

## **Sector Report Financial Management and Control**

**Assessing the Administrative Capacity  
Needed by the Candidate Countries to  
Effectively Manage the Structural Funds**

**Final Report**

**Client: EC DG REGIO/DG ENLARGEMENT**

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# 1 Introduction to the theme

Financial management and control is nowadays perhaps the single most important theme of Structural Funds management. The EU regulations nowadays attach much value to financial management & control. The first step in this direction was taken by launching the 2064/97 implementing arrangements, referring to the 1994-99 period. The General Framework Regulation 1260/99 was another step in this direction, and the 438/2001 implementation regulation has been a further specification of these requirements.

The responsibilities in the field of financial management and control are shared by a large and increasing number of stakeholders in the cascade, but particular final responsibilities lie with the Managing Authority and the Paying Authority. In addition to these general responsibilities, a number of specific tasks and functions in the field of expenditure certification, verification and forecasting of expenses is expected. In order to deal with the new requirements, the Commission has demanded the separation of Managing Authorities and Paying Authorities as well as the involvement of independent auditing capacity.

This report is built up as follows. The main findings are divided into several issues, under the respective headings of financial management and financial control. Each subsection starts with a brief description of the requirements in this field, followed by a description of the findings regarding the design and functioning in the four countries studied (New German Länder, Spain, Portugal, and Ireland). Following the general conclusions, relevant indicators are being proposed.

The reports are primarily based on the country reports that were prepared within the framework of this project. However, supplementary material and expertise was used where needed.

## **2 Main findings**

### **2.1 Preliminary remarks**

In Germany, the importance of financial management and control has increased significantly for the programming period 2000-2006. In particular regulation 438/2001 lays down the specific requirements for the administration and control systems. The central outcome of the interviews was that in most of the cases the establishment of the respective capacities is still not completed.

In Spain, on the basis of conversations held with the different Managing Authorities of Structural Funds, the greatest awareness has been expressed of the need to carry out financial controls of the activities co-financed with EU funds and of the great effort which is being made in the Spanish State in this respect. Due to the specific institutional and administrative structure, paying authorities and the bodies responsible for financial control do not coincide in any case. Furthermore, financial control activities are developed by different bodies either independent or dependent of the Council of Ministers, a fact that assures the complete independence and transparency of the controls.

In Portugal, financial management and control is becoming a priority from the perspective of the Ministry of Planning. From this perspective, and in its capacity as Managing Authority, it is raising awareness for financial management and control throughout the Portuguese Structural Funds system.

In Ireland, it was found that financial management and control is currently the key pre-occupation of most staff within the Irish Structural Funds system. Throughout the system, major efforts have recently been made in order to deal with the new requirements. For all the Funds, Paying Authorities could be identified that have embarked on their specific responsibilities and tasks.

### **2.2 Financial management**

#### **2.2.1 Paying Authorities**

According to Article 9, (1260/99), Paying Authorities are “one or more national, regional or local authorities or bodies designated by the Member States for the purposes of drawing up and submitting payment applications and receiving payments from the Commission. The Member State shall determine all the modalities of its relationship with the Paying Authority and of the latter’s relationship with the Commission”. Due to the discretion of the Member States, it is worthwhile to look into similarities or divergence in this field.

In Germany, the Paying Authorities exist both at the Federal and at the Länder-level, partially based on Funds and partially based on OP's. Fund-based PA's for the Operational Programmes at the Federal level are:

- For the ERDF: Federal Office of Economic Affairs (BAFA)
- For the Federal OP Transport: Federal Ministry of Economics (BMW)
- For the ESF: Federal Ministry of Social Affairs (BMA)
- For the EAGGF/FIFG: Federal Ministry of Agriculture (BML)

In Germany, the ERDF-PA consists of three employees (educational background: financial science, economists). As far as the financial control of the ERDF is concerned, the PA of the MW is supported by the Landesförderinstitut (LFI).

On the level of the Länder OPs the PAs are also separated from the MAs. The organisation of the PAs may be illustrated for the Land Saxony-Anhalt as an example. The PA for the ERDF is located in Dep. 26 of the Ministry of Economy and Technology (MW), the PA for the ESF in the Ministry of Labour (MS) in Dep. 43, whereas the department paying authority is responsible in the Ministry of Spatial Planning, Agriculture and Environment (MLRU).

In Spain, due to the specificities of each Fund and the high qualification necessary to verify the expenses certifications., 4 different Paying Authorities have been maintained, each per Structural Fund. Nevertheless, the procedures are the same for every Structural Fund. Their tasks are carried out by each of the four Structural Funds Administrative Units within the respective Ministries:

- For the ERDF and Cohesion Fund: Treasury Ministry, General Department of EU Funds and Territorial Financing
- For the ESF: Ministry of Labour and Social Affairs, The Administrative Unit for the ESF
- For the EAGGF: Ministry of Agriculture, Fishing and Food Department, Rural Development General Unit
- For the FIFG: Ministry of Agriculture, Fishing and Food Department, Structures and Fishing Markets Unit

Regarding staffing, the ESF Paying Authority is largest with 7 staff Members, the other PA's have a staff of 1 to 4 persons, including economists, lawyers and support staff.

In Ireland, 4 different Paying Authorities have been established, that fulfill their tasks both for Sectoral and for Regional OP's. They are:

- For ERDF and Cohesion Fund: Department of Finance
- For ESF: Department of Enterprise, Trade and Employment
- For EAGGF: Department of Agriculture
- For FIFG: Department of the Marine.

Regarding staffing, the EAGGF Paying Authority is largest with 7 staff Members, the other PA's have a staff of 1 to 4 persons each.

### 2.2.2 Payment flows and budget commitments

*Payments* from the Commission are being transferred to the Paying Authorities (Article 32, 1260/99). They may take the form of payments on account, interim payments or payments of the final balance. Interim payments and payments of the balance shall relate to expenditure actually paid out, which must correspond to payments effected by the final beneficiaries, supported by receipted invoices or accounting documents of equivalent probative value. One of the requirements for the final balance of assistance to be paid is a certified statement of expenditure actually paid, to be submitted by the Paying Authority to the Commission within six months of the deadline for payment. According to Article 9 of Regulation 438/2001, the certificates of statements shall be drawn up by a person or department within the Paying Authority that is functionally independent of any services that approve claims -

According to Article 31 (1260/99), *commitments* shall be effected annually. The Commission shall automatically decommit any part of a commitment which has not been settled by the end of the second year following the year of commitment. The contribution from the Funds to that assistance shall be reduced by that amount. This rule is commonly referred to as the automatic decommitment or N+2 rule.

In Germany, the central account is with the “Bundeskasse” (Federal Exchequer), to which all payments from the Structural Funds are transferred. Furthermore, a specific handbook has been elaborated by the BMWI in order to support the responsible MAs with the implementation of Regulation 438/2001. Further on, at the level of the Länder several guidelines have been elaborated from case to case.

In Spain, apart from advance payments, the financial payment cycle begins when the certifications of payment on the part of the Implementing Body of an OP are produced in sufficient quantity. At this moment the Paying Authorities apply to the Commission for the intermediate payments, provided that this is possible, and in batches, three times a year. The Commission makes the payment to the General Direction of the Treasury and Financial Policy, belonging to the Ministry of Treasury and Finance which in turn communicates having received the funds to the various Paying Authorities and submits the payment to the different final beneficiaries via the accounts that these bodies have duly credited in the presence of the Treasury. The payment orders detail the amount to be paid to the final beneficiary, the corresponding bank account number and the identity code of the payment so it can be monitored and controlled. Only when the final beneficiary of the assistance is a department or unit of the General State Administration, the payment authorities instruct the Treasury to carry over the amount received from the EU to the Income Budget of the Central State.

At national level, there is also an integral database called TESEO managed by IGAE, in which the various types of assistance given to the final beneficiaries from the various Funds is recorded. This database, whose usefulness is undeniable, has already facilitated the tracking down of possible cases of duplicated assistance; it currently

functions at national level and although it has to be improved in the near future, it is already working in the Autonomous Communities.

In Portugal, the automatic de-commitment rule introduced by the new regulations will require an incremental effort in time and resources consumed by monitoring activities. In Ireland, in order to draw down funding, all expenditure being reported must be certified through Forms (B1, B2, B3 and C), as eligible before making an expenditure declaration to the Commission. The bodies involved in the day-to-day management of Operations will be responsible for the certification process. There are three function levels involved in this process:

- Final beneficiaries/grant approving bodies – the bodies commissioning operations and/or implementing the activity (Level 1, Form B1)
- Intermediate bodies, all public or private bodies acting under the responsibility of Managing or Paying Authorities (Level 2, Form B2)
- Managing Authorities (Level 3, Form B3). Managing authorities will also fill in Form C, the statement of expenditure by priority and measure.

The administrative unit responsible for the relevant areas should reconcile their expenditure records with those of the accounts/finance unit before reporting to the next level.

The introduction of the automatic decommitment rule has had considerable implications for the Irish system. The Department of Finance has taken a strong stance on this issue, especially so in view of the Programmes with a phasing-out character. This results in the need to constantly monitor the financial progress per measure, almost on a daily basis. The concern has been expressed that a rigorous implementation of the N+2-rule could be contrary to the innovative nature of certain measures. Such innovative projects need time to be mobilised and prepared and their time-frame is often contrary to the N+2 rule. A concern arises that pushing the N+@ rule any further may lead to a tendency to approve less innovative projects.

## **2.3 Financial controls**

### **2.3.1 Internal audits**

At each level of the cascade, *system-based audits* are required under Article 10.1 (a) of Regulation 438/2001. It is the responsibility of the Member State to organise checks on operations on an appropriate sampling basis, designed in particular to verify the effectiveness of the management and control systems in place. To this end, the establishment of Internal Audit Units is a possible response. Alternatively, external auditors may be appointed to perform this task.

In Germany, a specific department of the LFI (ERDF Consult and Control) is responsible for financial control. The section is still in the starting phase and will at the end consist of 12 employees. They are paid out of the Technical Assistance section and are carrying out the following tasks on behalf of the PA:

- Examination of the systems of all ERDF-related measures of the OP
- Risk analysis of all ERDF-related measures
- 5% examinations of single projects including on-the-spot checks
- Reporting with recommendations
- Ordering of necessary reclamations

Eight people are working within the Consult and Control Unit, at the end 12 are envisaged.

In Sachsen-Anhalt, the MRLU takes on the system examinations and 5% examinations through the respective Department "Internal Audit". Up to now 2 people are working within the department and 4 are planned. Within the Ministry of Labour dep. 43 is in charge for this task (3 people).

In Spain, Implementing Bodies are increasing the control mechanisms by establishing in most cases Internal Audit Departments to assure the control of a larger number of projects. Secondly, due to the control requirements that are demanded nowadays and which have been largely increased, the Spanish control authorities had not only to increase the number of the Spanish civil servants and the technical resources dedicated to audit the EU cofinanced projects, but also, to subcontract most of the controls to qualified entities. The large majority of controls are subcontracted to specialist entities in the field of auditing and financial control. As an example of this practice, the Autonomous Region of Murcia undertook during the year 2000 a total of 245 controls, of which 182 were contracted out.

To this end, annual control plans exist on the financial assistance cofinanced with Structural Funds. For the co-ordination of said control plans a Co-ordination Commission and working group were created for ERDF, ESF, EAGGF(O) and FIGG. This commission assembles the management and administrative units related to Structural Funds, the IGAE as control agency, as well as other national bodies. The Co-ordination Commission jointly approves the annual control plans of the Structural Funds. On the other hand, since 1994, IGAE endorsed the Protocol, pertaining to co-operation in respect of control of structural community funds, with the Commission's DG of Financial Control. An agreement was reached on the appropriate provision to guarantee the necessary co-operation with regard to financial control of the Member States, and by virtue of which the auditing authorities of the European Commission and the IGAE do control the management system and the operative programmes or any other form of intervention within the framework of the SF.

Also, before the end of June of each year, IGAE produces an annual report directed at the Commission's DG of Financial Control where they report on the application of Regulation (CE)2064/97, as well as on the development of OP costs controlled and for each body controlled. To develop the control projects, the IGAE as well as the General Audit of the Autonomous Communities and any other bodies with control authority over co-financed performances, follow methods of public auditing based fundamentally in private auditing practices. In general the principles which govern this methodology

can be summarised thus in close approximation to the Regulations of Auditing in the Public Sector:

- The auditor must have the necessary professional qualification and act with professionalism, objectivity, diligence and confidentiality.
- The work must be adequately planned analysing the scope, level of reliability and extent of the tests to be undertaken; sufficient evidence must be obtained which is relevant and valid, with which to support the content of conclusions and recommendations. The performances must be perfectly documented and must have been supervised.
- The financial control reports must be produced in writing, must be of the appropriate quality, must be complete, objective, exact and clear, etc.

In Spain, all those devoted to internal control of the public sector report directly to the Council of Ministers, either central or regional ones.

In Portugal, coordination and control are separated functions within the scheme of the present CSF. Financial control is being executed at three levels, of which the first level corresponds to a form of internal control. At first level, all managers are responsible for creating a first level control associated to the Management Units of each Operational Intervention and acting independently from the Manager himself. The experience suggest that managers have in general 1 or 2 staff Members charged of control activities, sometimes complemented by external audits recruited outside within the most representative firms in audit work.

The Ministry of Planning is charged with implementing a tender for selecting and certifying private firms to make regular audits to Operational Interventions. This model is a good solution in order to reduce the magnitude of the staff that each Manager of each Operational Intervention should allocate to control activities and generate more flexibility in implementing control at first level. The practice of external control outsourced partially to the private audit firms stimulate the management units and the managers in order to be more cautious with eligibility procedures and analysis of candidatures, internalising the practice of rigour and diffusing it within beneficiaries and implementing bodies.

In Ireland, Internal Audit Units have been involved for carrying out the 5% checks. Every Department in charge of running a Fund or OP has involved an Internal Audit Unit. This independent auditing capacity is allows to carry out the 5% system-based audits at each level within the cascades, independent of the bodies implementing the co-financed measures. Lower in the cascade, audits tend to be carried out by external auditors that can be appointed to perform this task. These Internal Audit Units are usually staffed by 3 people, of which 1 FTE is related to the Structural Funds auditing. These numbers will become considerably higher when the whole cascade is being included. The number of auditors is expected to be especially high within Implementing Departments and Agencies, of which only a few were visited. Generally, the Internal Audit Units visited are being staffed by general civil servants, that are receiving a one-year auditing training, often as part of their general career development.

### 2.3.2 External audits

*External audits* are particularly required in the framework of Article 15, 438/2001, which states that declarations on winding-up of the assistance are to be drawn up by a person or department having a function independent of the Managing Authority and of the Paying Authority carrying out the certification or any intermediate bodies. The examination shall be conducted according to internationally accepted auditing standards.

In Germany, the independent institution with regard to Article 15 will be sourced out. A tender process actually has been introduced. In Spain, all the bodies in charge of financial control are completely independent from final beneficiaries or Paying Authorities. So, apart from reporting to EU Authorities, those in charge of external control report only to Parliaments, be it Central or Regional.

In Portugal, the second level control is composed of a general inspection whose responsibility covers the analysis and evaluation of the first level system of control as well as cross-control over other entities involved, in order to gain access to information deemed necessary for clarifying facts which are the subject of control. Second level control is performed by the following entities:

- ERDF – Directorate General of the Regional Development and Inspectorate General;
- ESF – European Social Fund Management Institute and Inspectorate General;
- EAGGF – European Agricultural Guidance and Guarantee Fund Guidance and Inspectorate General;
- FIG

Finally, the high level control is under the responsibility of the Inspectorate General of Finance – Ministry of Finance.

In Ireland, new functions have been given to the Financial Control Units that have been organised on a Fund-base. They have the responsibility for the audit of expenditures in compliance with the Articles 10,11,12 and 14 of Regulation 438/2001. These audits are undertaken from Paying Authority level down through the cascade to Final Recipient level. An ERDF & Cohesion Fund Financial Control Unit was established in the Department of Finance with the following key functions:

- Review adherence to best practice by all Irish stakeholders
- Review the implementation of systems-based audits by internal audit units
- Review the implementation of the 5% transaction verification
- Carry out control checks (audits) on expenditure claims
- Test the audit trail for selected expenditure
- Advice on any irregularities or system deficiencies
- Furnish a Control Check Report to the Department of Finance.

A similar Financial Control unit was established in the Ministry of Enterprise, Trade and Employment for the ESF. In the case of the were identified in the Departments that are housing the Paying Authority. In the case of EAGGF, financial control is part of the internal auditing capacities of the Ministry of Agriculture. In the case of FIGG, external financial control has been contracted out. Generally, the Financial Control Units are being staffed by accountants and other financial experts. At the moment, hiring of staff in the financial field is still on-going in several Departments, but there appear to be no particular problems in filling the vacancies.

## **3 Conclusions for indicators**

### **3.1 General conclusions**

In Germany, the establishment of management and control mechanisms due to regulation 438/2001 is a time-consuming process that is not yet completed. There was common sense in all interviews that the requirements of the EU in the field of financial control are extraordinary high and time consuming. Especially the funds with smaller projects (ESF and EAGGF) are confronted with increased work. This can be underlined by the annexe IV of regulation 438/2001 (Scope of information on operations to be made available to the Commission on request for the purpose of documentary and on-the-spot checks) which means that for 79 fields specific data on the project level have to be collected by the responsible authorities. Especially for small projects as for example in agriculture this is a huge amount of information which has to be documented.

In Spain, one of the main changes of this programming period refers to the increasing role that EU Regulation have given to financial control. As a consequence, more technical resources, personnel and subcontracting will probably be needed to meet these requirements. At the same time, a national computer database called TESEO, has been put in place by the Spanish General Audit Department, in order to concentrate all the information about state aids given to different projects and so to avoid double financing or exceeding the limits allowed by EU regulations.

In Portugal, until recently, financial management was not a very generalized practice within the managers. Only few relevant and specialised staff concerning financial management were identified. At national level, that is to say at the level of the Secretary of State, however, the question is seen as a major preoccupation in order to ensure a good level of implementation of the programmes, principally considering the delays in payments from the EU. There are informal agreements that allow some anticipation procedures used in the case of delays that may provoke significant problems in implementation. That is to say that the Secretary of State of Planning plays a role of financial manager of the whole CSF introducing some flexibility in payments system in case of delays of transfers from the EU.

In Ireland, the financial management & control regulations are having a significant impact on the staffing requirements. In addition to the Managing Authorities, over 25 staff was identified, mostly at the level of MA's, specifically working on the financial management of the Structural Funds, either within Internal Audit Units or Financial Control Units. The key to effective financial management & control lies in the availability of detailed and clear procedural manuals and guidelines, that are widely understood and used by all stakeholderse in the cascade. Throughout the Irish system, major efforts are currently being put in the preparation and elaboration of such manuals. The B2-form plays a key role here as well. Procedural manuals are being prepared by the Managing Authority and the Paying Authority, but with the support of others.

Financial Control Units can play a key role here, but external consultants are being hired as well.

Equally important is the awareness raising and transparency. In this respect, extremely high levels of transparency were witnessed among the civil servants interviewed. Mention was frequently made of practices under the previous period that are to be improved. The promotion of awareness raising appears to be effective in informing stakeholders lower in the chain that the correct use of Structural Funds money is of the greatest importance.

### **3.2 Identification of relevant Indicators**

The main findings as mentioned above give rise to the identification of indicators for measuring the effectiveness of financial management and control as part of managing the Structural Funds. Yet, the main findings also give rise to the need for extreme care in generalisations. As the indicators are designed for the candidate countries, they focus on design aspects – related to structure, human resources and systems & tools. The following indicators are to be regarded as input to the gross-list, that will ultimately be reduced to a selection of key indicators.

1. *Designation of Paying Authorities*
  - PA(s) designated, not legally formalised
  - PA(s) designated and legally formalised
  - Relation with managing pre-accession instruments secured
2. *Existing of an effective national state auditing institution*
  - Existence of an independent state auditing institution
  - Sufficient and competent staff
  - Experience and track record acquired by the state auditing institution
  - Existence of an annual audit control plan and/or system
3. *Designation of internal audit functions (5% examination)*
  - Designation of responsibilities for 5% checks in broad terms
  - Designation of 5% examinations in detailed terms
4. *Designation of second-level external audit functions (5% examination)*
  - Designation of responsibilities for second-level financial control
  - Designation of second-level financial control
5. *Human resources in financial management and control*
  - Evidence that adequate staffing of PAs can be secured
  - Experience in managing pre-Structural Funds utilised
  - Accounting skills sufficiently available
  - Auditing skills sufficiently available
  - Auditing training available for civil servants

6. *Existence of a detailed system of financial procedures*

- System of payment flows established
- Systems for expenditure forecasting in place

7. *Established practice in dealing with financial irregularities*

- Existence of published records on financial irregularities
- Track record on appropriate measures taken in dealing with irregularities
- Systems for correcting irregularities existing and applicable to Structural Funds