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REVISED

**MANAGEMENT AND CONTROL SYSTEMS
AUDIT MANUAL**

for the

STRUCTURAL FUNDS

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1. INTRODUCTION

1.1. Objective

The objective of this manual is to set out a methodology for the audit of Member States management and control systems for the Structural Funds. The manual provides a framework for audits of these systems carried out in accordance with Council Regulation (EC) No 1260/1999 and Commission Regulation (EC) No 438/2001. The approach set out in this manual may be regarded as a set of minimum standards for the audit of management and control systems and for operations co-financed by the Structural Funds. As each of the Structural Funds has certain specific rules and eligibility criteria, auditors may need to further develop their audit methodology based on the manual. While the manual has been developed for use by the audit services of the Structural Funds Directorate Generals, Member States' auditors are encouraged to follow the audit approach set out in the manual. The manual is in conformity with the generally accepted standards for audit. References to these standards are set out in Appendix 6.

1.2. Structure and contents of the manual

Part 2 of the manual sets out the audit arrangements for the Structural Funds, and the roles and responsibilities of the different bodies involved in the audit of Structural Funds activities.

The requirements for Member States' management and control systems are presented in **Part 3** of the manual - "Member States' Management and Control Systems - the Regulatory Framework". The aspects considered in detail include the provision of a description of the management and control system and the establishment of a satisfactory audit trail as an indispensable tool for reliable system controls, the requirements for Member States' audit of expenditure and for the declaration of validity on the winding up of assistance. Guidance on certain aspects of the requirements of Member States' controls is provided in Appendix 2 to the manual.

Part 4 of the manual, "The Audit Of Management and Control Systems", has the aim of providing a standard framework within which audits of Member States' management and control systems may be carried out, and which ensures consistency of approach between auditors and audits. It sets out an audit methodology and procedures which could be used to undertake systems audits of Structural Funds expenditure. This methodology comprises system-based audits, which are aimed at providing assurance that the systems of management and control put in place by Member States over Structural Fund actions are adequate and effective, and on-the-spot checks of operations designed to verify the correct functioning of the systems. Detailed audit objectives and questions to be addressed during audits are set out in Appendix 1. The overriding

objective of the manual is to provide a vehicle through which auditors can exercise their audit judgement to reach sound conclusions on the organisations which they examine.

The audit approach set out in this manual essentially covers the examination of Structural Funds activities within Member State authorities (managing authority, paying authority, intermediate bodies, and control bodies) and at the level of final beneficiaries and final recipients¹. In particular, the manual covers the documentation of management and control systems, **tests of controls** to determine whether internal management and control procedures exist and are operating continuously, coherently and effectively; and **substantive testing** to check the completeness, accuracy and validity of transactions, together with the practical effects of any identified weaknesses or errors. Appendix 3 sets out criteria which could be used to design substantive tests in relation to Structural Fund actions.

Part 5 of the manual, “Audit Reports”, considers how audit reports could be presented. An example of a standard audit report for the Structural Funds is included at Appendix 5 to the manual.

Part 6 of the manual deals with follow up of audit findings setting out the various procedural stages terminating in the possible application of a financial correction and recovery.

¹ The term “final recipient” is used throughout the manual for the body or firm carrying out the operation when this body is not the final beneficiary as defined in Article 9 (l) of Regulation (EC) No 1260/1999.

2. THE MAIN PARTNERS AND OTHER BODIES INVOLVED IN THE AUDIT OF THE STRUCTURAL FUNDS

Because of the involvement in the Structural Funds of a wide range of public and private sector organisations, the audit arrangements for expenditure supported by the Funds reflect this complex nature. The main bodies which are involved in the audit of the Structural Funds include:

- The European Court of Auditors (the external auditor of the European Commission);
- Commission services ;
- The audit services of the Member States;
- Member States' supreme audit institutions;
- The auditors of individual final beneficiaries and/or the final recipients.

2.1. The European Court of Auditors

The European Court of Auditors' primary tasks are to examine the accounts of all revenue and expenditure of the European Communities; to examine whether all revenue and expenditure has been received or incurred in a lawful and regular manner; and to examine whether financial management is sound. The Court is an independent institution whose role is to assist the European Parliament and the Council of the European Union in exercising their powers of control over the implementation of the budget. Additionally, the Court may, at any time, submit observations on specific questions and deliver opinions at the request of one of the European institutions.

As part of its audit work, the Court examines both systems and expenditure relating to the Structural Funds, and its audits take place in the Commission services and on the spot in the Member States. Its auditors have access to any document or information relating to the financial management of the departments and other bodies subject to its examination, and may carry out audits of all bodies receiving Community funds.

2.2. Commission services

Each Directorate General with responsibility for management of the Structural Funds has an audit unit. The overall objectives of the audits carried out by the audit units of the Structural Funds services are to:

- determine to what extent the Member States have put into place adequate management and control systems, and to what extent

these systems give a satisfactory assurance concerning the legality and regularity of the underlying operations;

- determine the accuracy of the expenditure declared to the Commission for co-financing;
- determine the level of ineligible expenditure where the Member State's management and control systems control have been proven inadequate.

Detailed audit objectives are found under points 4.1.4 and 4.1.5 and in Appendix 1.

The conduct of the audit work by the Commission services is governed by this audit manual.

The audit units of the Structural Funds services may be assisted by external audit firms to carry out audits in the Member States.

There is also the possibility that the Internal Audit Service of the Commission and the internal audit capabilities of the Structural Funds services could carry out audits on the spot, in pursuance of their own internal audit function.

2.3. The audit services of the Member States

The internal audit services responsible for verifying the effectiveness of the systems of the managing authorities, paying authorities and intermediate bodies in the Member States will examine and report on the operation of those systems in the respective bodies.

In addition, certain internal audit services, or independent control bodies may be responsible for carrying out the sample checks under Article 10 of Regulation (EC) No 438/2001 and/or be designated as the functionally independent organisation responsible for providing the declaration on the validity of the final certificate of expenditure on the winding up of the form of assistance under Article 15 of Regulation (EC) No 438/2001.

2.4. Member States' supreme audit institutions

The supreme audit institutions of Member States act as the external auditor of central Government bodies in those states. As such, these bodies may carry out audits of central Government organisations, which administer the Structural Funds, together with audits of any other public sector bodies to which they have audit access. Where these organisations have access to the records of private sector organisations, they may also carry out audits involving these bodies.

Where public sector bodies (for example, local Government) have auditors other than the relevant supreme audit institution, these auditors may also carry out audits of Structural Funds expenditure.

2.5. Other auditors (private)

In addition to the above levels of audit, final beneficiaries and final recipients may have their own auditors. The function of these auditors is to carry out audits to verify the accuracy of the accounts prepared by their clients, and as such, the auditors are likely to examine all types of financial records, not solely those relating to the Structural Funds. Final beneficiaries and final recipients may be required under national rules to present audit certificates as a condition for reimbursement of expenditure under Structural Funds programmes in which case their auditors will verify the accuracy and eligibility of the expenditure declared for reimbursement.

2.6. Co-ordination of audit activity

Given the number of different audit bodies involved, the question of the co-ordination of audit activity is particularly pertinent, both within the Member State and between national and Community audit services.

The bilateral administrative arrangements between the Commission and the Member States' control bodies have since 1994 provided a basis for co-operation and co-ordination of planning, methods and implementation of audits and for the review of the results. Article 38 (3) of Regulation (EC) No 1260/1999 sets out an explicit legal base for this process. In its Communication of 25 April 2003 on the simplification, clarification, co-ordination, and flexibility of the management of the structural policies 2000-2006, the Commission presents steps agreed with Member States for improving the co-ordination of audits, and refers also to the initiative of the "contract of confidence" which would enable the Commission to rely to a greater extent on the systems audit work carried out by national control bodies. The key elements for improved co-ordination are the exchange of audit plans between Commission and national audit services before the beginning of each year, an immediate dialogue to enable plans to be adapted to avoid duplication of audits, and the publication and regular updating of consolidated audit plans by Member States on the CIRCA site of DG Regional Policy. The implementation of the "contract of confidence", which is optional for Member States, would represent a concrete step toward the concept of a "single audit" since the Commission would use the results of the audit work of the national bodies as a basis for obtaining assurance on the adequacy of the management and control systems in the Member State or region concerned, with a consequent reduction in its own audit activity.

Before entering into a contract of confidence, the Commission will have obtained reasonable assurance that the systems for management and control of the forms of assistance concerned comply with the regulatory requirements, and will have accepted the audit strategy established for the audit work of the national bodies both in relation to the management and control systems and for the sample checks on

individual operations. Accordingly there will be a sound basis for considering that the forms of assistance concerned are low risk.

For those Member States or regions covered by a contract of confidence the level and focus of the audit work of the Commission would therefore change. Instead of carrying out audits principally to verify the functioning of the systems of managing authorities and paying authorities and the regularity of expenditure of operations, the Commission would concentrate its reduced audit effort on verifying the effective implementation of the agreed audit strategy and the reliability of the annual reports under Article 13 of Regulation No 438/2001, and on any specific risk elements identified.

3. MEMBER STATES' MANAGEMENT AND CONTROL SYSTEMS – THE REGULATORY FRAMEWORK

3.1. Introduction

As Structural Funds measures are implemented for the most part by the authorities within each Member State, the nature and effectiveness of the management and control systems operated by the Member States are of great importance in ensuring the proper use of Community funds. Given the central role of Member State systems in controlling Structural Funds expenditure, the examination of the operation of those systems is vital to determine whether they are working effectively to prevent, detect and correct errors and irregularities.

This part of the audit manual deals with the regulatory framework for Member States' management and control systems and explains in more detail the requirements for the descriptions of management and control systems (including the audit trail), the audit work of the Member State, and the declaration of validity on the winding up of the assistance.

3.2. The regulatory requirements

The regulatory framework for Member States' management and control systems is laid down in Council Regulation (EC) 1260/1999 (in particular Article 34 and 38), and Commission Regulation (EC) No 438/2001. The satisfactory application of the minimum requirements contained in these Regulations should be checked during audits of national management and control systems at all levels and will generally be the primary objective of the audit.

Regulation (EC) No 1260/1999 provides that Member States shall take responsibility in the first instance for the financial control of assistance and requires (inter alia) that Member States:

- verify that management and control systems have been set up and are being implemented in such a way as to ensure that Community funds are being used efficiently and correctly;
- provide the Commission with a description of the management and control systems;
- ensure that funds are spent in compliance with all the applicable Community rules and in accordance with the principles of sound financial management;
- certify that the declarations of expenditure submitted to the Commission are accurate and based on verifiable supporting documents;
- prevent, detect and correct irregularities;

- present to the Commission, when each assistance is wound up, a declaration of validity.

Regulation (EC) No 438/2001 sets out in Article 3 the key principles of the management and control systems of managing and paying authorities and intermediate bodies:

- a clear definition of functions;
- a clear allocation of functions;
- an adequate separation of functions (as necessary to ensure sound financial practice);
- effective systems for ensuring satisfactory performance of functions;
- reporting requirement on intermediate bodies on performance of tasks and means employed.

The 4 essential components of the control system required by the Regulation are:

- verification procedures at the management level on the delivery of the products and services co-financed and the reality of the expenditure claimed (Article 4);
- certification of expenditure statements by a functionally independent person or department within the paying authority which shall satisfy itself on compliance with all requirements relating to the accuracy, legality, eligibility and regularity of the expenditure (Article 9);
- verification of the effectiveness of the management and control systems and checks on operations on an appropriate sampling basis covering at least 5% of total eligible expenditure by a body which can assure an appropriate separation of tasks (Article 10);
- a declaration of validity of the final payment claim and the final certificate of expenditure on the winding up of the assistance by a functionally independent body conducting its examination according to internationally accepted audit standards (Article 15).

In addition the Regulation:

- requires Member States to provide within 3 months of the approval of a form of assistance a detailed description of the management and control systems (Article 5) and to submit any necessary completion or updating of the description on an annual basis (Article 13);

- provides that the management and control systems must ensure a sufficient audit trail (Article 7);
- specifies the arrangements for the retention of supporting documents on expenditure and controls (Article 7 as amended by Regulation (EC) No 2355/2002);
- provides for agreement between each Member State and the Commission on the scope of the records on operations which should be available to the Commission on request for the purposes of its audit work (Article 18 and Annex IV).

3.3. The description of management and control systems

Member States are required by Article 5 of Regulation (EC) No 438/2001 to provide within 3 months of the approval of an assistance to the Commission a description of the organisation of the managing and paying authorities and intermediate bodies, of the management and control systems in place, and of any improvements planned. In particular the description has to specify for each body the functions vested in them and the allocation of functions between or within departments, all procedures relating to the treatment of claims for reimbursement for operations, and the provisions for the audit of the systems. The Commission services carry out an assessment of the descriptions in accordance with Article 6 of the Regulation and inform the Member State concerned of “any obstacles which they present to the transparency of checks on the operation of the Funds and to the Commission’s discharge of its responsibilities under Article 274 of the Treaty”.

Member States have to complete or update the descriptions each year in the Report submitted under Article 13 of the Regulation and the Commission is required to undertake reviews of the operation of the systems on a regular basis.

The description of the Member States’ management and control systems will be the starting point for the planning and execution of an audit. Auditors should therefore ensure that they are familiar with these systems as part of the planning process for the audit, and they should also ensure that the description which they have is up to date.

In view of the specific constitutional and administrative characteristics of the Member States, each country and/or region has developed its own management and control systems. These individual systems should include the relevant bodies set out below:

- **paying authority**, which is the body authorised to issue certificates of expenditure under Article 32 of Regulation (EC) No 1260/1999 and Article 9 of Regulation (EC) 438/2001;

- **managing authority**, which is responsible for the management and implementation of the assistance in accordance with Article 34 of Regulation (EC) No 1260/1999;
- **intermediate bodies**, which carry out functions delegated to them by a paying authority or managing authority as defined in Article 2.2 of Regulation (EC) No 438/2001;
- **control authorities**, which have been designated as responsible for carrying out sample checks under Article 10 of Regulation (EC) No 438/2001 and/or the declaration of validity on the winding up of the assistance under Article 15; and
- **final beneficiaries/ final recipients**, at which level the specific operations are implemented.

The systems description should provide a clear description of the flows of Structural Funds' finance and information, their documentation and their control, analysed to final beneficiary/final recipient level to comply with the requirement in the Regulation for Member States to provide a sufficient audit trail² defined as one which permits:

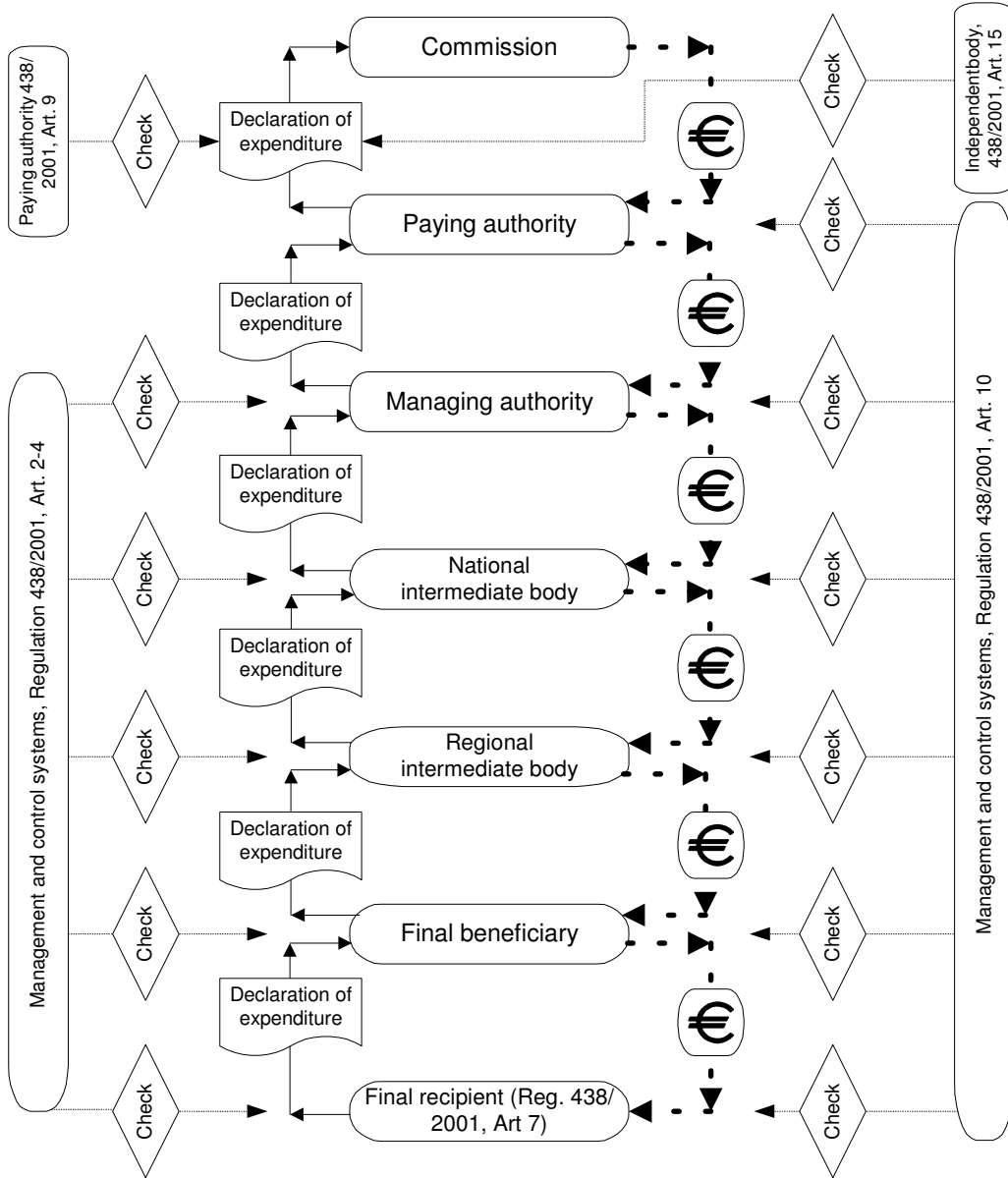
- reconciliation of the summary amounts certified to the Commission with the individual expenditure records and supporting documents at the various administrative levels and by final beneficiaries including, where the latter are not the final recipients of funding, the bodies or firms carrying out operations, and
- verification of the allocation and the transfers of the available Community and national funds.

An example of the audit trail is set out in Figure 1, which shows the flow of funds from the paying authority to the final recipient, and the flow of information on progress and performance from the final recipient through to the Commission. It should be noted that, while only one body is shown at each level in the Figure, in practice a range of organisations are likely to be involved at each level. The areas where appropriate controls should be present are indicated on the left of Figure 1. It is the operation of these systems which should be documented and tested during an audit of authorities or operations co-financed by the Community. Note that the actual controls implemented will vary according to the nature of individual

² Note that an indicative description of information requirements for audit trails is included as Annex 1 of Regulation (EC) No 438/2001

systems and according to the level of an audited body within the audit trail hierarchy.

Figure 1: Graphic representation of an example of the audit trail



The review of the systems description, including the audit trail, and the identification of possible weaknesses are an integral part of the preparation of an audit, and are dealt with in Part 4 of this manual. In the same way, the preparation phase of the audit should include consideration of the extent to which the description has been kept up to date.

3.4. Member States' audit activity

Member States are required under Regulation (EC) No 438/2001 to organise checks of operations on an appropriate sampling basis, designed in particular to:

- verify the effectiveness of the management and control systems in place; and
- selectively verify, on the basis of risk analysis, expenditure declarations made at the various levels concerned.

Overall, the sample tests carried out by Member States are required to be sufficient to allow a clear view of the validity of expenditure declarations. Samples should:

- ensure an appropriate mix of types and sizes of operations;
- include at least one check of the main intermediate bodies and final beneficiaries for each form of assistance;
- be applied evenly over the period concerned; and
- take account of the risk factors identified by national or Community checks.

Under the provisions of the Regulation, Member States must ensure that their checks cover at least five per cent of total eligible expenditure for each form of assistance under the Structural Funds. The exact percentage of expenditure controlled should be monitored progressively by the Member State and the coverage of at least five per cent verified in the closure phase for each form of assistance. Appendix 2 provides guidance on the requirements for Member State controls.

Member States are encouraged to develop an audit strategy covering the whole of the programming period which identifies the body or bodies which will carry out audit work, sets out the objectives of this work and indicates in particular how it will ensure that the requirements of Article 10 are fulfilled and how an adequate basis for the certification of expenditure under Article 9 and the declaration of validity under Article 15 will be provided.

3.5. Declarations of validity of expenditure drawn up by an independent body

Article 38 (1) (f) of Regulation (EC) No 1260/1999, together with Article 15 of Regulation (EC) No 438/2001, requires that when each assistance is wound up, a declaration drawn up by a person or department having a function independent of the designated managing authority, certifying department of the paying authority and intermediate bodies, shall be presented to the Commission. This statement shall summarise the conclusions of the checks carried out in previous years and assess the validity of the application for payment of the final balance and the legality and regularity of the transactions covered by the final certificate of expenditure. Declarations are drawn up on the basis of an indicative model and must be accompanied by a report including all relevant information to justify the declaration.

Where an overall positive assurance cannot be provided because of important management or control weaknesses or the high frequency of irregularities, the statement should provide details of the reasons and estimate the extent of the problems and their financial impact.

3.6. Annual control report

Member States are required by Article 13 of Regulation (EC) No 438/2001 to inform the Commission annually of their execution of the sample checks on operations. This information should include any necessary completion or updating of the description of management and control systems. Member States are strongly encouraged to use a standard model for their reporting. Use of the model will be a requirement for the “contract of confidence” in order to provide the necessary information from which the Commission can draw assurance.

The model which is a requirement for the “contract of confidence” is attached as Annex 7 to this manual.

4. THE AUDIT OF MANAGEMENT AND CONTROL SYSTEMS

The audit of management and control systems in respect of activities co-financed by the Structural Funds should aim to determine whether systems are operating effectively to prevent errors and irregularities, and that, where errors and irregularities do occur, the systems are effective in detecting and correcting them. It should be possible to conclude whether the system gives a satisfactory assurance of the legality and regularity of the underlying operations and of the accuracy of the expenditure declared. Essentially, Member State management and control systems should ensure at the appropriate levels that final beneficiaries/final recipients and operations are eligible when selected to receive Structural Fund support, that they remain eligible for the duration of the action, that objectives are being achieved, and that expenditure claimed is eligible and in accordance with the financial plan. Controls should also ensure that claims made to the Commission are correct.

This part of the manual considers:

- the planning of an audit, including the establishment of audit objectives and the selection of the bodies to be audited; and
- the on-the-spot audit, involving examination and testing of systems.

The reporting of the results of an audit is covered in Part 5 of this manual.

4.1. Planning the audit³

An individual audit in a Member State will generally take place within the context of an audit enquiry whose overall objectives relate to all or a significant number of Member States. An Enquiry Planning Memorandum (EPM) will be established for the enquiry which will set out:

- The basis in the Audit Strategy and Annual Management Plan for the enquiry;
- The audit objectives, scope and methodology;
- The global risk assessment;
- The selection of Member States/regions/programmes;
- The work planned;

³ The framework of audit strategy, EPM and MPM is followed by DG Regional Policy; other services may follow a different approach taking account of specific needs and risks.

- The planning of resources and timetable of missions.

This planning of the specific audit involves:

- the collection of relevant background information;
- the assessment of risks;
- the choice of detailed audit objectives having regard to those risks, including the determination of audit tasks and the definition of the specific sections of the questionnaires at Appendix 1 which will be used for the audit;
- the selection of specific auditees based on the risk assessment; and
- the planning of the timing, timetable and staffing of the audit;
- the establishment of a Mission Planning Memorandum (MPM).

4.1.1. The collection of relevant background information

The sound planning of an audit requires the collection and analysis of available information to provide a basis for the selection of the detailed audit objectives and of the specific auditees. This information includes the systems description provided under Article 5 of Regulation (EC) No 438/2001, as updated where appropriate, including the audit trail, and any audit reports carried out by auditors from the Commission, Member State or the Court of Auditors in the area under examination. This information should be reviewed and used for the risk assessment phase of the audit as set out below.

4.1.2. The assessment of risks

As outlined above, the main aim of the audits of Structural Funds activities is to verify that the relevant management and control systems are functioning effectively to prevent errors and irregularities, and that, where errors and irregularities do occur, the systems are effective in detecting and correcting them. In essence, this means that systems should be documented and tested at all levels of the audit trail to ensure their effectiveness. The actual checks carried out will be on a sample basis sufficient to enable overall conclusions to be drawn on the efficacy of systems. The selection of the auditees for each audit should be based on a risk assessment. The detailed methodology may vary according to the specific nature and objectives of the audit enquiry. A general approach is illustrated in Figure 2 below.

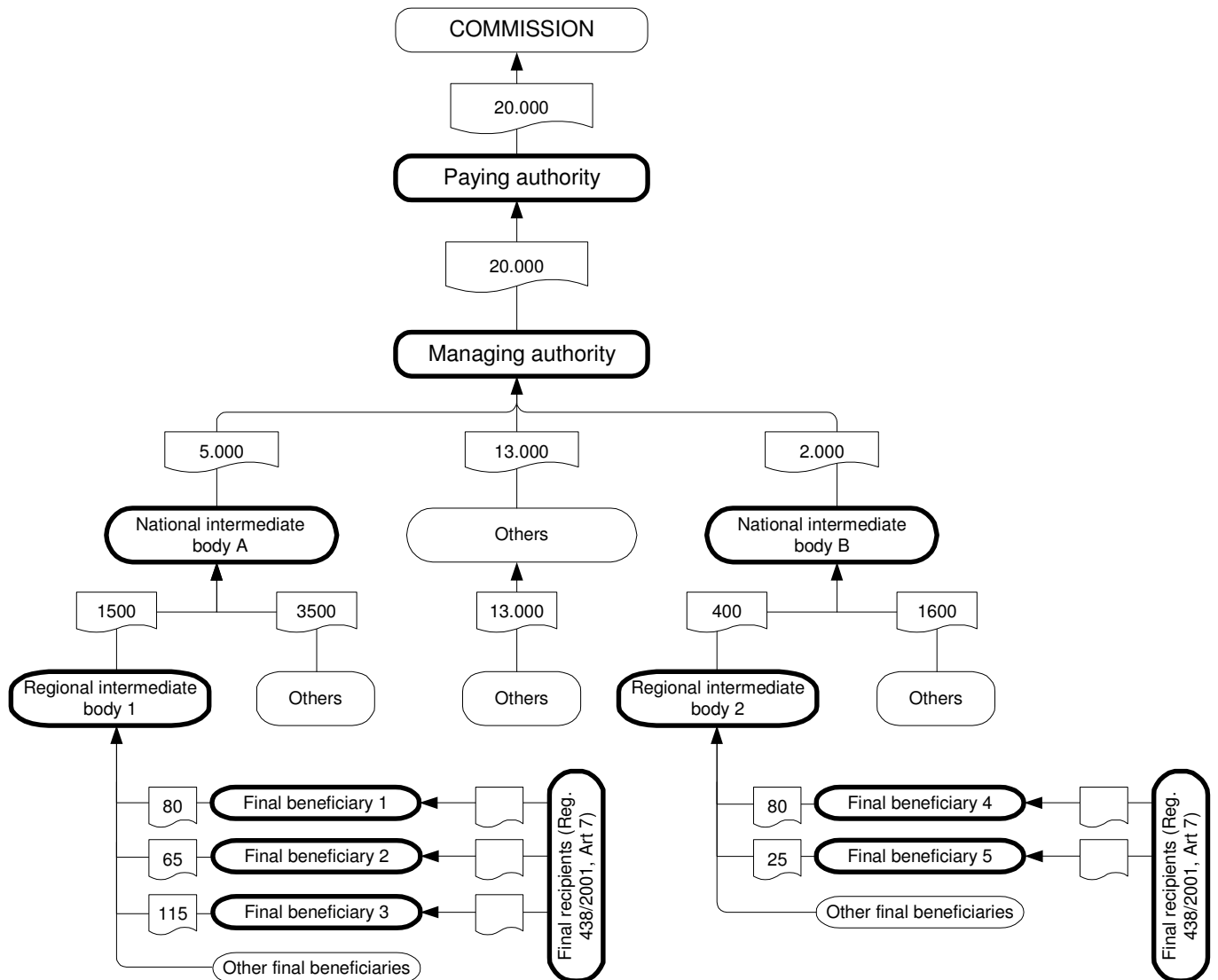
Figure 2 illustrates a fictional case where the paying authority has declared expenditure to the Commission. All of the

auditees to be visited are shown in bold in the Figure. As shown in the diagram, more than one intermediate body is involved in the management and control system for this activity, of which two (Intermediate Body A and B) are selected for examination on the basis of a risk assessment. During the audit, the systems operated by the managing and paying authorities are examined and tested (including verification of the expenditure declared by the intermediate bodies in the paying authority's accounting system), and the internal audit reports concerning the two selected intermediate bodies are examined.

During visits to the two intermediate bodies, their own systems are examined and tested, again including verification of the expenditure declared. Audit reports relating to the selected bodies at regional level are also examined. The same process is adopted during visits to Regional Bodies 1 and 2, which were also selected for examination on the basis of risk. During on-the-spot visits to the selected final beneficiaries and/or final recipients, local systems are tested and the expenditure declared is verified with the local accounting systems. Reports of sample checks on expenditure at this level are examined.

During the whole of the audit, the aim is to verify the existence of the management and control system as presented in the description communicated to the Commission, note relevant changes and test that the systems are operating effectively to prevent, detect and correct errors, both through examination of the actual systems and through tests of controls and substantive tests on selected transactions.

Figure 2: A graphical representation of the constituent parts of an audit of the implementing bodies of the Structural Funds



Note 1: the auditees selected on the basis of risk assessment are ringed in bold .

Note 2: Audit and control functions (Internal audit, systems audit and sample checks in accordance with Art. 10 of Regulation No 438/2001, and winding-up body in accordance with Art. 15 of Regulation No 438/2001) are not included in this figure as the arrangements for these vary considerably from Member State to Member State. Figure 1 of this manual include the control bodies required by the regulatory framework for Structural Funds. All of the audit and control functions are also subject to audits by the Commission.

4.1.3. *Determining the risks involved to select the areas to be audited*

The identification of key risk factors is essential to the planning of the audit. The risks involved include both the **inherent risk** (the risk of irregularity or material error occurring in any particular area irrespective of controls which may apply - for example where an action is governed by very complex rules, the risk of error may be high), and the **control risk** (the risk of controls not preventing or detecting such errors or irregularities, especially where there is evidence of poor quality or there has been a recent re-organisation). Audits should aim both to cover the areas where risks are assessed as highest and to offer a balanced coverage of the audit field over time.

The following factors should be considered as indicators when assessing the levels of **inherent risk** :

- the more complex the regulations governing the action (including relevant national rules), the greater the risk of error will be. These errors may occur either through the misunderstanding or misinterpretation of regulations, or through a simple error in application of the rules;
- divergence of management arrangements – for example, measures and operations implemented through a number of intermediate bodies may have a higher inherent risk than those implemented directly by a single managing authority. The more steps there are in the management process, the higher the risk may be;
- payments or receipts made on the basis of claims (for example, a claim by the final beneficiary in respect of contributions in kind), rather than in exchange for invoiced goods or services, are generally more difficult to verify, and therefore lead to an increased inherent risk;
- the absolute amount of the Structural Funds support, and the proportion of total cost supported by the Funds - where the absolute amount of the grant is high, or a very large proportion of total funding comes from the Funds, the inherent risks may be increased;
- the type of measure/operation - for example, some types of operation (for example global grants) may be considered to have inherently greater risk than others;
- the type of final beneficiary/final recipient - for example, public or private; well-established or newly-formed; and

- high levels of staff turnover, the use of temporary staff to undertake key tasks, or the use of untrained or inexperienced staff within the managing organisations or final beneficiary/final recipient are likely to lead to increased inherent risks because the inexperience of staff may mean that controls do not function properly.

Audited bodies may take action to address these inherent risks through the implementation of controls. The auditor therefore needs to assess the **control risk** in order to identify the residual risk (the risk that errors will escape detection by controls). Where **inherent risks** are highest, **controls** should be in place to reduce the actual risk of incorrect payments being made. For example, for schemes with very complex rules, the body responsible for checking and approving claims would be expected to put considerable effort into the verification of claims in that area. As such, an area with a **high inherent risk** may in fact have a low **control risk** where the systems are particularly effective at identifying errors.

4.1.4. The choice of audit objectives for audits of Member State authorities

Appendix 1 contains a set of questionnaires which set out the audit objectives and related evaluation criteria and audit questions which may be used during audits of Member State authorities. There are seven main audit objectives which may be addressed during audits of the Member State authorities responsible for managing and controlling Structural Funds actions. These audit objectives are intended to provide appropriate evidence to enable the auditor to draw conclusions on the effectiveness of the management and control systems in place. A typical audit will focus on one or more of the authorities or bodies involved, e.g. Managing Authority and Intermediate Body(ies), and/or Paying Authority, and/or control bodies. An audit that includes all authorities will typically both examine management and control systems, and verify one or more declarations of expenditure by means of following the expenditure through the system to final beneficiaries/final recipients.

Individual audits may seek to address all of the objectives set out, or may address specific areas determined as a result of risk assessment or for the purposes of a follow-up audit. The audit objectives and related assessment criteria are set out in Figure 3 and are considered in more detail at Appendix 1.

Part 3.3 of this manual, which considered the description of management and control systems, indicated that in practice several authorities (Managing Authorities, Paying Authorities, Intermediate bodies and control bodies) within a Member State (at different administrative levels) may be involved with

the same Structural Fund activity. Part of the planning process of the audit should be to determine which authority carries out which function⁴ and then, on the basis of risk, which authorities are to be audited, and which of the audit objectives set out in Appendix 1 are relevant for those authorities. The questions included in the Appendix are applicable to all levels of Member State authorities, and the appropriate questions and objectives should be identified for each audit, in relation to the objectives of that audit.

The audit objectives take account of the key elements for ensuring eligibility for co-financing as set out in point 2.2.1 of the “Guidelines on the principles, criteria and indicative scales to be applied by the Commission departments in determining financial corrections under Article 39(3) of Regulation (EC) No 1260/1999”. Appendix 1 sets out more specifically which questions relate to these key elements.

4 This includes establishing which intermediate bodies are involved, but also on the level of each body, which functions are carried out by which unit or person, e.g. who signs the payment declarations to the Commission in accordance with Article 9 of Regulation (EC) No 438/2001, who carries out the controls in accordance with Article 4 of the Regulation, who is designated as the person(s) responsible for the information and publicity by the managing authority (point 3.13 of the Annex to Regulation 1159/2000).

Figure 3: Audit objectives relating to the audit of Member States' management and control systems

	Audit objective for verification	Reference
1	Whether functions have been clearly allocated, authorities designated, and separation of duties ensured.	Art. 9 of Regulation 1260/99 Art. 3, 4, 9, 10 and 15 of Regulation 438/2001 Annex of Regulation 1159/2000
2A	Whether there are adequate arrangements to ensure that the procedure for grant applications, appraisal of applications and selection for funding comply with the relevant rules ⁵ , are in accordance with the needs of the area in question ⁶ , and that decisions by the authority are fully documented.	Art. 34 (1), in particular (b) and (g) of Regulation 1260/99 Art. 7 (2a) and (3) and Annex I of Regulation 438/2001 Guidelines on application of financial corrections point 2.2.1
2B	Whether there are adequate arrangements to ensure that the selection of contractors/suppliers complies with public procurement rules.	
3	Whether there are adequate procedures to verify the delivery of products and services, and the reality and eligibility of expenditure.	Art. 34 (1)(f) of Regulation 1260/99 Art. 4 of Regulation 438/2001 Guidelines on application of financial corrections point 2.2.1
4	Whether systems are adequate to provide reliable financial and statistical information on implementation.	Art. 18(3) and 34(1)(a) of Regulation 1260/99 Art. 18 and Annex IV of Regulation 438/2001
5	Whether checks are carried out on a sample basis, which are representative and based on risk-analysis, and cover at least 5 % of the total eligible expenditure; and whether checks are carried out to verify the effectiveness of the management and control systems in place.	Art. 10 and 11 of Regulation 438/2001 Guidelines on application of financial corrections point 2.2.1
6	Whether the bodies taking part in the management and implementation of the assistance maintain either a separate accounting system or an adequate accounting code for all transactions relating to the assistance.	Art. 34(1)(e) of Regulation 1260/99 Art. 7(2)(a) and 8 and Annex I of Regulation 438/2001

⁵ Apart from main regulations these also include rules on eligibility, publicity, equality of opportunity and public procurement, environment, equality of treatment, state aid, and national implementing rules reflecting the minimum requirements of the Regulations.

⁶ More specifically with what is set out in the programme and the programme complement.

7	<p>assistance.</p> <p>Whether there are procedures to ensure that certified declarations made to the Commission are accurate, result from accounting systems based on verifiable supporting documents, and that they only include expenditure that has been actually effected, incurred in operations selected for funding under the assistance and for which State Aid has been approved by the Commission.</p>	<p>Art. 38(1)(d) of Regulation 1260/99</p> <p>Art. 9(2) of Regulation 438/2001 and Art. 7(2a) of Regulation 438/2001 as amended by Regulation 2355/2002.</p>
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4.1.5. The choice of audit objectives for audits of final beneficiaries/final recipients

As set out above, the main purpose of the audits of final beneficiaries/final recipients is to determine whether the relevant aspects of Member State authorities' management and control systems relating to operations are functioning satisfactorily. Audits will involve the documentation and testing of final beneficiaries/final recipients' systems as they affect the Structural Funds activity. In accordance with this approach, the audit objectives which relate to audits of final beneficiaries/final recipients are set out in Figure 4 below. The audit objectives are explored in more detail in Appendix 1.

Figure 4: Audit objectives relating to audits at bodies/firms carrying out the operations

	Audit objective for verification	Reference
1	Whether authorities' accounting records correspond with supporting documents held by the body/firm.	Art. 11(b) and Annex I of Regulation 438/2001
2	Whether the nature and timing of the relevant expenditure comply with Community provisions and correspond to the approved specifications of the operation and the work actually executed.	Art. 11(d) of Regulation 438/2001 Regulation 1685/2000 (eligibility rules) as amended by Regulation 1145/2003
3	Whether the use or intended use of the operation is consistent with the use described in the application for Community co-financing.	Art. 11(e) of Regulation 438/2001
4	Whether the Community financial contributions are within the applicable limits provided for in Art. 29 of Regulation 1260/99 ⁷ and any other applicable Community provisions and are paid to the final beneficiaries without any reduction and unjustifiable delay	Art. 29 and 32(1) of Regulation 1260/99 Art. 11(f) of Regulation 438/2001
5	Whether the appropriate national co-financing has in fact been made available	Art. 11(g) of Regulation 438/2001
6	Whether the body/firm has complied with Community rules and policies including on publicity, information, competition, award of public contracts, equality of opportunities, and protection of the environment	Art. 12 of Regulation 1260/99 Art. 11(h) of Regulation 438/2001 Regulation 1159/2000 (publicity rules)

4.1.6. Using a risk-based approach to the selection of bodies to be audited during on the spot checks

The overall aim in the selection of forms of assistance and individual Member State authorities for examination is to ensure that audit effort is directed towards those areas where

⁷ See also point 9.3 of Commission Communication on the simplification, clarification, coordination and flexible management of structural policies 2000-2006 of 25.04.03 (C(2003)1255).

risk is likely to be greatest, while also ensuring adequate coverage of lower risk areas. Checks should be carried out on a sample basis, with the aim of carrying out sufficient examination to provide a reasonable level of assurance that the management and control systems to be examined by each audit are operating effectively to prevent errors or irregularities.

Given the large number of different management and control systems and the extent of the bodies involved, the overall audit strategy and specific audit enquiry should foresee the coverage of all relevant areas (for example, main implementing authorities, main final beneficiaries, forms of assistance) are covered, over a given number of years.

The selection of authorities, forms of assistance, priorities and operations to be audited should be based on a full risk-analysis firstly for the purposes of establishing the EPM, and secondly to identify the specific auditees for the audit in the Member State, which takes account of previous audit activity by all relevant auditors (Member State auditors, Commission services and the Court of Auditors).

The process set out above may be used to develop an audit approach which may then be adjusted on the basis of any additional information available to the auditor. Among the main factors to be considered in selecting the bodies to be audited are:

- information about the control environment and specific control risks within the audited body;
- the type of body involved and their collective experience of Structural Funds activities;
- whether the nature of the measures or operations managed means that there are particularly high inherent risks (see section 4.1.3 above);
- information from other sources relating to specific risk factors;
- information on the quality of the authorities' management and control systems, in particular the results of past controls by Commission services or other auditors on the authority or type of measure or operation concerned, together with information from Member States' annual implementation reports and annual control reports;
- the need to follow-up a selection of past audits to ensure that necessary improvements to systems have been made;

- the programme of control planned by the other auditors, in particular to avoid duplication and address any identified gaps in coverage;
- the volume of certified expenditure at programme, priority and measure level.

Adjusting factors may be applied to the selection of the bodies to be audited including the physical location of organisations (for example to prevent excessive travelling time during the audit), and the types of project to be covered. These adjusting factors may also be applied as a filter before the selection process.

Appendix 4 sets out examples of approaches to risk analysis and the development of an audit plan for sample checks applied by Member States to meet the requirements of Art. 10 of Regulation (EC) No 438/2001.]

4.1.7. Preparatory work before the audit is carried out

Sound preparation is vital to the efficient and effective conduct of an audit. To ensure that preparation is adequate, the auditor should carry out the following tasks, and record the results in the audit file with a summary in the MPM:

- document the initial risk assessment which led to the selection of specific auditees ;
- review available information on the selected authorities, in particular from the systems description under Article 5 of Regulation (EC) No 438/2001 and any update, and any previous audit reports commenting on it to identify any possible weaknesses which should be addresses during the audit;
- request from the Member State copies of relevant records on final beneficiaries/final recipients and carry out review to determine whether there are any particular issues which should be addressed during the audit;
- an analytical review of financial and other information relating to the auditees to identify any issues which should be pursued during the audit⁷;

⁷ Analytical review comprises three elements – trend analysis (the analysis of financial information over time), ratio analysis (comparison of appropriate ratios – for example cost per week for trainees), and predictive analysis (using financial, operating and other data to predict expenditure or income and compare with actual figures).

- obtain information from the relevant service responsible for internal audit in the organisation concerned about national audits, the control environment and possible modifications of national management and control systems;
- review the annual implementation report and annual control reports of the Member State in question to identify any issues which should be addressed during the audit;
- update the consolidated audit plan for the Member State to take account of any changes made. Where visits are planned or have taken place to the same authority or programme, care should be taken not to duplicate recent control effort, while ensuring proper follow-up of reports
- where IT systems are involved, auditors should ensure that they obtain appropriate documentation to enable the audit to take account of these systems; and
- for the selected operations, the auditor should request from the responsible authorities the grant application, the grant letter, and all payment claims, and examine this documentation to determine the need for any specific additional checks.

As a result of the above work, the auditor should produce an adjusted risk profile of the bodies to be audited and a list of the particular risks to which special attention should be given during the audit. The detailed objectives of the audit, together with the specific work programmes and questionnaires to be used, should be described in the MPM.

4.2. On-the-spot examination and testing of management and control systems

On site, the auditor must aim to obtain sufficient convincing, appropriate and reliable evidence that the management and control systems in place are operating as described and that they are adequate to ensure the regularity of Structural Funds expenditure and the accuracy and completeness of financial and other information. In carrying out audits, auditors should check that the system described actually exists in practice, and that appropriate mechanisms exist to keep the documentation of the system up to date.

Testing to be carried out involves the documentation of systems through reviews of files, supplemented where necessary by interviews with relevant staff, together with the testing of the operation of those systems. Testing of the operation of systems is carried out through examination of a sample of transactions. Taken together, sufficient testing should be carried out to enable sound conclusions to be reached on the efficacy of the systems under examination. The audit objectives which may be addressed during

the audits are set out in Appendix 1. The actual content of each audit should be adjusted by the auditor to take account of the control environment as part of the preparation stage for the audit discussed in section 4.1 above.

4.2.1. Internal audit

The auditee's own internal audit function is responsible, inter alia, for the examination and evaluation of the adequacy of the organisation's own internal control systems. As such, information from internal audit is vital to inform other audits of the organisation (indeed, this should already have been taken account of in the planning of the audit – see sections 4.1.5 and 4.1.7 above). In particular, any findings in respect of the system under examination should be taken into account to determine whether appropriate and effective corrective action has been taken to address weaknesses identified by internal audit.

4.2.2. Documentation and testing of systems

A key element of an audit of activities co-financed by the Structural Funds is to examine whether management and control systems are operating effectively at all relevant levels. This examination involves the documentation of the relevant systems (i.e. completing the information available in the description communicated to the Commission), together with testing (**tests of controls**) to examine whether the systems are actually operating as described and are effective.

Tests of controls should check that management and control systems are operating consistently and effectively. Tests should be carried out on a sample of transactions relating to the final beneficiaries/final recipients selected for on the spot audits. Where the effectiveness of the management and control system is likely to vary (for example where different staff are responsible for applying the same checks on different transaction streams), the auditor should ensure that the sample is representative of these possible differences. It is important during tests of controls to identify the reasons for any errors and omissions identified, which may indicate weaknesses in management and control systems.

The results of the tests of controls should be documented in working papers for presentation in the audit report. Auditors should clearly describe in separate working papers the problems or errors identified during audits, their effects, and the recommended solutions. All weaknesses and errors should be discussed with auditees, and their views should be recorded for use in the audit report. Working papers, including the analysis of problems, effects and solutions should then be used in the preparation of the audit report.

Appendix 1 sets out standard systems audit checklists for Member State authorities and for final beneficiaries/final recipients. This compliance test programme (used in its entirety or using individual elements) is intended to enable the auditor to determine whether management and control systems are operating satisfactorily. Any weaknesses identified during the audit should be notified to the audited body or bodies, and appropriate changes recommended.

4.2.3. Audits of final beneficiaries/final recipients

The nature of final beneficiaries/final recipients varies enormously depending upon the Fund and the type of operation, and accordingly the audit work carried out will be adapted appropriately. In general, on-the-spot audits at the level of operations should aim to document and evaluate the management and control systems as they affect Structural Fund activity. In addition to the documentation of systems, these audits typically involve **tests of controls** and the in-depth checking (**substantive testing**) of a selected expenditure declaration against source documents and other relevant information. The purpose of this checking is to enable a conclusion to be reached on the accuracy and validity of the particular expenditure declaration examined, as well as to assess the quality of the controls operated by the Member State authorities responsible. The key objectives for substantive testing are set out in Appendix 3.

Substantive testing may also include analytical review – for example the comparison of different ratios or trends to identify possible areas for further investigation. Tests should also include a reconciliation between expenditure declared by the auditee to a higher authority, and the financial records maintained by the auditee. In addition to verifying the accuracy of payment requests, such checks can be a useful indicator of the effectiveness of the audit carried out by higher authorities and of the proper functioning of the audit trail.

5. AUDIT REPORTS

5.1. Recording and discussion of findings

Audit findings should be recorded in working papers during the audit, which are then filed in the audit file together with copies of supporting documents (see point 5.3). These papers should set out clearly the problems or errors identified, their effects and the auditor's recommendations. The findings should always be discussed with the auditee on the spot so that their responses can be taken into account in the audit report.

The audit report is the main vehicle for communicating the results of an audit. Reports should be clear and concise, highlighting the main conclusions of the audit, and indicating the action which is needed to address weaknesses identified. All reports should contain an executive summary setting out the key findings and conclusions and should contain key recommendations. An example of a standard report is presented in Appendix 5 of this manual.

Major errors or system weaknesses should be discussed with relevant staff from the audited body during the audit (for example during a summing-up meeting at the end of the audit), both to confirm the auditor's understanding of the nature of the error or weakness, and to allow discussion of and agreement on the action needed to correct errors or improve systems. Following the conclusion of the audit, auditors should aim to produce the draft audit report as quickly as possible to ensure that auditees can rectify weaknesses at the earliest possible opportunity. Once the draft final audit report has been prepared, this should be sent to the operational service of the Directorate General for observations within a set deadline. The findings, conclusions and recommendations of the audit are sent to the Member State when the final version of the report has been established (see point 6.1).

Reports should contain enough detail on audit findings and conclusions to demonstrate to the audited body the weaknesses in the systems, and recommendations should state clearly the remedial action which is necessary. The report should also set out how the auditor will follow up the audit to determine whether suitable remedial action has been taken, for example by requesting written reports from the audited body setting out the action taken in response to the recommendations.

5.2. Structure of the audit report

The audit report should contain the following items:

1. Executive summary
2. Objectives and scope of the audit

3. Work carried out
4. Findings
5. Conclusions and recommendations.

The length of the audit report will depend on the objectives and scope of the audit. However, in line with established best practice, in order to ensure that the report remains readable, it should not generally exceed 20 pages, and there should be an executive summary of not more than 2 pages. Where necessary additional information can be included in annexes to the report.

5.2.1. Executive summary

The executive summary should present an overview of the objectives and scope of the audit, the main findings and conclusions (setting out clearly the main strengths and weaknesses found and their impact), together with the key recommendations identifying the main areas which need to be addressed by the auditees.

5.2.2. Objectives and scope of the audit

The audit objectives should be set out and the scope of the audit should be briefly outlined. Information provided should include the authorities and measures chosen for examination, and the reasons for the choice.

5.2.3. Work carried out

The audit work carried out on the spot should be summarised.

5.2.4. Findings

This section should record the findings of the audit, providing a clear and logical analysis of any problems identified, and their consequences. The report should provide sufficient details of the weaknesses identified in management and control systems to enable audited bodies to verify the points made and to take corrective action. The report should also include a short description of any element of the management and control systems operated by the selected authorities which differs from the description provided under Article 5 of Regulation (EC) No 438/2001 and the overall assessment of the management and control system.

For the audits carried out at final beneficiaries/final recipients, a short factual description of the operation should be given, together with the findings and conclusions on the functioning of management and control systems in the light of the audit tests carried out on site.

5.2.5. *Conclusions and recommendations*

Reports should provide specific conclusions on the basis of the findings as well as an overall conclusion on the system. They should also include specific recommendations for action by the audited body to address weaknesses found during the audit. These recommendations should be clear and should be supported by convincing evidence as to the need for action. They should be clearly linked to the weaknesses identified and reflected in the section on findings and conclusions. A time limit should be set for taking and reporting on the corrective action, the length of which will vary according to the type of action required. The recommendations will form the basis for any follow-up examination in the future.

5.3. **Audit files and working papers**

After issuing the audit report, audit working papers should be moved to central storage so that the information can be shared with other auditors. The retention period will be defined by the DG subject to archiving regulations.

The files will consist of Current Audit Files containing all of the working papers related to the particular audit mission. A Permanent Audit File should also be maintained for each Member State (and each Region where applicable).

5.3.1. *Current Audit File*

Working papers are the records maintained by the auditor of the work planned and carried out in relation to the audit, including the procedures followed, the tests performed together with the information obtained and the conclusions formed. Working papers should be prepared at the time the work is carried out.

Such papers are the property of the auditors and accordingly appropriate procedures should be adopted to ensure their safe custody and confidentiality. Audit working papers should be held in the Current Audit File.

Although the quantity, type and content of working papers will vary between audits, they should be sufficiently extensive to serve to:

- a) assist auditors in the conduct of their work
- b) provide adequate support for the auditor's opinion
- c) enable the work carried out to be independently reviewed
- d) encourage a methodical approach to the work being undertaken.

The purpose of the Current Audit File is therefore to provide a record of the audit work performed and to enable any person reviewing the audit to satisfy themselves that an adequate audit examination has been made of the organisations audited. The file should include the following elements

- Planning and audit timetable.
- Extracts from the meetings held
- Audit report
- Working papers relating to the tests carried out and verifications.

5.3.2. *Permanent Audit File*

The purpose of a Permanent Audit File is to provide auditors with a source of background information about the organisations being audited thus allowing them to obtain a greater understanding of their systems.

The Permanent Audit File should be updated each year and will thus provide the auditor with the most up to date information available. It should include

- Protocol, notes of any arrangements or agreements for co-operation with the organisation
- Details of the functions and activities of the organisation.
- Administrative and control systems, audit trail, flowcharts, accounting procedures.
- Organisation charts, including the titles and names of the responsible officials showing the line of responsibility.
- Previous audit reports (ECA, Commission and Member State audits).

5.4. SYSAUDIT

DG Regional Policy is in the process of developing and introducing a new Audit Management System, SYSAUDIT. The objectives of this system are to offer a standard tool for the various Commission services auditing the Structural Funds and the Cohesion Fund, to provide a common data base for audits planned and executed by these services, to facilitate the standardisation and co-ordination of audit work and give easy access to information for the geographical units. It is intended, after sufficient testing of the system has been carried out, to give access to the system to approved administrations in the Member States.

The application consists of a series of modules which cover the following principal actions:

- Recording each EPM established
- Planning of audit missions with reference to the associated EPM
- Preparation of mission, allocation of auditors, production of MPM, notification of auditee
- Audit report production
- Recording of findings from the audit
- Follow-up of findings
- Follow-up of financial correction procedures
- Document management for securely storing all correspondence related to an audit.

SYSAUDIT will facilitate the follow up of audit findings and recommendations and will trace the status of each finding until it has been closed.

Where there are open items, the SYSAUDIT system will issue a warning to the auditor at the date fixed, who will be able to generate a standard letter to the auditee, reminding it that follow up action needs to be taken.

Once all the individual findings have been closed, either because satisfactory actions have taken place or because a formal financial correction procedure has been launched, the audit report can be closed.

6. FOLLOW-UP OF AUDIT FINDINGS

Once the audit report has been completed, the findings, conclusions and recommendations must be communicated to the auditee (Member State) and followed-up. The follow-up of the findings, which may eventually result in financial corrections, consists of a number of steps, which are summarised in Figure 5. The steps are as follows :

6.1. Communication of audit findings

Following the completion of the final audit report, the findings, conclusions and recommendations must be communicated in the official language to the Member State. A version in one of the official working languages of the Commission must be available for the audit file. The established best practice is that the audit report should be finalised within two months following the end of the audit mission and the communication sent out to the auditee in the following month. However, this communication will be in the original language of the audit report, i.e. usually English or French. The version in the language of the Member State where different may be sent later as a further month is usually necessary for translation. The Member State is given two months from receipt in its national language to reply to the audit findings.

A copy of the final complete audit report is also forwarded to the protocol partner of the Member State in accordance with the bilateral administrative agreement signed between the Commission and the control partner in the Member State, as well as to the Court of Auditors, OLAF and to the audit units of the other Structural Funds services.

6.2. Analysis of reply from Member State

Once the reply from the Member State is received, it may have to be translated into one of the official working languages in order for the auditor to proceed with the analysis.

Where the reply received is satisfactory, the audit file should be closed and the Member State informed of this.

However, the analysis may result in the request for additional information from the Member State and/or may result in the conclusion that a financial correction appears justified. Requests for additional information should be sent to the Member State within one month in order to establish whether financial corrections are appropriate.

6.3. Suspension of payment

If following the receipt of the reply from the Member State and any additional information required, the Commission services conclude that

- (1) the Member State has not complied with its obligations under Article 39(1) of Regulation (EC) No 1260/1999; or
- (2) all or part of an operation justifies neither part nor the whole of the contribution from the Funds; or
- (3) there are serious failings in the management or control systems which could lead to systemic irregularities;

the Commission services can propose suspension of interim payments to be decided by the Commission.

Furthermore, the Commission services shall write to the Member State stating the reasons for the conclusions and request the Member State to submit its comments and where appropriate carry out any corrections (Article 39(2) of Regulation (EC) No 1260/1999). The Member State has two months from the date of the official language version of the letter to reply and make corrections (Article 5(1) of Regulation (EC) No 448/2001)⁸.

6.4. Type of financial correction

The type of financial correction to be applied is determined on the basis of the “Guidelines on the principles, criteria and indicative scales to be applied by the Commission departments in determining financial corrections under Article 39(3) of Regulation (EC) No 1260/1999”⁹. If the Commission services propose financial corrections based on extrapolation or a flat rate (where it is difficult, impossible or impracticable to determine exact correction or disproportionate to cancel all assistance), the request for comment must include an invitation for the Member State to demonstrate, through an examination of the files concerned, that the actual extent of irregularity was less than the Commission’s assessment. Article 5(2) of Regulation (EC) No 448/2001 sets a deadline of two months for this examination.

6.5. Hearing

If after the expiry of the two months the Commission services and the Member State authorities have not agreed about the corrections to be made, and the Member State has not made the corrections, the Member State must be invited to a hearing. The purpose of the hearing is to try to come to an agreement about the findings and the conclusions to be drawn from them (Article 39(2) of Regulation (EC) No 1260/1999).

⁸ Except in duly justified cases where the Commission may agree a longer period.

⁹ Com(2001) 476 of 02.03.01

The Commission services send out the invitation to the hearing which includes a justification for the corrections proposed. This justification must take into account any information received from the Member State within the two months period.

6.6. Financial correction

If the hearing does not produce any agreement and the Member State has still not made the corrections, the Commission, taking account of the comments made by the Member State, can take steps to apply a financial correction. The financial correction decision can either take the form of :

- (1) Reducing a payment on account; or
- (2) Cancelling all or part of the contribution of the Funds to the assistance concerned (which may or may not result in the repayment of part of the interim payments already effected).

The financial correction must be decided by the Commission within three months of the date of the hearing (Article 5(3) of Regulation (EC) No 448/2001), or if the Member State did not want a hearing within three months of the date the Member State has officially informed the Commission that it does not want a hearing, i.e. the date of receipt of the information from the Member State.

Any proposed financial correction based on extrapolation or fixed on a flat rate basis should be presented to an ad hoc interservice advisory panel prior to the decision.

6.7. Commission decision

A financial correction must be adopted by Commission Decision, either by delegation to the responsible Commissioner, by written procedure or by oral procedure.

Following the completion of the contradictory procedure with the Member State, the responsible service prepares a draft Commission Decision, which includes the arguments put forward by the Member State as well as the justification of the Commission for maintaining its position. Once the draft text is agreed within the relevant authorising service it is sent for interservice consultation. The Decision is then presented for adoption by the Commission. A Member State has 2 months from the date of notification of the Decision to bring proceedings before the Court of Justice to contest the decision.

6.8. Recovery

In case the financial correction is to be implemented by recovery, the terms of the repayment are set out in a recovery order including the due date (Article 7(1) of Regulation (EC) No 448/2001). If the Member State does not pay by the due date, the Commission effects

recovery by deduction from the next payment(s) to the same Member State⁸.

FIGURE 5

STEP	Reference	Deadline ⁹
Audit report		Two months after mission
Internal consultation on draft report - finalise report and prepare transmission letter	Other services have 10 working days to reply	
Translate letter and findings, conclusions and recommendations from report into national language		Usually one month
Member State's reply		Two months after letter sent in official language
Translate reply		Usually one month
Draft letter of conclusions (including request for additional information) to the Member State and internal consultation ¹⁰	Application of Article 39(2) of Regulation (EC) No 1260/1999	As soon as possible after receipt of translation
Translate letter		Usually one month
Member State reply	Article 5(1) of Regulation (EC) No 448/2001	Two months after letter sent in official language, except in duly justified cases where a longer period may be agreed by the Commission
Translate reply		Usually one month
Member State's further enquiries	Article 5(2) of Regulation (EC) No 448/2001	A further two months after the two months mentioned above
Translate reply		Usually one month

⁸ In accordance with Art. 73 of the Financial Regulation applicable to the general budget of the European Communities, Council Regulation 1605/2002 of 25.02.02.

⁹ NB deadlines have only been included where there are fixed deadlines or they are approximately known.

¹⁰ At this stage the Commission services may also propose suspension of interim payments to be decided by the Commission (see point 6.3 above).

Call hearing	Second sub-paragraph of Article 39(2) of Regulation (EC) No 1260/1999	As soon as possible after receipt of translation of reply/information on further enquiries.
Hearing	See above	
Examination of proposal for extrapolated or flat rate financial correction by interservice advisory panel		
Communicate final position to the Member State		
Commission Decision	Article 39(3) of Regulation (EC) No 1260/1999 and Article 5(3) of Regulation (EC) No 448/2001	Three months after date of hearing or three months after receipt of Member State's confirmation that no hearing is requested.
Member State refunds any correction	Article 7(1) of Regulation (EC) No 448/2001	Usually two months after receipt of recovery order.