implementation System LOT I – Annex II




Source: Internal Control: Providing a Foundation for Accountability in Government, International Organization of Supreme Audit Institutions

### 3.4.1.5. Responsibility for internal control

The responsibility of internal control highlighted by an example; criticism by the European Parliament of financial management practices within the European Commission which led to the resignation of the entire Commission in March 1999, a Committee of Independent Experts concluded that "*the existence of a procedure whereby all transactions must receive the explicit prior approval of a separate financial control service has been a major factor in relieving Commission managers of a sense of personal responsibility for the operations they authorised while doing little or nothing to prevent serious irregularities*."[62] The committee recommended that a professional and independent Internal Audit Service (IAS) should be set up reporting directly to the President of the Commission, that the existing centralised pre-

[62] Second Report by the Committee of Independent Experts on Reform of the European Commission, September10, 1999) (Paragraph 4.18.1).

audit function should be given out, and that internal control should be decentralised to the Directorates General (DG) in the Commission. In 11 April 2000 the Commission announced the defined role, mission, and organisation and structure of the Internal Audit Service.[63]

The creation of an Internal Audit Service, separated two services; the internal audit from the ex ante financial control so all the obstacles removed for the establishment of the Commission's independent internal audit. The new establishment also generated two separate Directorates-General, one responsible for ex ante financial control, the other for internal audit, which are Directorate General of Financial Control, financial controller of the Commission, and Directorate general of Internal Audit Service, internal auditor of the Commission. In general, the term management control or internal control describes the systems, processes and methods of managing activities rather than a specific unit in a ministry or government agency. However, the Committee of Independent Experts recommended that a specialized internal control function should be established in each Directorate General of the Commission which is interesting. This function should be exercised under the responsibility of a senior official reporting to the Director General or Head of Service and an accounting function exercised under the responsibility of a delegated accounting officer. Internal controls are the responsibility of the leadership of an organisation. Therefore, to establish and maintain effective internal controls, the top leadership of the organisation must, first of all, be committed itself to the effective management of the entity only if sufficient leadership and commitment are in place there will it be possible to establish and maintain an effective system of controls. Internal control requires a strong control environment as well as a coherent framework of control systems and procedures. The control environment includes management's philosophy and operating style, the assignment of responsibility and the policing of internal control systems and procedures. It therefore affects the way in which control systems and procedures operate in the organisations concerned.

*The main risks in the financial control environment are:*

- *Inadequate management integrity and weak ethical values.*
- *Inadequate management commitment to professional competence among staff and inappropriate assignment of authority and responsibility.*
- *Inadequate management oversight.*
- *Inadequate management policies to prevent monitor and respond to illegal acts.*

*The consequences of a weak financial control environment include:*

- *Expenditure for purposes other than originally intended.*
- *Inappropriate or misleading reporting.*
- *Financial losses.*
- *Loss of public confidence.*
- *Increased risk of fraud and corruption.*

[63] Pending the amendment of Article 24, and to speed up the completion of the actions set out in the White Paper, the Commission chose to set up the Internal Audit Service within the Directorate-General for Financial Control (DG Audit). In 2002 the Inspectorate General of Services and also Directorate-Genral for Financial Control were both abolished and Internal Audit Services replaced them. Therefore, this allowed the Internal Audit Service to organise itself both from an administrative(*) and an operational point of view, to draw up its independent programme, put in place the necessary resources, etc. in line with the Commission's decision of 11 April 2000.

The next requirement is a careful and detailed assessment of the risks facing the organisation and an identification of useful controls to manage those risks. In a complex organisation such as in European Union, this can be a difficult task and one for which the leadership of the entity may wish to seek expert assistance. Internal and external auditors are frequently the source of such assistance. However, it is essential that the leadership of the entity remain involved throughout the process and especially in the decisions about the control arrangements to be put in place. The controls that are implemented must be ones that the management will actually use, even when they create some inconvenience during the operations, they must be used in the entity. Few things weaken the credibility of the system more than the introduction of controls that are then left beside. The controls must therefore be cost-effective. They must not be detailed and must not be difficult to read, not to paralyse the organisation. The cost of the control systems must not be out of proportion to the risk they are intended to avoid.

#### 3.4.1.6. Drawing the lines of internal control system in an organisation

In any organisation internal control is an essential part of the structure and operations. The larger and more complex the organisation and its activities, the more care must be given to the design of the control systems. Within the human nature there is no possible way of creating a perfect design of the control system, so no system can be an absolute guarantee against the risk of fraud or separating an error if it is honest or dishonest. Any system that attempted to reach near to excellence, especially in a complex organisation, would pay the price and would create strict ambience in the organisation which conclude with crisis. The proper goal of the control system should be to provide “reasonable level of assurance” to prevent fraud. If fraud will occur, it will be exposed and will be reported to the appropriate authorities. The organisations have to be aware of certain risks involved in building and maintaining management control systems and must draw some lines to make it work. *Design flaws:* It has been stressed that internal control systems must be designed for the specific organisation, operations, and environment in which they will function, after careful consideration of the risk involved in that particular situation. Managers are sometimes tempted to shortcut the design process, for example by adopting the control systems designed for another organisation. This can be dangerous. A flawed design may leave the impression of safety but may overlook important risks in one part of an operation while creating unnecessary rigidities in another.

*Poor implementation:* The best-designed system will achieve its goal only if it is implemented properly. Managers and supervisors at all levels must be vigilant to ensure that everyone complies with applicable control procedures. Even more importantly, the required procedures must be ones that employees will appreciate and accept, and which they will not be tempted to ignore when the procedures become inconvenient or in times of pressure and stress. Meeting this criterion is one of the key considerations in the design of effective control systems. Managers should also plan ahead for alternative arrangements that might need to be put in place in the event of an emergency requiring the regular procedures to be bypassed.
*Poor response to reported anomalies:* Control systems are designed to call attention to events that depart from normal expectations. For the systems to remain effective, therefore, it is essential that supervisors and managers respond properly to alerts. The triggering event should be investigated promptly to determine if an irregularity was involved. If so, corrective action should be initiated. Failure to respond effectively to reports of anomalies will quickly undermine the effectiveness of the control system. This should also be a factor in the design of control systems. However, care should be taken to avoid making the systems so sensitive that they yield frequent “false alarms”. If this happens too frequently, valid alarms might be

ignored. *Collusion:* Any system of controls can be defeated if a sufficient number of dishonest key individuals conspire to subvert them and are able to falsify the relevant documents. A sufficiently complex set of controls can make it difficult to assemble the needed number of conspirators, but at a potentially great cost in organisational inefficiency. Conspiracies of this sort usually come to light when they are observed (and reported) by someone who is not a party to the conspiracy, or when there is a falling out among conspirators. They may also be detected during a routine audit if substantial amounts of funds are involved or if the conspirators are not sufficiently careful in falsifying the documents. *Wrongdoing by top managers:* Internal (management) controls are designed to help control the organisation on behalf of its management, not to control the top managers themselves. There are many examples of dishonest top managers evading the control systems to commit various forms of fraud and abuse. In a large organisation, however, such activities are usually noticed by subordinates. Thus, the best protection against wrongdoing by top managers may be an environment of openness, in which workers are encouraged to report evidence of irregularities, confident that they will not be punished for being disloyal to their superiors. Such openness in an organisation becomes part of the control environment. [64]

#### 3.4.1.7. Design of internal control system and categories of control

Internal controls have to be designed for the individual circumstances so that there is no generally applicable list of controls for a particular entity. However, it is possible to separate into categories of controls and the circumstances:

- *Financial accounting and reporting*
- *Performance monitoring*
- *Effective communications:* Managers should recognise that subordinates perform better if they have a clear understanding of the mission and goals of the organisation and the purpose being served by the activities they are asked to perform. Channels of communication are part of the management control system. For example, managers should communicate their performance expectations to subordinates, who should then define the expectations for their components of the organisation that are needed to accomplish the overall goals of the organisation. It is important that *communications flow upward as well as downward*. When management sets clear goals and expectations, workers can often suggest ways of achieving greater efficiency in the attainment of those goals. *Management should pay careful attention to such suggestions*, as front-line workers are often aware of procedural inefficiencies that escape the notice of senior managers.

In addition to ensuring that the goals of the organisation are achieved, however, managers are also responsible for ensuring that the resources available to the organisation are protected against improper use. A variety of devices might be used for this purpose:

- *Physical controls:* These would include, primarily, the security procedures intended to control access (i.e. to accounting records or to inventories of items and to the items themselves that have high value and might be easily stolen).
- *Accounting controls:* These include the procedures by which transactions are required to be recorded in the accounting system. For example, there might be a requirement that all cash receipts be deposited daily in a bank. The person who collects the cash

[64] Richard Allen and Daniel Tommasi, Managing Public Expenditure A Reference Book for Transition Countries, OECD, 2001.

might be required to provide a written receipt to the payer and to file a copy with the accounting clerk. The person who deposits the cash in the bank would be required to file a copy of the bank receipt with the accounting clerk. Accounting controls also include the internal procedures within the accounting systems that are intended to detect and report any anomalies. In this example, the accounting clerk might be required to reconcile the two reports, cash collection and cash deposit, to inform any discrepancies. Another typical accounting control would apply to expenditures, which would be compared with the budget or other authorisation. Expenditures that depart from the expected pattern would be reported while expenditures that exceed the maximum authorised amount would be blocked.

- *Process controls:* These are the procedures designed to ensure that actions are taken only with proper authorisation. For example, the issuance of a purchase order or the approval of a sizeable contract might require documentation from the requesting official, review by a purchasing clerk, and approval by a supervisor. Large purchases might require approval from a higher official. Payments to contractors might require documentation in the form of the original purchase order, a voucher from the contractor describing the goods and services provided, and a certification from the receiving official that the goods and services were received. Payments above a certain amount might require review and approval by a higher authority. In some countries, personnel standards are an important part of the management control system. Applicants for a post undergo rigorous examination and must receive a qualifying certificate before assuming the position.
- *Procurement controls*
- *Separation of duties:* This is both a control measure and an indispensable element of many control systems. The central feature is that, in any transaction, at least two people should be involved to minimize the risk of improper actions. In the previous example concerning the handling of cash receipts, one person collects the cash, another makes the bank deposits, and a third reconciles the cash receipt documents and enters the data in the accounting records. Separation of duties in this way is an essential element of almost every financial control system, but its use can be overdone. If carried to extremes, however, it can severely degrade the efficiency of an organisation and impair its ability to accomplish its mission efficiently.
- *Internal audit* which will be emphasized.[65]

While all institutions would like a positive DAS to be granted on the implementation of the budget, it is for the Commission and the Member States together to ensure that the Court is in a position to find audit evidence of progress towards an adequate management of the risk of error. This will not happen overnight, and the DAS should not be expected to turn from negative one year to clean the following year. However a positive DAS would be much more effective in helping the Commission and Member States to make accelerating improvements towards a DAS. The Commission is realistic and it accepts the continued critical inspection from the Court of Auditors, and its advice, as an independent observer, on all the preparatory work. With this Communication, the Commission intends to initiate a process which can lead to a common understanding by November 2005 between the Commission, Parliament and the Council on how the current internal control framework can be improved in order to make it possible for the Commission to provide the Court of Auditors with reasonable assurance as to the legality and regularity of transactions. As a matter of fact in the financial year of 2004, the

[65] Richard Allen and Daniel Tommasi, Managing Public Expenditure A Reference Book for Transition Countries, OECD, 2001.

eleventh successive for which the European Court of Auditors issued a DAS, for the general budget was the result is positive for payments relating to administrative expenditure, pre-accession aid and that part of agricultural expenditure subject to the Integrated Administration and Control System (IACS). The qualified DAS reflects the complexity of the issues facing the Commission in implementing the European Union budget, and the challenge it faces in providing the Court of Auditors with satisfactory audit evidence.

### *3.4.2. Internal Audit - (part of the Internal Control System)*

Management of each organization have to established an internal audit unit to provide a healthy management with necessary analyses of audit, assessments with necessary documents, and in conclusion completed by a recommendations to improve the procedure. The internal audit service carries a vital value as regards the governance structure. "Internal auditing is an independent, objective, assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve effectiveness of risk management, control, and governance processes."[66] The management of public entities in a country should be clearly responsible for defining the role of internal audit and ensuring the appropriate level of authority and independence. One of the crucial instruments in developing and providing effective internal audit services is the Central Harmonization Unit (CHU). However, CHUs is not only in charge for internal audit area, CHUs are also responsible for developing and harmonizing of control, audit methodologies based on European Union and coordinating the further development of sound financial management by promoting best PIFC practice and quality assessment/compliance testing including internal control system and internal audit throughout the public sector.

An "Audit Capability"[67] is set up within each Directorate to assist the Director General to make sure the internal controls are in place and functions well. The primary objective of the Audit Capability is to provide assurance to the Director General as to the adequacy and reliability of internal controls over the activities of the Directorate. The Audit Capability must operate in accordance with internationally accepted professional standards for internal audit (INTOSAI standards). The Head of the Audit Capability reports directly to the Director General and the audits done will cover all systems of control established by the Director General and applied to all activities of the Directorate, not just the controls over financial accounting and reporting, but all operational and management controls. The Audit Capability must be independent of the activities it reviews and therefore has no executive responsibility. It has access to people, systems, documents and property inside the Directorate, as it considers necessary for the proper fulfillment of its responsibilities. The modus operandi for each Audit Capability is laid down in an Audit Charter.

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[66] Definition approved by the Board of Directors of the Institute of Internal Auditors in June 1999.

[67] According to Article 48 of the PFA(Public Finance and Accountancy), the Minister of Finance is responsible for the regulation, development, harmonisation and coordination of Financial Managment/Control and internal auditing. The Central Harmonisation Unit established within the Ministry of Finance carries out this task. The CHU prepares legislation; elaborates, issues and regularly reviews methodological guidelines; furthermore monitors the implementation and assesses the quality of the internal audit performed through compliance tests. A Consultative Inter-ministerial Committee for PIFC has been established in order to strengthen the functional independence of internal auditors, and to help the Minister of Finance in performing his tasks., The Chartered Institute of Public Finance and Accountancy 2002

The “Internal Audit Service” (the IAS) is the supervisor of the quality, independence and effectiveness of the Audit Capabilities. It provides general audit guidance to them and co-ordinates training in internal audit. The IAS reports directly to the Commission and is independent from all other services of the Commission. The independence and work-practices are confirmed in a so-called Internal Audit Charter. The IAS has to operate in accordance with internationally accepted professional standards for internal audit. Its mission within the EC is to assist management in controlling risks and monitoring compliance with relevant decisions and regulations. It fulfils its mission by providing independent opinions on the quality of management and control systems, and making recommendations in order to improve the economy, efficiency and effectiveness of operations. The IAS audit scope is all EC activities, notably the independent appraisal of the adequacy and quality of the Commission’s internal control systems as well as the examination of the adequacy and effectiveness of systems and operations. The IAS should also follow the audit trail and may investigate operations on the ground when necessary. The Head of the IAS must immediately report to the Head of the European Anti-Fraud Office (OLAF) any evidence which gives rise to presumption of the existence of cases of irregularity, fraud, corruption or any other illegal activity. The IAS forwards copies of all its reports to the European Court of Auditors.

The “Audit Progress Committee” has been established within the Commission. It is an advisory body for the Commission. Its primary function is to ensure the independence of the Internal Audit Service. It has also a function to help to make sure the results and recommendations of the internal and external audit activities, formally accepted by the Commission, are implemented. This Committee is also monitoring the quality of audit work inside the Commission. The Annual Report and Statement of Assurance coming from ECA are the starting points for the discharge procedure that completes the cycle of accountability for all European Commission funds. In essence this requires the Parliament and the Council to give their opinion on the Commission’s stewardship of the funds, and then for the Parliament to decide by the end of the following April on a recommendation by the Council, whether formally to discharge the Commission from any further responsibility for the Budget. The granting of discharge indicates acceptance that the Commission’s stewardship of the resources has been sound, expenditure lawful and regular, financial management effective, and appropriations utilised in accordance with objectives set when the Budget was adopted.

#### 3.4.2.1. The mandate of the internal auditor

The internal auditor carries out his/her functions by looking into how a selection of the transactions has been processed and also by evaluating how the systems and procedures of internal control function. These significant questions could only be answered if the definitions of financial audit and performance audit are made. To begin with the financial audit; the audit of budgetary and financial systems with compliance tests which is also called as the “*walkthrough*” and substantive tests of actual transactions. Financial audits are generally carried out on the basis of an annual plan providing for each department within a ministry or agency to be covered at least once in the course of a multi-annual cycle and may also involve a specific assessment of the effectiveness of accounting systems, including IT system safeguards and reporting facilities. Secondly the *performance audit*; Performance, or “value for money” audits, which should also be part of an annual plan, cover the extent to which established objectives and specific programs of the ministry or agency have been achieved or implemented, taking into account the extent to which they have been achieved— or not achieved—at a cost commensurate with the risk, and in an accurate and timely fashion with minimal use of resources. Internal audit may also cover a specific analysis of staff resources with a judgment

adjusted which they correspond to the objectives of the ministry or agency and the tasks it is required to carry out. If the agriculture expenditure has been taken into consideration, the auditor will wish to have solid evidence that grants to aid livestock or crop production have been used for that purpose, and have gone to farmers eligible to receive them. Similarly, grants for training the unemployed must be shown to have been used for the intended purpose and for real and eligible applicants. In the European Union context, a common problem is detected by the auditor which is the funds are claimed for estimated expenditure rather than for expenditure which has actually been deserved and paid. In the area of public procurement the internal auditor will seek assurance that there has been adequate publicity for calls for tender, that there are satisfactory procedures for receiving and evaluating tenders and that the justification for the award of contract is in accordance with national and European Union requirements.

#### 3.4.2.2. The independence of the internal auditor

"Internal auditors are independent if they can carry out their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of audits. It is achieved through organisational status and objectivity."[68] It goes without saying that, as the Institute of Internal Auditors stresses, "internal auditors should be independent of the activities they audit." There can be no question of an official responsible for allocating grants subsequently carrying out an internal audit of the systems and procedures used in the allocation. Since the internal auditor is not independent of the ministry or agency in which he functions it is essential for the internal audit function to achieve an appropriate status and weight in the organisation. One of the means of reinforcing the status of internal audit is to have an *audit committee* with, preferably, the head of the ministry or agency in the chair. The committee should include representatives of the ministry's senior management in addition to financial management and audit specialists. The private sector as well as the public sector has come to recognise the value of the audit committee in ensuring that all levels of staff take internal audit seriously and give their full co-operation to the auditors. The development of such attitudes on the part of the staff will help create the right conditions for effective internal control. An important function of an audit committee is to identify the areas to be covered by the ministry's future audit programme and the conclusions to be drawn from ongoing audits.

#### 3.4.2.3. Roles related to internal audit in the Directorate General level

The primary objective of the Internal Audit Capabilities is to add value to their DG or Service in relation to the effectiveness of internal controls over the activities of the DG. They are responsible for audits within the DG or Service. In order with individual arrangements decided by the Director-General or Head of Service and in accordance with the nature and the scope of their work during the year in question, they should express an opinion on the state of control as a contribution to the preparation of the AAR. Together with the Director-General or Head of Service, a work plan should be established on the basis of a risk assessment. Internal Audit Capabilities (IACs) do not form part of the management control functions and are at the service of their Director-General, while retaining independence vis-à-vis the auditees. Because they already report to their Director General, IACs cannot be considered as hierarchically dependent on Internal Audit Service (IAS), but they should co-operate constructively and coordinate their workplans. Auditnet remains the main forum for exchanges of methodology and best practice, and for such coordinating of workplans.

[68] Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

### 3.4.2.4. Roles in the context of the Annual Activity Report (AAR)

The Director General or Head of Service should have appropriate mechanisms to ensure that procedures are followed, and that all applicable statutes and regulations are complied with and that best practice is taken into account when setting up and implementing the relevant processes. To deliver this assurance the following key actors may assist in the process leading up to the preparation of the AAR: In the debut the operational directorates and units, who have basic responsibility for ensuring the compliance and effectiveness of the internal controls in their domains, deliver regular management reporting; these reports prepared by the Authorising Officers by Subdelegation (AOS) which is specified in the charter that they signed with the Director General or Head of Service; and the evaluation units provide regularly reports in the framework of their work program. The financial units for providing the service's annual accounts for which a draft is provided by the Accountant. The Resource Director co-ordinates the preparation[69] of the AAR and will report to the Director-General or Head of Service his advice and recommendations on the overall state of internal control in his DG, on the basis of information provided by the directorates, AOS, IAC and other relevant partners. This will apply fully in 2003; it will be applied to the 2002 exercise within limits which individual DGs may wish to explain; the Internal Audit Capability (IAC) which gives advice regarding on the AAR process and in accordance with the nature and the scope of their work during the year in question, they should express an opinion on the state of control as a contribution to the preparation of the AAR. It should be noted that the IAS does not provide an annual opinion on the individual AAR of the DGs. In preparing their Annual Activity Reports, the Director-General or Head of Service will also draw upon their own direct knowledge of the activities in the DG or Service and upon the relevant audit reports produced by the Court of Auditors, IAS and IACs, and the extent to which recommendations and action plans have been implemented.

### 3.4.2.5. Roles relating to internal audit at Commission level

The mission of the IAS remains to assist management in controlling risks, monitoring compliance, to provide an opinion on the quality of management and control systems and to improve efficiency and effectiveness of operations. The IAS assists management through the audits of Commission activities, and by examining the adequacy and effectiveness of systems and operations and, more widely, the quality of performance of Commission services in carrying out policies, programs and actions. IAS will assess the suitability and quality of internal control and audit systems as stated in Article 86§1 (b) of the new Financial Regulation. Action 87 of the Reform White Paper foresees that the IAS will carry out a complete cycle of in depth audits of management and control systems in all DGs some 18 months after the first round of DG's annual reports i.e., by the end of 2003. The IAS annual work programme is established on the basis of a risk analysis, which implicitly expresses a professional judgment on the capacity of the Commission's services to achieve their objectives and the effectiveness of their related controls. The IAS will also assure methodological co-ordination of internal audit activities with the IACs through Auditnet. The objective should be to establish a common internal audit methodology, tools and related guidelines in this perspective and to promote a coherent planning of internal audits.

[69] Taking account of the specificities of the DG or Service, the Director General or Head of Service may designate another person as co-ordinator of the preparation of the AAR.

The role of the Audit Progress Committee is to ensure that the work of the IAS is properly taken into account by Commission services and receives appropriate follow-up. In its Annual Report 2001, the Court of Auditors recommended that the Commission revisit the composition and the functional responsibility of the members of the Audit Progress Committee to ensure that audit work receives appropriate response and follow-up. While this issue may justifiably be revisited, it is considered that – after less than 2 years in operation – the present arrangements could be improved through procedural measures rather than changes to composition and functional responsibility.

#### 3.4.2.6. Roles in the context of the synthesis of the Annual Activity Report

In adopting the synthesis of Annual Activity Reports, the College takes note of the achievements and performance of Commission departments and their reservations for the overall soundness of the system, and responds to any issues which arise. To that effect, the College will examine a synthesis report prepared in the form of a communication by the President in agreement with the members of the Commission responsible for Administration and Budget. Regarding internal control elements, the following actors intervene: the Director General or Head of Service, who is responsible for the effectiveness of internal control in his DG or Service and reports each year in his annual activity report on the status of the systems under his charge and on the use that he has made of the resources at his disposal; the Internal Audit Service, who establishes its yearly IAS internal audit report in accordance with Article 86§3 of the Financial Regulation and comments in the context of the inter-service consultation to prepare the synthesis report; the Central Financial Service, who provides an overview of the overall state of internal control on the basis of the individual annual activity reports, audits of Court of Auditors, IAS and executive summaries together with their action plan of completed audits and reviews by IACs. This overview will be integrated as a distinctive part in the synthesis report.

#### 3.4.2.7. Relations of internal audit with internal Control and external audit

The internal auditor should not be involved in the internal control process which (s)he is required to evaluate and judge. There is clearly no objection to the internal auditor being asked to give an opinion on, or carry out a "*pre-audit*" of, the systems and procedures being prepared for a new action or programme. However internal audit should not become a part of, or should not be linked on a permanent basis with, internal control. It is essential that internal audit keeps its distance, so that line management recognises its responsibility for internal control and its interest in demonstrating that it is maintaining efficient internal control through its own efforts. If the external auditor is seen as the supervisor or assessor of internal audit then the relationship between the internal and external auditor in trouble. The establishment of relationship is necessary in which each side clearly understands the role and responsibilities of the other side.

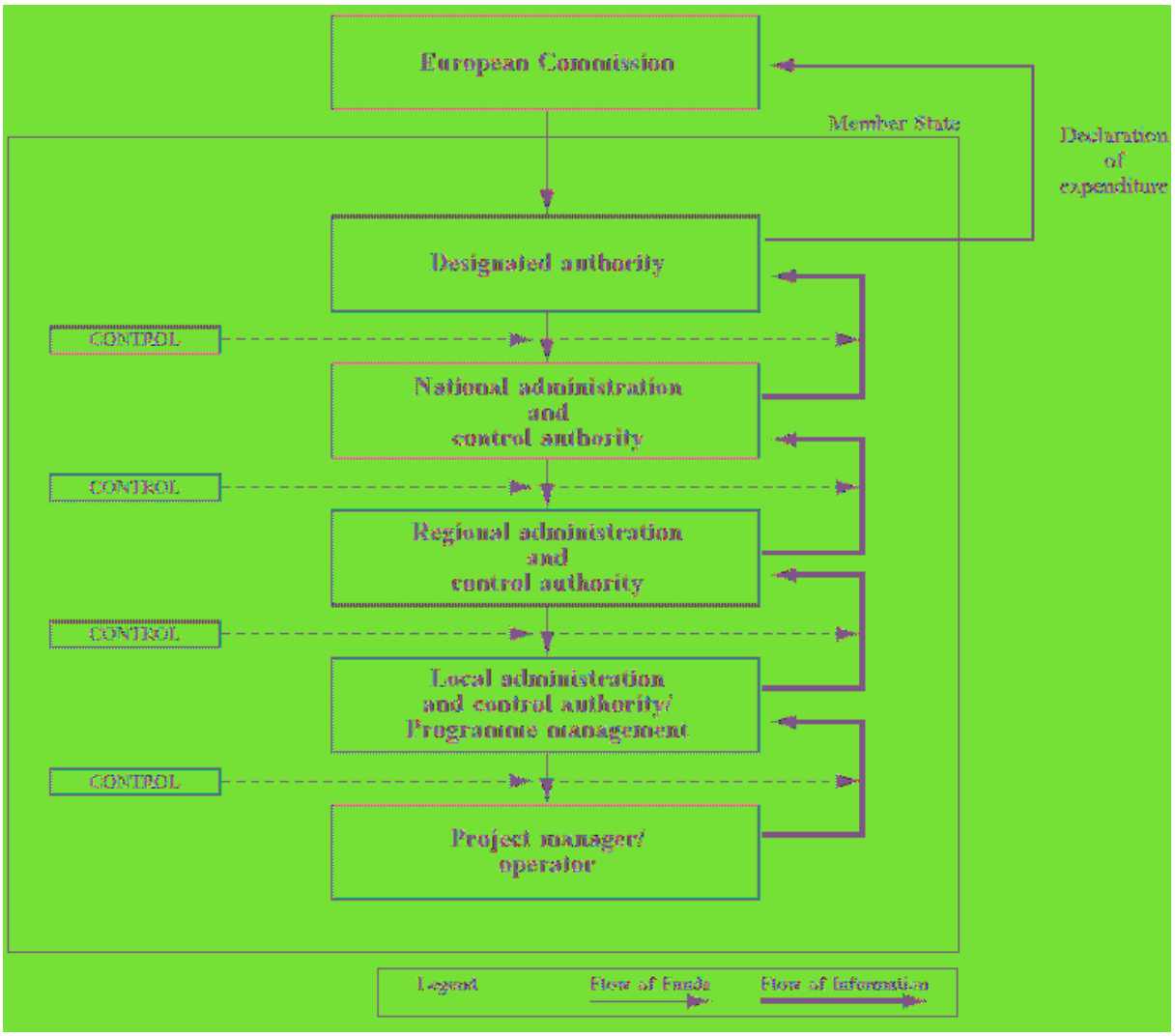
While the external auditor may find some room for improvement in the work of the internal auditor or may even be called upon to audit his work, this need not prevent a sensible working relationship based on partnership. There can be productive exchanges of views, experience and information on methodology, and valuable time and resources can be saved if both sides have confidence in each other's work and plan their own work accordingly to each other. This can only be done without any blurring of the distinctive features and objectives of the two types of audit. It is essential for both auditees and auditor that a clearly defined *audit trail* (Annex A16) is available. It allows the auditees to keep constantly under review the timely and adequate flow

of funds and the procedures for efficient accounting, and the reconciliation of expenditure reports with the funds received or claimed.

#### 3.4.2.8. Role of internal audit in external aid

The debut in external aid is to decide on incorporate into the national budget or not, secondly the practice of the national financial control mechanisms, "*internal control, internal audit, external audit*, to ensure proper and efficient use of the aid. It is an opportunity for the beneficiary country to prove that its financial control mechanisms are sufficient to ensure *sound financial management* of the aid and the aid can be directed through existing systems (budget through the public procurements or in private sectors). Where this is not the case solutions should be found, in consultation with the Ministry of Finance, through specially created programme management units or through a network of implementing agencies linked to line ministries, with funds being directed through a mechanism located in or attached to the Ministry of Finance (i.e., the National Fund in the case of European Union pre-accession funds Phare, I(S)PA and SAPARD).As in any internal control situation, it is essential to base the controls on realistic evaluations of the risk in the country concerned; however the tendency of international organisations is to apply their "national rules" across the board which is an acceptable reason to get tense. This is inevitable, but to equalize this situation measures have to be taken by the international organisations in order to harmonise as far as possible these rules in order to facilitate the task of beneficiary countries in managing funds and to make optimum usage possible in their existing systems. For their part, beneficiary countries can facilitate fund management by making one ministry generally the Ministry of Finance the co-coordinating body for external aid. In the figure below the funds and the information can be clearly perused in the transaction of a European Union fund.

**The Flow of resource and information in the European Union Funds**




Source: Richard Allen and Daniel Tommasi, Managing Public Expenditure a Reference Book for Transition Countries, OECD, 2001.

### 3.4.2.9. Fight against fraud and corruption (OLAF - European Anti Fraud Office) - **(Annex A17)**

The year 90s' have brought growing concerns within the Community, and the Commission, about the problems of combating fraud in the area of agricultural spending and other Community programme. The Commission's Unit for the Co-ordination of Fraud Prevention (UCLAF) was set up in 1987. An effort was also made to strengthen co-operation between the Commission and Member States in the anti-fraud area. In April 1999 (Annex A18), following financial scandals in the Commission and the resignation of the Commission itself, UCLAF was replaced by OLAF (Office de Lutte Anti-Fraud), with enhanced powers and resources. The financial management arrangements within the Commission are also being strengthened.

The objective of the "European Anti Fraud Office" (OLAF) is to protect the financial and other interests of the European Commission against fraud and irregular behavior to result in administrative or criminal proceedings. OLAF is an administrative body doing administrative investigations.

OLAF replaced an earlier strictly internal anti fraud and corruption organisation. The motive

behind the creation of OLAF as a part of the new control system was a growing awareness of the impact of deceptive activity on the interest of the European Commission, particularly with regard to the growth of organised crime syndicates in the context of increasing globalisation. It was clear for the Union that in order to create a truly effective institution, OLAF would need to be seen to be legitimate, with safeguards protecting the rights of the individuals concerned, and that investigations would have to be conducted objectively, on the basis of independence and impartiality. For that reason OLAF was created with three principles in mind: effectiveness and transparency in all its operations and complete independence from the political and administrative systems in its investigations.

OLAF is competent to fight against fraud, corruption and any other illegal activity affecting the financial interests of the EC. This includes the budget, budgets administered by or on the behalf of the EC and certain funds that are not part of the budget. The Office has also to combat any infringement of a provision of EC law resulting from an act of omission, which has or would have an effect on the EC budgets either by reducing or losing revenues or by an unjustified item of expenditure or by affecting the value of assets. However the responsibility of the Office extends beyond the protection of financial interests to include all activities relating to safeguarding EC interests against irregular conduct liable to result in administrative or criminal proceedings. The office therefore participates in the *protection against money laundering, counterfeiting, and forgery of the Euro*.

OLAF undertakes four categories of casework. *Internal investigations* are cases related to the irregular conduct of individuals working within the European Institutions, bodies, offices or agencies. *External investigations* are cases relating to irregular conduct of individuals working outside the European Institutions, and where OLAF is providing the majority of the investigative input. *Co-ordination* cases are cases of the same type as the external ones but where OLAF is acting purely in a co-ordination role in relation to other investigation bodies of the European Union. *Criminal Assistance* cases are cases where OLAF assists the national authorities to conduct criminal investigations, or asks the authorities to open criminal cases.

In order to fulfill its role as an *autonomous* impartial organisation, free from outside interference, the legislative basis of OLAF enshrines the principle of independence. The Office is a part of the Commission even though it exercises its operational powers in full independence. The Head of OLAF has a responsibility to neither seek nor take instructions from the Commission, any Government or any other institution or body is totally independent. The office also has budgetary independence and the freedom to appoint staff within the frame of some general rules.

*A Supervisory Committee* consisting of five elected members for three years monitors on a regular basis the investigative role of the Office. This committee is carrying a crucial role in reinforcing the independence of the Office in relation to any government, institution, body or agency, which is to ensure the independence of OLAF conducting an investigation function of "*by regular monitoring of the implementation*". The Director General of OLAF reports regularly to keep the Committee informed of the activities, its investigations, the results and the action taken on them and at the same time to the European Parliament, the Council, the Commission and the Court of Auditors on the findings of investigations carried out by the Office. These reports must respect the confidentiality of those investigations, the legitimate rights of the persons concerned and, when appropriate, legal provisions in the Member States applicable to judicial proceedings. At the request of the special control committee in the European Parliament the Director of OLAF may attend meetings of the committee to give oral progress reports on specific cases. *These reports are confidential.* The Committee is also informed of cases where the institution or body concerned has failed to act on OLAF's recommendations and of cases which have been referred to national judicial authorities for

action.[70] The Supervisory Committee's role has developed so that it has become also "a kind of management committee". It has been concerned with the administrative structures within OLAF and with such matters as the rights of those being investigated. The Committee also comments on OLAF's draft budget. The Supervisory Committee, is not a Commission (or a comitology[71]) committee but is independent and reports to all the institutions.17 It is, however, dependent on the Commission for its budget. Reports from the internal Audit Capabilities and the Internal Audit Service are regularly sent to OLAF. Presumption of the existence of irregularity, fraud corruption or any other illegal activity must immediately be reported to OLAF from all entities in the Commission. The European Court of Auditors forwards to the Office certain types of information on its own initiative. OLAF on the other hand has a duty to give a feedback to the Court about every case involving information addressed by the Court. OLAF operates a phone service open in every Member State via which individual citizens may give indications to the Office on suspected fraud or irregularities detrimental to the financial interest of the European Union. OLAF is subject to the control of the European Court of Auditors in the same way as any other Commission institution. The actions of OLAF can be subject to the control of the Court of Justice as any natural or legal person may for the purpose of protecting their prerogatives, institute proceedings against a decision addressed to or of individual concern to the person. The Office is also subject to the powers of the European Ombudsman.

### *3.4.2.9.1. Independence of European Anti-Fraud Office (OLAF)* - **(Annex A19)**

In this findings, OLAF's' independency will be discussed in an academic approach. It is commonly said that OLAF has a hybrid status (mixture of two models-generations). OLAF is formally part of the Commission: in this context OLAF is able act and exercises the equivalent powers of the Commission, i.e., in relation to external investigations. At the same time, OLAF has budgetary and administrative autonomy, intended to make it operationally independent. "With respect to the core function of OLAF, which is the opening of investigations, conduct of investigations and the production of the final case report, there is complete independence". However certain aspects of OLAF's work, in particular its legislative and "*fraud-proofing*" functions, which are closely related to the Commission in other words OLAF's functions is being under the control of the Commission. The operational independence of OLAF is secured in two main ways:

#### 3.4.2.9.1.2. The Director General Effect

The Director General is appointed by the Commission and is a member of the staff of the Commission, which has disciplinary oversight over him. Although these appointments differ from other Commission employees, the Director General is appointed following consultation with the Supervisory Committee, the European Parliament and the Council of Ministers. The Director General has the final say on appointments of OLAF staff, though they are not subject to any other special procedure. The Director General is empowered to open investigations on his own initiative. The Regulations require that in exercising this power, he should neither

[70] Article 11(1) and (7). Regulation 1073/99.

[71] The process in which the Commission, when implementing Community law, has to consult special Committees made up of experts from the Member States. For a fuller explanation see our Report Reforming Comitology (31st Report 2002-03, HL 135).

seek nor take instructions from any government, the Commission or any other institution or body. If he considers that a measure of the Commission calls his independence into question, he is entitled to bring an action against it in the European Court of Justice.[72]

### 3.4.2.9.1.3. The Supervisory Committee

"The Supervisory Committee shall reinforce the Office's independence by regular monitoring of the implementation of the investigative function".[73] "The Director General has to keep the Committee regularly informed of OLAF's investigative activities. The Supervisory Committee exercises its influence through its opinions and reports. The Committee can deliver opinions, either on the request of the Director General or on its own initiative, on OLAF's investigative activities. It must not, however, interfere with the conduct of investigations in progress".[74] The Committee is required to make at least one report each year on OLAF's activities. The Committee's reports are submitted to the Community institutions.[75] Witness differed on whether the Commission's proposed Regulation would have any impact on the independence of OLAF. The main weakness of OLAF remained in its semi-autonomous status. According to ACFE (Association to combat fraud in Europe) "OLAF's uncertain status as a part of the Commission is not resolved in the amended regulation. Given the distinct probability that OLAF's investigations may involve combinations of abuse of the Commission itself, corruption or participation by Commission civil servants and the need to obtain evidence from Commission records and staff members it is vital that OLAF's precise status be resolved. Questions of exchange of information, data protection exemptions, participation in joint investigations and even ability to provide admissible evidence may turn on its legal status".[76] On the other hand OLAF's independence and its operational efficiency would be strengthened by new provisions allowing OLAF to concentrate on the priorities to be fixed in its annual work programme (this would increase the efficiency of OLAF by enabling it to concentrate on fewer cases and close investigations faster), as well as by the amended Article 1(3) which would allow OLAF priority and exclusivity in internal investigations.[77]The Commission's proposals would not do much to strengthen the independence of OLAF. Only more radical changes split OLAF's body completely from the Commission. At this point the argument gets a more fundamental and deeply on a political issue. Although it is possible to foresee number of ways in which OLAF might become independent, both legally and factually, of the Commission and the other institutions, the future of OLAF has become tangled with the notion of the European Public Prosecutor. "OLAF has demonstrated that it has sufficient independence to combat fraud within the Institutions without fear or favour. There is no operational need for further independence. On the contrary, separation from the Commission would raise complex legal, management, operational and logistical questions"[78] and also divert OLAF's job in hand and will negatively effects staff's morale and effectiveness. "Such problems could be managed in the context of an orderly transition towards the European Public Prosecutor, where the objective was well

[72] Regulation 1073/99, Article 12

[73] Regulation 1073/99, Article 11

[74] Regulation 1073/99, Article 11

[75] Regulation 1073/99, Article 11(8)

[76] Dr Lothar Kuhl, Director of Legislation, Legal Affairs and Relations with other Institutions, and Mr Sébastien Combeaud, OLAF

[77] Dr. Stefanou and Dr. Xanthaki, Institute of Advanced Legal Studies, University of London, Strengthen OLAF's Independence, 2004

[78] Mr. Bruener, the current Director General, OLAF: Fourth Activity Report for the year ending June 2003

understood and generally shared". The unpleasant effects of the "mixed status" of OLAF have been underestimated. The further step is to split OLAF from the Commission.

#### *3.4.2.9.2. Accountability of OLAF*

An investigative body such as OLAF needs to be independent and it also needs to be accountable. The position of OLAF is a bit complex. But in practical terms, OLAF is responsible to a number of bodies:

a) The Commission: OLAF remains a part of the Commission. The Director General and his staff are subject to the disciplinary control of the Commission. The Commission is answerable for OLAF before the European Parliament and the Court of Justice.

b) The Supervisory Committee: The Director General provides the Committee with OLAF's programme of activities and keeps the Committee regularly informed of investigations and their results. The Committee is also informed of cases where information is sent to national judicial authorities and where a Community institution or body fails to act on an OLAF recommendation.

c) The European Parliament: the Commission, including OLAF, is accountable to the Parliament. "The Commission is required to report annually to the Parliament and the Council on measures taken to counter fraud affecting the financial interests of the Community"[79]. OLAF produces an annual report on the protection of financial interests of the Communities and the fight against fraud. Under the Regulations governing OLAF, the Director General has to report regularly to the European Parliament, the Council, the Commission and the Court of Auditors on the findings of investigations carried out by OLAF.[80] OLAF produces an annual activity report. In practice the Parliament Budgetary Control Committee (COCOBU) exercises political oversight over OLAF. The Director General provides oral reports, on the progress of specific cases. COCOBU has taken an intense interest in OLAF and for the Commission. The Commission and COCOBU exercised some influence over OLAF. This situation resembles a kind of political football being kicked between the Commission and the Parliament.

d) The Court of Justice: the legality of the acts and omission of OLAF are subject, in the same way as other acts and exception of the Commission, to review by the European Court of Justice and the Court of First Instance. It is the Commission's lawyers, not OLAF's, who defend OLAF (a part of the Commission) in court. But as will be seen the Court of First Instance has been unwilling to deal with irregularities in the course of an investigation before the investigation is completed.

e) The Court of Auditors: The Court is required to provide the Parliament and the Council with an Annual Report on the implementation of the Community's budget together with a Statement of Assurance as to the reliability of the Community's financial accounts and the legality and regularity of the transactions underlying them. OLAF accepts that it should co-operate with the Court and, subject to the protection of personal data, supply information needed by the Court.

[79] Article 280(5) of the EC Treaty.

[80] Regulation 1073/99. Article 12(3).

f) The European Ombudsman: OLAF, as part of the Commission, is subject to the jurisdiction of the Ombudsman and aggrieved parties have on occasion complained to him. For the purposes of his inquiries the Ombudsman treats OLAF as a body independent of the Commission.

The Committee's opinion is that the proposed Regulation would do little to increase the accountability of OLAF. Further, the Regulation would not make it any clearer whether the Commission, the Council, the European Parliament, or the Court of Auditors should be the body to which OLAF must account in respect of its investigatory activities. The proposed Regulation would increase the number of cases where the Supervisory Committee could give opinions on decisions taken by the Director General, in particular as regards extensions of investigation deadlines, complaints from individuals, observance of procedural guarantees, and provision of information to the institutions and other bodies.

### *3.4.2.9.3. Powers of inspection of OLAF*

OLAF can conduct both internal and external investigations**.** OLAF investigations are not restricted to the European Union institutions and bodies and can be carried out in relation to economic operators in the Member States (i.e., firms benefiting from Union contracts or funding). Its *internal investigative* function extends to all Community institutions and bodies, including the European Parliament, the Council, and the Committee of the Regions. Recent attempts by the European Central Bank and the European Investment Bank to retain competence over investigations of their respective internal cases were canceled by the European Court of Justice which is also mentioned in the internal control system.[81] The Office is also responsible for detecting serious offences related to the exercise of professional activities that may lead to disciplinary and even criminal proceedings.

The external investigations, OLAF is entitled to exercise the powers of investigation given by Member States to the Commission.[82] These investigatory powers are broadly similar to those of the Commission in competition cases, which are more widely known. Therefore OLAF has power to conduct on the spot inspections, to examine business records and ask for explanations. Before carrying out such checks and inspections the Commission must notify the competent authorities of the Member State concerned. It is critical to remember that OLAF has no powers to take measures with respect to economic operators. If a firm blocks or resists an on the spot inspection, then the Regulation requires the Member State in question to step in and provide the necessary assistance to enable the investigators to carry out the inspection. OLAF maintained a policy of "zero tolerance" when evaluating an investigation of accusations of corruption within European Union Institutions. Further improvements were also made to its case management system (CMS). If the activity reports of OLAF are observed, it is easy to say that the working of OLAF is making a progress every year but also the number of accusations and fraud attempt are increasing within the new member states and candidate countries.

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[81] For the Court of Justice's discussion of the scope of OLAF's powers, see Case C–11/00 Commission v European Central Bank, [2003] ECR I–7147, Case C–15/00 Commission v European Investment Bank, [2003] ECR I–7281 and Case C-167/02 Willi Rothley and Others v European Parliament, [2004] ECR I–000. Judgment of 30 March 2004**.**

[82] Council Regulation (Euratom, EC) No 2185/96 of 11 November 1996 concerning on-the-spot checks and inspections carried out by the Commission in order to protect the European Communities' financial interests against fraud and other irregularities.

### *3.4.2.9.4. OLAF's responsibility in external aid*

OLAF plays the leading role in the investigation of direct expenditure and external aid cases, since these concern expenditure managed completely by the Commission and other European Union Institutions and bodies, such as the European Investment Bank (EIB), rather than by Member States. OLAF's internal organisation was improved in November 2003 in order to handle respectively those cases which are related to direct expenditure within the European Union and the Phare and TACIS programs, and all other external aid programs. In line with OLAF's strategic risk assessment and ongoing intelligence support, small groups of investigators are increasing their specialist knowledge on the specific regions and economic operators benefiting from the programs, particularly in procurements, allocation and execution of contracts. The development is an on going procedure which is in a close cooperation with the Commission services, such as DGs, ECOFIN, and AIDCO and with the operational investigative and judicial partners through the support of the Anti-Fraud Coordination Services (AFCOS) in the new Member States and in the Candidate Countries. The OLAF is evaluating information from case records which were opened since the creation of European Anti-Fraud Office, concerning the new member states and candidate countries; the relevant programs[83]are also such as The Anti Fraud Information Systems (AFIS).
The success of OLAF's operations in the external aid sector depends heavily on the quality and enhancement of the information received. An advanced level of cooperation with European Union and other international bodies is essential. The same is acceptable for the cooperation with the relevant administrative and judicial authorities of European Union member states and third countries. On one hand the development of methods and techniques and on the other the nature of fraud which is well coordinated. "Typical modus operandi[84] revealed in recent cases highlights the complex and well organised nature of financial fraud in humanitarian and development European Union aid to third countries. Such fraud takes advantage of the lack of coordination in monitoring and auditing activities between the various international donors and also of the lack of coordination between the multiplicity of intermediary and beneficiary organisations, both within the European Union and in third countries. The combination of multiple sources of financing and other factors has increased the complexity of accounting and reporting requirements and so made it easier to divert funds for personal or criminal benefit. The methods employed include declaring phony costs and financial transfers, declaring projects as completed when that is not the case, and seeking and receiving double or multiple funding of projects from different donors".[85] OLAF will attempt to improve the efficiency of investigation by developing arrangements for the exchange of information with relevant bodies in member states, in third countries and as well as with international institutions. OLAF is also developing a specific computerised tool to support these investigative operations. Examples will be given to support the idea, from the report European Anti-Fraud Office report to clarify what the OLAF is dealing with:

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[83] ECHO: European Humanitarian Aid Office I(S)PA: Instrument for Structural Policies for Pre-Accession; JOP: Joint Venture Programme; DA VINCI: Vocational Training Action Programme; LIFE: Financial Instrument for the Environment; MEDA: European Mediterranean Aid Programme; OBNOVA: European Programme for the rehabilitation and reconstruction of Bosnia-Herzegovina, Croatia, the Federal Republic of Yugoslavia and the FYR of Macedonia PHARE: Technical assistance for 10 Central and Eastern European countries; SAPARD: Special Accession Programme for Agriculture and Rural Development; TACIS: Technical Assistance for the Commonwealth of Independent States; TEMPUS: Higher Education Cooperation between EU Member States and Partner Countries - (the common ones are in italic)

[84] Often used in the abbreviated form MO; is a Latin phrase, approximately translated as "mode of operation." in a non-criminal sense to describe someone's habits or manner of working, the method of operating or functioning.

[85] Report Of The European Anti-Fraud Office, Fifth Activity Report for the year ending June 2004

**Case Study: Water Supply Project in Paraguay**

*In early 2004, the European Commission Delegation to Paraguay informed OLAF of the alleged misappropriation of Community funds that were intended to improve the water supply system in 50 local authorities of that country. An external audit at the end of 2003 had indicated that about 90 % of the EC funds transferred to the project had been diverted to a bank account belonging to a foundation that was not involved in the project. The relevant Paraguayan authorities had reported the matter formally to the Public Prosecutor's Office which began a judicial enquiry in January 2004. OLAF opened an external investigation and carried out an on-the-spot control of the use of these EC funds in Paraguay. An in-depth analysis of the relevant documentation, in close cooperation with the Prosecutor, identified an additional fraudulent practice; the declared sub-contractors for one part of the project turned out not to exist, and the work was carried out by a company controlled by one of the directors of the project. It is also possible that the expenditure was significantly inflated. A Paraguayan lawyer has been appointed to defend the EC's interests in the ongoing criminal proceedings.*

**Case Study: Non-Governmental Organisation**

*In April 2003 an Italian Public Prosecutor launched an investigation into a non profit making organisation whose aims are to assist developing countries in cooperation with local NGOs of third countries and national or regional institutions. In this context, the organisation in question has received finance of almost € 17 million from the national budget for 23 projects, and of € 11 million from the European Commission for 28 projects. The judicial authorities seized a large number of documents during the investigation. They requested OLAF's assistance to examine details of the projects funded from both the Italian and EC budgets, since dual financing can only be demonstrated by an investigative process which involves both donors. Due to the nature of the documentation proving expenditure within certain third countries, OLAF concentrated its initial efforts on verifying direct bank transfers from Italy to those countries. Investigations indicated that bank statements showing proof of payment for projects had been at times duplicated and falsified, especially where projects were being financed by different bodies in the same third country. Sometimes only half the sum was actually transferred. Other anomalies were identified such as references in the accounts presented to the donor agencies to fictitious supporting documents, duplication of supporting documentation for more than one project, unsigned invoices and procurement of goods through a commercial firm owned by the legal representatives of the non-profit making body. Investigations in Italy are ongoing in close collaboration with OLAF and the Italian Ministry of Foreign Affairs.*

**Case study: Call for Tenders**

*On the basis of information received from the EC delegation in Romania, a case was opened to investigate problems in relation to two contracts for which the design and treatment process varied from the offer and accepted tender. OLAF began to investigate this matter and is continuing in full cooperation with the Romanian administrative and judicial authorities.*

**Case Studies: Cigarette Smuggling into the European Union**

*Lithuanian Customs informed OLAF about a suspect container coming from the Russian Federation destined for an unknown Northern European port. This led OLAF to alert all*

*possible ports' customs offices. Belgian Customs subsequently reported that they had detected the container in which about 1 million cigarettes had been concealed in a double wall.*
*A Lithuanian national was arrested in Latvia on a Belgian international arrest warrant. The Belgian Judge was able to base this warrant on specific information received from OLAF which OLAF requested from partner contacts in Lithuania. The person in question has been extradited to Belgium and is allegedly involved in a case involving the smuggling of alcohol contaminated by methanol. This alcohol caused the deaths of 13 people in Norway, and OLAF organised several meetings with the authorities from Sweden, Norway, Belgium and Eurojust in order to ensure a successful outcome to the case.*

Source: Report of the European Anti-Fraud Office, Fifth Activity Report for the year ending June 2004

#### *3.4.2.9.5. OLAF's co-operation with European Court of Auditors (ECA) -* **(Annex A20)**

"European Commission Treaty Article 248(2) defines the tasks of the Court of Auditors as examining whether Community revenues and expenditures have been incurred in a lawful and regular manner, and whether the financial management has been sound. The Court has been granted broad treaty-based powers to collect the information that it needs from other Community organs to perform its function of auditing the lawfulness of Community revenues and expenditures. Article 248 of the Treaty and Articles 140 and 142 of the Financial Regulation specify the conditions under which the Court of Auditors can have access to documents and information related to the financial management of the services or bodies under its control.[86] Both provide that the other institutions of the Community shall forward to the Court the documents and information, including that stored on electronic media, necessary for the performance of its tasks. Much of the information in OLAF's possession would be relevant to the Court's task of examining whether expenditures have been incurred in a lawful and regular manner, and whether irregularities have occurred. OLAF should, in general, cooperate with the Court's requests for the information that it needs to perform its auditing functions. The Court of Auditors may, at any time, submit observations, particularly in the form of special reports, on specific questions to the other institutions. To this end, the Court prepared a special report on UCLAF in 1998[87], covering a broad range of issues (the Commission's organisation of the fight against fraud, organisation of UCLAF, financial follow-up and recovery, reliability of information in the annual report on the fight against fraud, corruption and breaches of discipline)".[88]

### *3.4.3. External audit*

The auditing consists of processes and mechanisms which are created to ensure the planning, budgeting, use of public resources in accordance with a country's regulations and follow the defined objectives of the government however without the help of internal control and evaluation system, it is not realistic so that it is not possible to play with one striker and score.

[86] Council Regulation (EC, Euratom) 1605/2002 on the Financial Regulation Applicable to the General Budget of the European Community, OJ L 248, 16.9.2002.

[87] Court of Auditors, Special Report No 8/98 on the Commission's services specifically involved in the fight against fraud, notably the "unite de coordination de la lutte anti-fraude," OJ C 230, 22.7.1998.

[88] OLAF manual — 25 February 2005

Without these mechanisms, there is a considerable risk that policy decisions will be based on flawed information, that resources will be mismanaged, or that policy decisions will be ignored by the relevant operating organisation or both. Audit in the public sector has also an important function, when giving the final decisions, the decision-makers parliament and government, or when assuring taxpayers' that their money has been spent to the right places by giving them reports of concrete results (i.e., investments, technological developments, etc.), and also the management of assets and liabilities under public control. There is an significant and fundamental distinction between external and internal audit which arises from basically the degree of independence of the auditor or the organisation responsible for the audit has in relation to the audited entity and also to whom the result of the audit for.

In order to understand the external audit the process which functions effectively and be trusted as an objective mechanism, must be fully independent from the auditee and its reports should be addressed to entities that are separate from the bodies being audited. This does not prevent close links, contrary facilitating the practical work between the two types of audit organisations. *Both external and internal audit mechanisms are established within the public sector in most countries of the world*. The Lima Declaration of Guidelines on Auditing Precepts, published by the International Organisation of Supreme Audit Institutions (INTOSAI), opens with the following statement:[89]

"The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent or at least render more difficult such breaches." Effective auditing can contribute in several important ways to the management of a government's finances as well as giving the parliament and citizens an objective description of how public funds have been spent. The first contribution is to detect irregularities involving the misuse of public funds and identify related weaknesses in management controls that may imperil the integrity of the organisation and the effective implementation of budgetary and other policy decisions by determining the reliability of reports on budget execution and other financial data. In fact to identify instances and patterns of waste and inefficiency that, if corrected, will permit more economical use of available budget resources by providing reliable data about programme results as a basis for future adjustments in laws, policies, and budget allocations. The role of the organisations which are responsible for auditing the government as a whole have many different names but, communally these organisations call themselves as Supreme Audit Institutions (SAI). As it is mentioned before state audit has several hundred years of history in most of the European countries. Certainly, the time and the changes in the administration of state made most of the SAIs to change in their structure, as well as in powers.

There are three main types of SAIs in Europe.[90] All varieties can be found within the European Union. These are, first, the 'court' *with judicial functions* (i.e., *Cour des Comptes* of France, *Corti dei Conti* in Italy, *and Curtea de Conturi* in Romania). The second type is the

[89] *The Lima Declaration which* was released in October 1997 at the 9th INTOSAI Congress and restated by INTOSAI in 1998.

[90] There are considerable variations between the SAIs when it comes to audit remit and scope of the audit. Many SAIs combine characteristics of different models, National Audit Office 1996.

'*collegiate*' body *without judicial function* but with collegiate decision procedures similar to those found in courts (i.e., *Nejvyssí kontrolní úrad* in the Czech Republic, *Bundesrechnungshof* in Germany, *Algemene Rekenkamer* in the Netherlands). The SAI of the European Union, the European Court of Auditors, are both formed according to these lines. A third type is the *monocratic audit office*[91] headed by an Auditor General only (i.e., *Rigsrevisionen* of Denmark, *Riigikontroll* in Estonia, and National Audit Office in the United Kingdom). The judicial functions of the courts show variety but implementation of the obligation to judge and punish who the responsible of abuse in financial regulations is still out of question. The SAIs in Europe are still have very limited judicial functions or none at all.[92]

INTOSAI has established principles and standards for the audit of government organisations and operations which have been adopted around the world, by all SAIs. The cooperation between the European branch of the INTOSAI, the EUROSAI, and the European Court of Auditors supported the external auditors' in the European with the SAIs structure.[93] The nature and functioning of external audit is not strictly a part of the *acquis communautaire*, but the laws, regulations and procedures which altogether constitute the European Union. However, the criteria that are given in the Copenhagen Meeting, all Member States and candidate countries will need to apply the additional political and economic conditions which will lead especially the candidate to achieve stability of institutions guaranteeing democracy, the rule of law and including the existence of an effective SAI. The EC Treaty implies the existence of such institutions and their capacity to cooperate with the European Court of Auditors (Articles 246-248 – Annex A19). Moreover, the general financial control standards for the management of European Union funds and resources (i.e., customs duties and value added tax - VAT) require an effective external audit of all public sector resources and assets, and that this should be carried out in a continuous and harmonised way. In fact separating SAIs in the external audit mechanism is not a realistic approach for the European Commission's funds. In order to identify the weight of SAI in Union funds, it will be useful to understand the relations with the European Union bodies.

### 3.4.3.1. European Court of Auditors (ECA)

The Court was established on 22 July 1975 by the Budgetary Treaty of 1975 and started operating as an external Community audit body in October 1977. Since the Treaty of Maastricht the European Court of Auditors has been recognised as one of the five institutions of the European Communities. Even after enlargement there will still be one member per state. For the sake of efficiency, the Court can set up "chambers" (with only a few members each) to adopt certain types of report or opinion. The external auditor of the European Commission and all other institutions in the Union with a 25 member (Table 4) independent entity based in Luxembourg performs an external auditing function for all of the budgets of European institutions. In contrast to a common thought in the Member States, the Court has no jurisdictional power. The ECA examines all revenue and expenditure to determine whether all revenue has been received and expenditure sustained in a legally and in a manner of standards,

[91] Finland and Sweden have currently a unique system that combines an SAI within the structure of the government with an audit body appointed by the parliament. However, the Finnish system is likely to be changed to the conventional model of an audit body reporting to the parliament.

[92] Relations Between Supreme Audit Institutions And Parliamentary Committees Sigma Papers: No. 33, SIGMA 2001

[93] Auditing Standards issued by the Auditing Standards Committee of INTOSAI in 1992, amended in 1995. The INTOSAI standards and the EUROSAI guidance are available from the INTOSAI secretariat in. The European Court of Auditors in Luxembourg published the "European Implementing Guidelines for the INTOSAI Auditing Standards" in 1998.

and whether financial management has been sound with around 800 auditors, translators and administrative support staff originating from all the European Union Member States. The Court's auditors have a broad range of professional backgrounds and experience, including accountancy, internal and external audit, law and economics. The ECA's audit covers not only the use of resources for the administration of the Commission and its Directorate Generals but also all use of European Commission funds by national and local administrations in Member States and any other beneficiaries of funds in both the public and private sector. The Court has a right of access to all bodies that has received funding from the European Commission irrespective of their legal status. Certainly conceding an audit from ECA was not so easy although they are capable of controlling on its own," nobody would want to show their bedroom to an outsider".

Whereas EIB case is a good example for the quote because Commission sued the EIB on grounds of violation of a regulation which concerns the investigation conducted by the EIB. The claim was its independence will be harmed by the conducted audit. To overcome this issue the tripartite agreement signed among the European Central Bank, Commission and Court of Auditors in October 2003. ECA functions independently and autonomously with the freedom to organise its own work programme, plan its auditing activities and schedule the publication of its reports. Parliament and Council constitute the budgetary authority and the Court of Auditors assists both bodies in exercising their powers over the implementation of the budget. The Court's Annual Report together with Special Reports and the Statement of Assurance (DAS, the acronym for Déclaration d'assurance) are the basis in the discharge procedure for the Council to recommend and the Parliament to decide the granting of discharge.

This procedure provides the ECA with the most appropriate opportunity to present the observations contained in its Annual Report for the previous financial year to the competent authorities. Once adopted by the ECA, in November of each year, the Annual Report is presented by the Court's President to the European Parliament where it becomes a key document in the latter's deliberations on whether or not to grant discharge to the Commission. The discharge procedure includes an assessment of the Commission's responsibility in the implementation of the budget. The European institutions are required to follow up the observations contained in the Parliament's discharge resolution and take steps to safeguard the European taxpayers' money by improving the quality of management systems and adopting the measures necessary to protect Union finances. The Financial Regulation also stipulates that the institutions must give an account of the measures taken. It is also mention in the context that the European Court of Auditors has not approved any of the budgets in the last ten years except the financial year of 2004 which is audited in 2005. The main products of ECA's audit work are the Statement of Assurance and special audit reports and so called sector letters on the revenue and expenditure programs of the EC. In beginning of March each year Commission is required to present to the Parliament, Council and the ECA accounts of revenue and expenditure, assets and liabilities, to show how the budget for the previous year was implemented. These accounts form the basis for the ECA's audit work for the Statement of Assurance. This together with other special audit work on the revenue and expenditure programs of the European Commission is brought together in the Annual Report published by the Court in November the same year. In some countries, the SAI has an obligation in certain circumstances to carry out some performance audit or to reach an opinion upon the reliability of performance indicators published by audited entities in their annual reports or similar. Even in countries where the constitution or legislation do not require the SAI to carry out audits of economy, efficiency and effectiveness, present practice shows a tendency to include this sort of work as part of financial and regularity audits ("comprehensive/integrated audits").

These audits often require the auditor to assess systems resulting in professional judgments relating to the efficiency and effectiveness of organisational structures and procedures, and to the economy with which actions were undertaken. All projects funded by the European Communities are subject to audit at any stage, whether during the award process, during execution of the project or once the project has been completed. The Contracting Authorities must keep all the documents relating to the award of contracts for a *period of seven years* from payment of the balance. These documents must be made available for inspection by the European Commission and the *European Court of Auditors*. These must include the originals of all tenders submitted, together with the corresponding tender dossiers and any related correspondence.

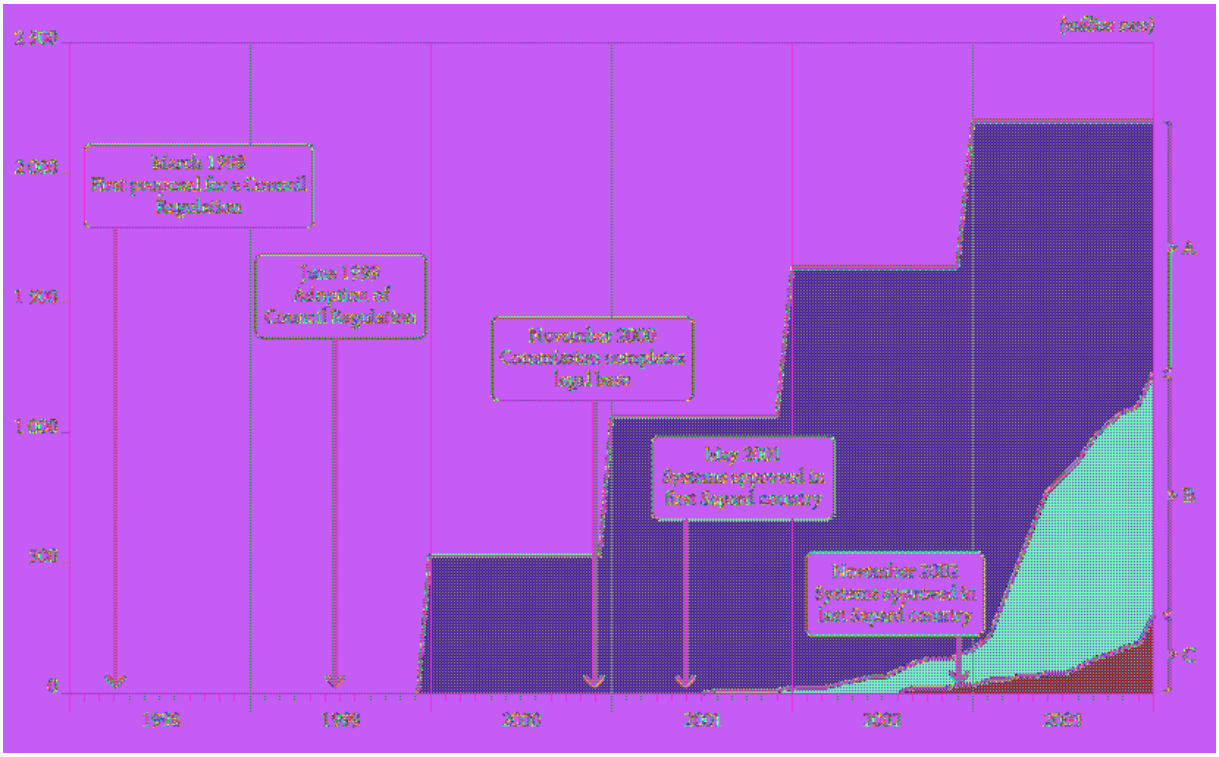
#### *3.4.3.1.1. The History of an implementation model of the European Union Fund: Special Accession Programme for Agriculture and Rural Development (SAPARD)*

Due to the large increase in the pre-accession budget in general, which effectively doubled from 1999 to 2000 and which, for SAPARD, was to be managed by newly created structures under newly created rules, the Court decided to perform an audit which aimed to answer the question: "Is SAPARD well controlled?" so, three audit objectives were defined, which sought to review: First one is the Commission's management and control systems for the programme, secondly the quality of systems set up in the applicant SAPARD countries, and the last objective project selection, approval and implementation by national and regional authorities. These objectives allowed the Court to analyze whether the management and control systems were effective and applied reasonably or whether they were insufficient in their coverage. Audits were carried out in the Commission (DG Agriculture) and in four SAPARD countries (Bulgaria, Lithuania, Poland and Romania). Documentary checks were made for a sample of 76 projects, of which 42 were visited on the spot between November 2002 and September 2003. The projects in the sample covered the main measures implemented at the time of the audit, which themselves represented around 95 % of all contracts concluded and payments made in these four countries[94]. The staff of the Supreme Audit Institutions of the countries visited which have worked with and accompanied the Court's auditors. The audit of SAPARD built on the results of previous audits, which had focused on the setting up of the programme and the Commission's analysis and monitoring of the SAPARD systems, which have been published in the Court's Annual Reports[95]. The main conclusions were that considerable time was used in setting up the instrument, in particular in clarifying and working out the details of the complex legal basis, and that the management and control systems predicted insufficient checks in risk areas such as staffing, *prevention of double funding, sound financial management, bank interest, and compliance with minimum standards for environment, hygiene and animal welfare.*

The stages in the implementation of the SAPARD programme from the first proposal for legislation until the beginning of 2004.

[94] The main measures are: investments in agricultural holdings, improving the processing and marketing of agricultural and fishery products, and development and improvement of rural infrastructure. This represents some 80 % of commitments made in all applicant countries.

[95] Court of Auditors Annual Reports concerning the financial year 2000 (OJ C 359, 15.12.2001)



Source: European Court of Auditors: payments and contracts in the SAPARD countries

The amounts indicated in "A" show the gap between the total Community financial contribution in the general budget and the total amount for which contracts have been concluded with beneficiaries. The difference thus reflects the amount available in the budget which was not used by the SAPARD countries because of the time needed to have their systems approved, and the delays in those countries arising from difficulties in implementation. In "B" demonstrates the amount of contracts concluded with final beneficiaries but which have not yet been paid. This reflects the time needed for the implementation of projects, which, for example for construction projects, can normally take more than a year which considered as long term projects, but also reflects administrative delays. The "C" explains the actual flow of funds to beneficiaries. The stats maybe not recent but the result is obvious the implementation was not successful, so the efficiency of the system in arguable.

In June 1999, the Council adopted the Commission's proposal for a Regulation on SAPARD. This set out a new and complex legal framework, took the Commission seven months to set out the implementation principles; then six months to draft and adopt the detailed rules; then a further six months to draft, negotiate and adopt the agreements with the SAPARD countries. By the end of March 2001, all countries had signed the agreements. The Commission did not use the time available in the period between March 1998, when it proposed the SAPARD Regulation[96], and June 1999, when it was adopted by the Council, to make further implementation preparations. This 15-month period could have been used to prepare detailed principles and rules which would have clarified the policy and accelerated implementation. After completion of the legal framework in November 2000, the start of SAPARD depended on the time needed to set up the systems by the countries. Some countries were quick in implementing: the Commission approved the systems for some of the measures in Bulgaria in May 2001. Hungary did not start the implementation of some of the SAPARD measures until 27 November 2002 and also because of delays in implementation. Since the start of SAPARD

[96] Proposal from the Commission for a Council Regulation (COM(98) 153 final, 19 March 1998)

in the countries concerned, heavy administrative procedures, stricter than required by the SAPARD rules, have disadvantaged an efficient implementation of the programme. Romania was the last but one SAPARD country to have parts of its systems approved, but it was not well-prepared for applying the programme in August 2002. The time between receiving the application form and approving it took up to seven and-a-half months. Since April 2003 the situation has improved because the Romanian authorities have changed certain procedures and increased the number of staff available to deal with these applications. Despite these delays, the large number of applications made it possible for the Romanian authorities to use all funds planned for rural infrastructure for the whole seven-year period. Poland also received a large number of applications for this type of project. However, for administrative reasons not required by the SAPARD rules, more than 250 million euros which were available were. In Lithuania, the average time between submission of the project application and signature of the contract is 4.5 months. One of the main reasons for the delays in approving the applications is the lack of staff in the key unit which evaluates all project applications. In Bulgaria, all checks made at local level, in central level the SAPARD Agency performed to implement. This adds about one month to each project approval which means delay in project implementation and about one month to each payment approval stage. The Commission has not looked actively for implementation problems although in some cases the Commission has taken action by discussing the issue with the country concerned, this was not done systematically. Key steps have not been analysed so that lessons can be learned 22. The Commission did not analyse the critical steps which delayed the setting up of the systems by the SAPARD countries. Such an analysis should include its own role and would have been useful, because SAPARD countries could have taken into account success factors when setting up systems for the management of European Union funds. Later, the Commission also did not include such an analysis in the mid-term evaluation of the programme in each SAPARD country.

By including this element, success factors and constraints in putting in place the systems could have been identified, in that way assisting similar exercises in the future. An external evaluation was not launched to ensure that the experience gained from SAPARD could be used in the future. The Commission could not make accurate estimates of the amounts included for payments in the budgets for the first three years. Up to the end of 2002, it made 850,8 million euro available for payments, of which only 154,4 million euro (18 %) were used, while the other part was cancelled. The Commission noticed that the payment estimates were uncertain because they depended on factors which were out of its control and there was no previous experience in managing external aid in a decentralised manner. The amounts could not be based on sufficiently detailed documentation and calculations. Instead, other arguments were provided to justify the amounts, such as the need to give a positive signal that the Commission was confident that the countries concerned would be able to implement SAPARD. There is a need to separate political will and economic reality but, as a consequence of an emphasis on the former, the Commission systematically overestimated the amounts for payments in the budget.

#### 3.4.3.2. Supreme Audit Institution (SAI)

Over the past decade, the European Commission, as the institution responsible for implementing the Community Budget, has taken an increasingly interest in the effectiveness of the control measures applied by Member States to Community funds. Without any doubt, it is in the common interest of the Member States to exercise proper control of Community funds. The responses of European Union member states' is the Supreme Audit Institutions (SAIs) to the Commission's external audit procedures and requirements which are opposing for various reasons, including legislative ones. Pooling of the responses of different Member States to the external audit procedures and requirements of membership could guide the applicant countries

of Central and Eastern Europe, as well as indicating issues for possible future examination in the context of the European Union's ongoing development in the areas of financial management and external audit, including co-operation with the Commission's services, the European Court of Audit and Member States' Supreme Audit Institutions.

#### 3.4.3.2.1. Historical reflection over the background of SAI

From the earliest days of the Community, the heads of national SAIs have come together, usually once a year, in a Contact Committee. This body has no formal basis in Community legislation. In the early 1970s, the Contact Committee co-operated with the Assembly (ancestor of the European Parliament) to draft the EC Treaty amendments which created the European Court of Auditors (ECA). The amendments were adopted in 1975 and the ECA took office in October 1977. By the time the ECA was set up, Member States were already adapted to receiving inspection and audit visits from the Commission services. Even today numerous ECA audits took in Member States. Prior to the ECA, the Community system of control and audit was essentially autonomous and self–regulating. The key role of ECA is the Financial Controlling when *ex ante* approval needed an inspection in terms of expenditure. The Treaty amendments which set up the ECA introduced the first reference in Community legislation to national SAIs. The ECA's audit work in Member States is required to be carried out in liaison with SAIs; SAIs are required to inform the ECA whether they intend to take part in the audit; and are also required to forward to the ECA, any document or information necessary to carry out its task. The SAIs is like a guarantee of reliable documentation and information for ECA. In 1979 the ECA became a member of the Contact Committee and since then its presence has emerged increasingly large on the perspective of SAIs. In practice the ECA is now the main focus for the work of the Contact Committee, and the time and effort required to participate in the Committee with its supporting committee of Liaison Officers and working groups which is important for national SAIs. It seems that the Commission will continue the policy of implementing control and audit procedures for Member States. With the issue of "*Enlargement*", the additional demands occurred on the Commission's control and inspection services, which need to add new improvements to the process.

#### 3.4.3.2.2. Co-Operation with the European Court of Auditors (ECA)

A well-established liaison practice which covers the scheduling, implementation and follow-up of ECA audits in Member States. Its modus operandi[97] is presented in several of the country papers. The underlying principle of co-operation is stated in the on of the paper in the following terms: "Co-operation between auditing bodies within the European Union must also be characterised by respect for the independence of the various audit bodies involved, where leadership is not imposed as a rule, but decided by the needs, case by case. The a priori conditions are that, basically, each body must itself determine whether co-operation will give it some added value".[98] The country papers reveal some differences in national approaches to co-operation with the ECA because of the option which is described in Treaty for SAIs to take part in ECA audits is interpreted in a variety of ways. In United Kingdom the policy of the SAI is, not to participate in some audits. On the other hand, the Portuguese SAI "has accompanied every Court of Auditors audit on Community revenue and expenditure carried out in Portugal". For some SAIs, the extent of participation appears to be decided reasonably in the light of available resources and reliable information. *The Austrian SAI* believes in a more efficient way

[97] Mode of Operation, it was mention on the OLAF

[98] The underlying principle of co-operation from the paper of Sweden

of participation by cooperating in an audit conducted by ECA. The SAI put an end to the discussion over the optional article about the audit by means of "an independent audit, which was announced to the auditees. This means that "the SAI examined the same subjects as the ECA" and "used its own methods and evaluations of audit findings, its own reporting procedure as laid down in the constitution and the Court of Audit Act".[99] However there is a *tiny problem* the SAIs and the ECA have been cooperating since the early 1990s and both carry out limited number of joint audits. This cooperating brought a new understanding to the audit in which the ECA and one or more SAIs combine their resources in a single audit investigation. As an alternative on that idea, there have also been some experiments with parallel or coordinated audits, in which two or more audit bodies carry out separate investigations into the same subject area. *The Austrian formula* for participating in ECA audits is a parallel audit which created the whole idea of joint audits which is instructive for both sides.

The Portuguese SAI expresses its support for joint audits in the following terms: "In spite of the difficulties and additional costs involved, the experience continues to be regarded as positive and enriching as it allows for a useful interpenetration of knowledge in areas which are particularly relevant to integration, and provides an opportunity for an exchange of experience as to audit methods and procedures which mutually benefits both SAIs and encourages the necessary uniformity for the development of co-coordinated audits".[100] Although the ideology has given by the Austria the results of joint audits are not as positive as expected. "Generally speaking, and in consideration of tight resources (money, personnel time) of the SAI, it has a reserved position relating to joint audits with the ECA...because the efforts and expenditures for planning and co-coordinating the joint audits are considerable". Another form of co-operation between SAIs and the ECA related to private sector which depends on the ECA's obligation under 188.c.3 of the Treaty to "provide the European Parliament and the Council with a statement of assurance (DAS) as to the reliability of the accounts and the legality and regularity of the underlying actions." This is a very specific responsibility, comparable to the audit opinion which is the normal conclusion of an auditor's work in the private sector. It places a big burden on the auditor to ensure, and if necessary to be able to show, that his conclusion is supported by the audit evidence and the recommendations follows the DAS. European Union legislation allows the SAI of a new Member State independence to decide on the role it wishes to play in the control and audit of European Commission funds. According to the stats European Union SAIs wish to continue to develop their co-operation with the ECA and other SAIs and with the European Commission indirectly.

#### *3.4.3.2.3. Independence of SAI's in auditing*

In the auditing organisation and its auditors, it is essential to ensure the independence of the work which will not be influenced by any relationship in the audit conducted. Independence is also a necessary condition for internal audit, whereby the entity responsible must not be part of the finance or treasury function of the ministry or agency concerned, but must report directly to the senior manager overseeing financial transactions. In the Lima Declaration, INTOSAI made the following statements about the independence of the SAI: "Supreme audit institutions can fulfill their tasks objectively and effectively only if they are independent of the audited entity and are protected against outside influence. Although state institutions cannot be absolutely independent because they are part of the state as a whole, the supreme audit institutions shall have the functional and organisational independence required to fulfill

[99] Effects of European Union Accession Part 2: External Audit Sigma Papers: No. 20, SIGMA – Paris 2002

[100] Effects of European Union Accession Part 2: External Audit Sigma Papers: No. 20, SIGMA – Paris 2002 – (Portugal)

their tasks." Independence of the external audit process is accomplished by creating the SAI as an organisation apart from the government with its mandate and scope of work laid down in the constitution or law. The SAI reports and is responsible for to the national administration. Another method to secure independence from the auditee (the government); is to reunite the head of SAI and the government under the same framework to obtain a healthy auditing. In this method the institutional independence of the SAI must be guaranteed by the lawful basis. Unquestionable statutory authority must be given to SAI to make requests easily to the parliament on funding issues such as in determining the scope of audits, obtaining any documents and records relevant to the audit, and to exercising its judgment as to the audit results to be reported. *Even the smallest details must be taken into consideration*; the individual auditors' status must not be ignored in the context of maintaining an independent SAI. Internal regulations published by the SAI or the national laws could support the auditors to make their standing. This situation is maybe a bit abstract but observing in an example will clarify it the subject.

It has been said that laws and regulations required for the continuity of the independence. However an auditor is also an individual so in view of the fact that (s)he can be invested in an entity that might be affected by the results of the audit, such potential conflicts of interest arise in our daily lives. If the SAI is auditing the operations of a government computer system, for example, the auditors on that assignment should not have a personal interest in or contractual relationship with, the firms which might compete to supply replacement computer equipment. Other requirements may be imposed to avoid any possibility that the audit work will be subjected to improper influence. In Europe countries some of public sector auditors are prohibited from active participation in political parties. They may be prohibited from auditing an entity in which a close relative by blood or marriage holds a position of responsibility. The decision-making procedures used by SAIs with a court or member structure avoid to a certain extent these kinds of problems by separating the decision on an audit from the auditing activity itself. Rules to avoid such conflicts of interest are often inconvenient, but the independence of the auditor is central to an SAI's credibility and the inconveniences must be tolerated.

#### *3.4.3.2.4. The Range of audit for SAI*

The objective of government auditing is to meet the observation of all *revenues, expenses, assets and liabilities of the state sector* which is explained in the Lima Declaration of INTOSAI by statements. (Annex A21) In many countries, fundamental public services are carried out by organisations whose activities are not reflected in the national budget. These activities include extra budgetary funds, partially or wholly state-owned enterprises and private organisations financed by state subsidies which is common in transition economies. In fact the boundaries of the state sector cause this complication. The existence of state-owned organisations, which conduct profit-making or industrial operations, might resemble a private-owned corporation. In order to over come this problem; if their activities are estimated to be an ongoing responsibility of the state such organisations either converted into corporate bodies of the government, or privatised. However these organisations must be audited by the SAI in the period up to privatisation. The reason why they require audit is because they were often created by state law to carry out a state-mandated public function. Their resources are collected under authority of the state. In spite of their relationship to the national budget, these are public organisations using public funds and the state has the same responsibility to safeguard these funds as it has for the resources of any line ministry or agency of the government. Nevertheless the risks of waste, fraud, abuse and mismanagement are often even greater than for a typical ministry because of the absence of effective direction and

supervision by the government and parliament. Bad management can cause such organisations to fail to carry out properly the functions for which they were created or to create an unnecessary budgetary burden for the state. Effective auditing can help reduce these risks. Special issues are involved in state-owned enterprises that are planned for eventual privatisation. While such enterprises remain in state ownership, the state's interests are to maintain the assets and to maintain or increase efficiency, both to minimise the potential budget burden and to increase the potential value when the entity is sold. However experiences in several transition countries, provide sufficient evidence that the current managers of these enterprises have a different range of interests.

Besides effective government regulation and strong management controls by the auditing of SAI, are essential to prevent expenditure of state resources. The process of privatisation, itself, also guarantees audit oversight by the SAI. To minimize this risk, it is highly desirable that the SAI has full authority to audit such secret organisations. If the SAI does not have such audit authority, the responsibility for assuring the probity of such organisations falls entirely on the government, which would be prudent to take steps to ensure an effective audit.[101]

#### *3.4.3.2.5. The role of the SAI regarding to European Union Funds (SAPARD, IPA, PHARE, CARDS, Other)*

The application for European Union membership by the candidate countries and current conditions of pre-accession funds have provided a urgent need for SAIs to improve their organisation by carrying out audits more professionally and by increasing the necessity to get on with the best European practices in state auditing. When it comes to the European Union perspective, an important keystone is a sound and efficient financial management in the execution of the budget. In the Partnership Agreements the governments of applicant countries and the European Commission agreed upon the need for strengthening the chain of management control, including external audit. The SAI itself has interest in effective management control system so that: it can anticipate and prevent errors and defects, fraud and irregularities in earlier stages than external audit, and the reliability and effectiveness of management control systems can save the SAIs resources. To fulfill this need, it is crucial that the legal authorization of SAIs includes the responsibility to audit and to focus on the quality of management of European Union funds.

#### *3.4.3.2.6. Mandates of SAI*

Concerning the implementation of active approach with regard to the European Union requirements for external audit, all SAIs have reached this important stage: mandate for auditing European Union funds in the European Union candidate countries. This has not been an easy task, but the SAIs did not stand alone in this challenge. The network has functioned as a powerful framework for all sorts of activities which supported the SAIs in many areas. This will necessitate many requirements, which will be emphasized shortly but first of all the SIGMA in this process. SIGMA, funded mainly by the Commission, has given important support and advice, partly through the network, partly on a bilateral basis. Maybe one of the most important contributions of the network in supporting the SAIs has been the development of a link between the people which is a mutual and beneficial for both sides. These people are the liaison officers, audit staff participating in the workshops, audit staff from the candidate countries having

[101] Different solutions on how to organise the audit of such organisations are described in SIGMA (1998) *Central Bank Audit Practices* and SIGMA (1997b) *Effects of European Union Accession. Part I — Budgeting and Financial Control.*

worked as intern in the ECA, SIGMA experts, audit staff from especially the United Kingdom National Audit Office (UK NAO), the French Cour des Comptes and of course the INTOSAI Development Initiative (IDI) that have been specifically involved in cooperation projects with SAIs in candidate countries, through the development of network.

The requirements set by the Commission and approved by the Council concerning the acquis in the area of financial control however the Supreme Audit Institutions in the candidate countries have set their ambitions at an equally high level. This comes out clearly in the products brought into the open in the context of the network, and the quality of the preparatory discussions in the candidate countries, and the interest from the outside world in these products. To give just some examples to explain the situation in detailed way: the Report on the relations between SAIs and Parliaments, prepared by the Polish and Maltese SAIs, has been presented and discussed in Brussels and also the certification of paying agencies for SAPARD funds is a particular area. Only two SAIs (Hungarian and Romanian) have decided to take on this task of being involved formally in the accreditation of SAPARD Agency, while four SAIs have been appointed as the certifying body for pre-accession funds (Hungary, Lithuania, Romania, Slovakia).

Especially interesting is the recommendation that SAIs should further encourage the strengthening of the internal audit function. In the context of the European Union with its shared management structures such a strengthening should harmonise with those implemented in the Commission services. The European Court of Auditors shortly published an opinion on the issue of single audit, which precisely deals with the establishment of an effective and efficient control framework, with beneficiary level until the external auditor of the European Union budget, the European Court of Auditors. It shows that the European Union still has a way to go trying to realize 11th recommendation. The importance of a good relationship between the internal auditor and the external auditor, both at the national level and in a more institutionalized way within the European context cannot be underestimated.

Until now it is clear that accession will necessitate to redefining the objectives and the structures of the cooperation in the candidate countries but let me make clear that the Court's position is to maintain its interest in cooperating with, and supporting the development of the SAIs in the remaining candidate countries. At the same time the Court will do what ever necessary to make the cooperation within the SAIs and Commission for a success accession.

### *3.4.3.2.7. Audits carried out in candidate countries*

The auditing is like a technology that needs to develop itself with the aim of meeting the requirements necessary and matching up the innovations so that the SAI is designed to navigate the countries by the manual given (INTOSAI standards). Based on the implementation of the "*11th Recommendation"* [102](AnnexA15) concerning the functioning of SAIs in the context of the EU accession, adopted at the Meeting of SAIs' Presidents in Prague in 1999. Brief description of *Internal Control System (ICSs) in countries concerned, position and role of SAIs regarding those systems, recent audits of Internal Control/Internal Audit (IC/IA) systems and major observations, recent changes in SAI's methodologies, organisation or powers related to auditing ICSs and development of relations between SAIs and Internal Audit Units (IAUs) in public sector* will be indicated in details. Reports on auditing European Union funds with observations and recommendations were broadly addressed: mostly to the national authorities

[102] Recommendations concerning the functioning of SAIs in the context of European Integration: Recommendation 11

such as auditors, Parliament and Ministry of Finance. In nine cases[103] reports were sent to European Court of Auditors or European Commission also, and in some cases also to some other stakeholders such as government in the Czech Republic, or special investigation services and other ministries involved in Lithuania.

*In all countries except Romania those reports have been published (although in Albania – partially, in Lithuania - only some of reports, and in Slovakia – in the form of brief extraction). Follow-up on those audits have been made in seven SAIs so far, in following forms:*

- *auditing of measures taken for implementation of recommendations from previous audits (Albania Hungary, Slovakia),*
- *reports on the implementation of the recommendations of the audit report (Bulgaria),*
- *monitoring, in some cases repeated or additional audit (the Czech Republic, Romania), and changes made to legal acts (Latvia)*

*Twelve SAIs have reported that they have already carried out audits of European Union funds in their country. Some of these audits were legality or financial audits, some were performance audits, and in some SAIs this was reinforced by carrying out of special investigations. The possibility of joint or parallel audits with the ECA or with SAIs from EU member states was also used (e.g. in Estonia and Romania).*

*Replies to how many audits of European Union funds have SAIs performed so far, differs from one SAI to another: from 2 to 35 audits, depending on the fact if auditing European Union funds was a part of regular audits.*

*Referring to the subject of the audits: seven SAIs (Bulgarian, Estonian, Hungarian, Latvian, Lithuanian, Polish and Slovenian) were auditing both, administrative preparedness to receive European Union funds and management of received European Union funds. Four other SAIs (Albanian, Czech, Romanian and Slovakian) reported that they audited only management of such funds or some other topics (Romania). Concerning the reorganization of the SAIs considering the audit of European Union funds, seven SAIs (Albanian, Bulgarian, Hungarian, Latvian, Lithuanian, Romanian, Slovakian) have organized a separate unit/department for carrying out such audits, while a few others (e.g. Croatian SAI) are in the process of reorganization or intend to do made more efforts in this respect in the near future. As regards the staff involved in European Union matters and requirements related to the audits of pre-accession funds, the number of auditors involved in these audits starts from 3 auditors (in Albania and Slovenia for instance). Staff carrying out EU related audits are still higher then the number of auditors actually trained for such tasks. Namely, percentage of auditors specifically trained for auditing European Union related funds is at present very different. In some countries (the Czech Republic, Slovakia) it was hard to precise, because training is still in the process. Stated numbers certainly shows the need for further investments in term of human (and consequently financial) resources development in this area.* [104]

This stats show us that in every SAIs audited country, there is an ignorable development and inevitable changes in the audit manuals. Some changes concentrated on the Twinning projects

[103] Meeting of the Heads of the Supreme Audit Institutions of the Central and Eastern European Countries, Cyprus, Malta, Turkey and the European Court of Auditors, Riga, 31 March - 1 April 2004 - ECA/04/9

[104] Working Group on Audit Manuals, Prepared by the PIFC Expert Group, November 2004 – Internal Control System in Candidate Countries Volume I

such as Bulgaria, Hungary, Latvia, Poland, Romania and Slovenia; some focused on the Internal Control of the European Union funded projects within the detailed procedures. Not only is the main source the International Organization of Supreme Audit Institutions (INTOSAI) Auditing Standards but also International Federation of Accountants (IFAC) Auditing Standards, Reports of Working Groups, various materials developed by SIGMA and SAIs from EU member states, relevant EU and national regulations and guidelines, instructions of experts of European Commission, international agreements. In SAIs of Bulgaria, the Czech Republic, Hungary and Slovakia training has been organized to assist in the implementation of Audit Manual for auditing European Union funds and in these six SAIs (*Bulgarian, Estonian, Latvian, Lithuanian, Romanian, Slovakian*) pilot audits on management of European Union funds have been performed, mostly assisted by the SAIs of member states where Croatian and Slovenian SAI stated that plan to do the same in the near future. The application for European Union membership by candidate countries and current provisions of pre-accession funds, have provided more urgent needs for SAIs to improve their organization by carrying out audits more professionally and by increasing the necessity to remain the best European practices in state auditing. In this respect, the existence, preparation, distribution and implementation of appropriate Audit Manuals are essential requisites for the proper functioning of SAIs. Absolutely in implementation with this recommendation based on European Union accession requirements, eleven SAIs accepted, mostly based on their practice, importance of developing a common audit manual for all European Union funds, while Estonian and Polish SAIs stated that there is no need for such Manual. They think that it should be based on good practice and experiences, and supplemented by technical guidelines with worked examples and case studies, to help promote practical use of Manual. All SAIs stressed that Audit Manual and guidelines, once prepared, should be tested in each country to assure that it is applicable to its circumstances and environment by applying through the pilot audits.

*The International Federation of Accountants (IFAC) through its International Auditing Practices Committee (IAPC) has issued International Standards on Auditing (ISAs) which were initially prepared for the private sector but now a 'Public Sector Perspective (PSP) issued by the Public Sector Committee of IFAC is set out at the end of an ISA. Where no PSP is added the ISA is applicable in all material respects to the public sector. Where national auditing standards are in all material respects consistent with either INTOSAI or ISA they may be used after clearance from the Commission.*[105]

#### *3.4.3.2.8. New developments in general principles*

The general principles for the audit of Internal Control System (ICSs) in the framework of new developments are defined by the SAIs. They also consider and discuss in the framework of EU requirement for public internal financial control (PIFC) and the SAIs' involvement in promoting the concepts of these systems, and technical support when it comes to audit them. However, additional attention should be given to the audit of external aid, especially since the concept of managing those funds is different in various countries. In that sense, SAI's standards are likely to be improved and adjusted in a way to reflect the SAIs particular duties and responsibilities as laid down in the Treaty and the Financial Regulation, and to take the European Community context into account. As the accomplishment of the presented tasks required to precise information from SAIs, a detailed questionnaire has been prepared and, together with the letter to the Presidents with explanation of planned activities, sent to all fifteen SAIs concerned. In

[105] Multiple Framework-contract in the Field of External Audit of Programmes and Projects of External Aid managed by the European Commission, DG Enlargement - Audit Contracts Implemented Under a Decentralised Implementation System LOT I – Annex II

addition to assist in the drafting of the final report, SAIs has been asked to provide a brief description of the ICS that operate in their countries as well.

*The questionnaires are based on system descriptions, and all other relevant materials, short report has been prepared and together with the first results presented and discussed at the EUROSAI Seminar on Evaluation of Internal Control Systems. The draft report has been prepared for the meeting of liaison officers in Luxembourg, while final report will be prepared for the Meeting of the presidents of candidate countries to be in April 2004 in Riga, Latvia, together with the conclusions and recommendations on:*

*- how to reaffirm benefits of an external audit by SAIs in the area of assessment and development of ICSs, and consequently, to improve the management of public funds,*
*- how to best promote the involvement of SAIs in control of EU funds, taking into account the varying auditing mandates and systems among countries,*
*- is there a need for specific guidance for auditing EU funds and how to best respond to that, and at last*
*- based on experiences and in the light of carrying out audits according to the highest professional demands, to consider whether the need for development of current audit standards has been recognised.*[106]

## 3.5. Future of audit in terms of Development

All of the audit manuals are like prescriptions; although they are only created for one person (country), the accurate diagnosis will solve a common problem. There are still possible ameliorations for the audit mechanism which is offer by the countries applied. So when it comes to the question: is there a need to continue developing ICS's auditing practice; the answer is hidden behind the enlargement procedure of the Union. SAIs do think that the ICS/PIFC issue should be further developed, as it is mentioned before through the establishment of the new sub-group for development of audit manuals for European Union funds or through the establishment of the special strategic committee. In the guidance of the experiences of candidate countries, it is much easier to fill the gap. There even have been some other proposals such as from the countries: on-the-job training in more experienced SAIs, long term advisory work by experts from member countries, learning-by-teaching programs, web discussions through an electronic network, which is obviously an area where all SAIs would like to invest more in the future, in one way or another. Nevertheless, it is evident that the SAIs of the candidate countries, have already taken concrete measures to improve their situation regarding the improvement and development of effective internal control and risk management systems in their countries, either by efforts made by themselves or through the co-operation with ECA, SAIs from European Union member states or SIGMA and achieved a significant progress in this area. The present situation shows that continually improvement and developing in the direction meet the Union requirements. All countries are ready to ensure the audit methodologies which are in line with INTOSAI audit standards, and being acceptable to the ECA, the European Commission and other European Union bodies. In this respect, additional actions are needed to be taken for further improvements. Improvements like the establishment of sound financial management and control systems for their national income and spending, even including in European Union funds, increasing efficiency and effectiveness, countries are

[106] Working Group on Audit Manuals, Prepared by the PIFC Expert Group, November 2004 – Internal Control System in Candidate Countries Volume I

getting closer to the expectations day by day. However, the review of progress, current position and experiences gained by SAIs of all countries has revealed number of issues that still need to be improved and updated by the SAIs. The most important needs were summarized in 9 recommendations. (Annex A22)

## Opinions on the effects of aid on growth

There are and have always been many opinions regarding the effects of aid on growth in the developing world, and especially when it comes to the effects of official or governmental development assistance. The discussions regarding foreign aid have always been a source to disputes and controversies. The opinions are ranging from one extreme to another. The traditional economists argue that foreign aid has and had always positive effect on growth and on the structural adjustment in many developing nations allowing for poverty reducing investments not possible. In spite, while critics claim that foreign aid have not had any effect at all, or even a negative effect.

The critique against the official aid has been concentrated on the fact that; it is far too focused on growth in the modern industrialised sectors. This could, according to the critics, lead to a widening gap between the rich and the poor in developing countries so far the candidates in the European Union are the victims of this dilemma.

Therefore due to decrease of progress in growth, lower savings and growing inequalities in the income distribution cause discussions that some take even further. By claiming that the aid has had a negative influence on the growth of the developing countries. This argument can not be proven for every developing country. Others meant that the official aid programs have failed since they have been adapted by corrupt bureaucrats and decreased the initiatives in the third world. Some even argue that foreign aid is a form of colonialism.[107] As if this was not enough, there has been a growing dissatisfaction with the foreign aid policy within the donor countries over the last two decades. This is due to domestic problems like unemployment, budget deficits and balance of payment problems. Tax-payers around the industrial world want to focus more on the domestic economic problems especially after realizing that their part of taxes going to foreign aid often favors small elite groups in the developing countries, many richer than themselves. All this has decreased the interest in donating money and developing support has decreased. However at the same time the support towards nongovernmental organisations has increased.

In European Union, to highlight the aspects of the aid results, some implications has to be examined for the design of co-financing policies for infrastructure building by involving financial assistance to candidate countries under regional policies. The implication is that since this type of financial assistance aims on a strong growth differential in favor of these countries. The co-financing ratios must be lower for less developed ones because of the insufficient resources and, the amount of financial assistance transfers to the candidate countries should be determined in the context with the co-financing share which is determined by the domestic resources, since for any co-financing share there is a specific amount of financial assistance that a country could absorb to reach the optimum growth rate where it is maximized. This is experimented in the enlargement procedures in the European Union, may be these suggestions seem to be in contrast with the implementation and evaluation of European Union assistance programs, whose success or failure is often evaluated only on the basis of the absorption of funds but when we observe the specific growth-maximizing absorption rate of funds, which

[107] Todaro P Michael, Smith Stephen C, Economic Development, eighth edition, Pearson Addison, Wesley 2002

decreases with the domestic co-financing ratio. Absorbing additional assistance under a co-financing method implies that the country has to raise its tax rate to finance the required national contribution. Thus, when aid exceeds a threshold of distortions is generated by excess taxation, this may lead to a decline in the growth rate of the economy.

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