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IAS Audit Report: IAS.B2-2010-DG INFSO-001

European Commission

Internal Audit Service

Final Audit Report on DG INFSO's Control Strategy for on the-spot control and fraud prevention and detection

06 October 2011

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1. EXECUTIVE SUMMARY AND CONCLUSIONS[1]

1.1. Background

Together with the other Research Commission Services (RCS), DG INFSO implements EU research policy and supports the development of the European Research Area mainly through the Research Framework Programmes. Under the Seventh Framework Programme (FP7) for 2007-2013, which is currently being implemented, DG INFSO's share is some EUR 10 billion in total. In 2010, DG INFSO's payments were EUR 1.23 billion for FP7 and EUR 150 million for non-research programmes. Although the programming period for the Sixth Framework Programme (FP6) for 2003-2006 has finished, DG INFSO made payments amounting to EUR 160 million against cost claims during 2010 for on-going projects financed under FP6.

In recent years there have been a range of initiatives aimed at addressing the difficulties which have characterised the previous programming periods, in particular the development of common control and audit strategies amongst the RCS and in particular a common FP7 audit, or on-the-spot control, strategy designed to test the veracity of cost claims submitted by beneficiaries at different stages of the project cycle.

In line with the increased focus on fraud prevention and detection in the Commission[2], and following a recommendation made by the IAS[3], DG INFSO has developed an Anti-Fraud Control Strategy. This document outlines its anti-fraud strategy and sets out existing anti-fraud controls, those being presently developed and outlines future developments.

1.2. Audit Objectives

The objective of the audit was to assess the internal controls underpinning DG INFSO's on-the-spot controls processes and the adequacy and effective application of the fraud governance, risk management and internal control processes for fraud prevention and detection.

1.3. Audit Scope

The audit of the on-the-spot control processes focussed particularly on:

- the on-the-spot audit strategy and planning processes for ex-ante, interim and ex-post audits;

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[1] The Executive Summary provides a synthesis of information on the audit including critical and very important findings, risks and recommendations as well as the audit opinion – its emphasis is on providing a quick understanding of the audit and its main results. The body of the report contains the detailed validated audit information and as such is the authoritative text.

[2] Communication from the Commission "Protection of the Communities' financial interest " COM(2000) 358; Communication from the Commission concerning the fraud – proofing of legislation and contract management SEC(2001) 2029; Communication from the Commission to the Council, the European Parliament and the European Court of Auditors "Prevention of fraud by building on operational results: a dynamic approach to fraud – proofing" COM(2007) 806

[3] Audit on DG INFSO's Internal Control System for managing the 7th Framework Programme – Design; Recommendation 6: "Developing a fraud awareness strategy"

- the methodology, guidelines and procedures and the coordination with the other research DGs and executive agencies;
- the implementation/execution of the audit plan by the ex-post audit unit directly and by the external audit firms (outsourced audits);
- the monitoring and reporting arrangements;
- the measures to ensure the quality of the work undertaken;
- the follow-up given to audit results including the monitoring and implementation of corrective actions.

The scope of the audit encompassed both fraud prevention and detection controls. Prevention encompasses controls to reduce opportunity and decrease motive. Detection encompasses controls, which indicate possibility of fraud. The audit covered the different internal control system components as defined by the COSO model: control environment, risk assessment, control activities, information and communication, monitoring. The scope included the control systems to the extent they cover FP6, FP7 and other programmes managed by DG INFSO (Non-research programmes).

DG INFSO has made reservations in recent years on the rate of residual errors on the accuracy of cost claims in FP6. Nevertheless in its 2010 AAR there is no reservation that relates to the process audited on the grounds that the cumulative residual error rate for FP6 (2.2%) is close to the materiality level and expected to fall below 2% in the course of 2011 (once all ongoing audits are closed and all initiated extrapolation exercises have been completed). Therefore, the reservation regarding the accuracy of FP6 claims made in previous AARs was lifted.

The fieldwork was finalised on 3 June 2011. All observations and recommendations relate to the situation as of that date.

1.4.   Strengths

Since the IAS' previous audit on ex-post controls[4], DG INFSO has invested heavily in strengthening the ex-post audit function and has made significant efforts in improving its processes and procedures. Over time, it has become a well-established, mature activity and a key pillar of control, responsible for delivering the bulk of the assurances in the AAR declaration. The issues identified in the present report are aimed at reinforcing the measures already taken and building on the systems already in place.

The IAS notes the significant increase in audit activity in general terms and for audits conducted in-house, particularly when compared to the first IAS audit. The audit methodology is mature and well documented in manuals, procedures and checklists. In addition, there has been an increased focus in recent years on risk-based (potential fraud cases) audits, with significant efforts made to refine the techniques in this area in order to undertake more focussed and targeted work. DG INFSO has made particular advances in 2010 on its risk-based approach by linking data-gathering, risk-assessment and specific audit procedures. This approach is now also applied to audits, which were selected previously on the basis of being in the MUS sample or in the list of Top 200 beneficiaries. Particular efforts have been made to report very clearly the results of its ex-post controls strategy in the AAR.

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[4] IAS audit report "Ex-Post Controls – DG INFSO" 21.12.2006

The IAS acknowledges the fact that DG INFSO was the first to develop a comprehensive anti-fraud control strategy, which was also used as reference point and helped to trigger the development of anti-fraud strategies in some of the other RCS. DG INFSO has also designed and implemented particularly innovative audit methods using advanced IT data mining tools (PLUTO), which have been very widely recognised and appreciated in the Commission's anti-fraud effort.

In addition DG INFSO has made significant efforts to improve ex-ante anti-fraud measures, including guidance on the use of the Commission's Early Warning System (EWS). Also, for the negotiation and payments phases and termination of FP7 Grant Agreements. It has developed fraud indicators and red flags to help operational staff in detecting anomalies and guidance on handling exceptions at different stages of the project and provides fraud awareness training to staff on detecting anomalies in projects. In 2009 it organised specific ethics awareness sessions for senior and middle managers and other staff with an end result the publication of a guide on ethics and integrity in 2010.

1.5. Audit Opinion and Major Audit Findings

Based on the results of our audit as described in the objectives and scope of the audit engagement, we believe that the internal control system in place provides reasonable assurance[5] regarding the achievement of the business objectives set up for the on-the-spot controls and fraud prevention and detection processes in the DG, except for the following issue:

a) Common audit strategy and coordination issues

Ex-post audits, carried out either after interim and/or final payment on a project, are the main pillar of control in the research area and aim to identify and correct errors in beneficiary cost claims. The number of audits conducted has increased significantly over recent year, whereas ex-ante controls have been reduced under FP6 and even more under FP7, with the push for greater simplification. However, increased audit activity means an increased audit burden on beneficiaries and comes at a high cost to the RCS generally in terms of resources.

The interconnected nature of research means that there are common beneficiaries and therefore a strong need for effective coordination between the eight Commission Services. However, to date this coordination has not always been effective for the research area in general, despite the efforts made. The extent of the problems varies from service to service. DG INFSO perceives itself to be less affected than the lead DG RTD. It considers that the necessary coordination tools are in place and has made its own proposals for improving the situation. However, the IAS considers that, although better working arrangements would help, there is a more structural problem in so far as each service effectively has to act independently in order to satisfy its own accountability needs rather than coming together to serve the needs of the research area as a whole. The result is extensive and costly audit work, timing problems and inconsistencies of approach across the RCS in general. These problems have been flagged and recognised

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[5] Even an effective internal control system, no matter how well designed and operated, has inherent limitations – including the possibility of the circumvention or overriding of controls – and therefore can provide only *reasonable assurance* to management regarding the achievement of the business objectives and not *absolute assurance*.

as a risk and the idea of a single, representative sample put forward as a solution. However, the IAS is aware that this may impact on the present accountability structure.

1.6. Risks and audit recommendations

In arriving at the above opinion, the following high risk that may impact the achievement of the business objectives for the process audited was identified:

(a) Common audit strategy and coordination issues – Risk rating: High

Although the RCS have worked hard to install credible control strategies through a common audit approach, there is a risk that the lack of effective coordination, due in part to the present accountability framework, coupled with the increasing cost of ex-post audits will lead to inefficiencies and increase the burden on auditees without the proportionate increases in assurances.

DG INFSO should, in conjunction with the other RCS and horizontal services, appraise the costs, benefits and accountability implications of consolidating the control strategy. To avoid the inefficiencies caused by auditing separate representative samples by each DG the aim should be to have a single representative sample for the research area as a whole, aimed at determining the error rate for the policy area rather than for each service. To ensure that each RCS meets its own accountability and assurance needs, the central representative sample relating to each RCS could be augmented as necessary.

In addition, to address specific risks, each RCS should draw its own specific risk based sample. The planning of these audits should be centrally coordinated in order to avoid several audit visits to the same beneficiary.

More fundamentally, it could include the possibility of a single audit service or appointing a 'control architect' to oversee the existing structure, responsible for coordination, overseeing the work of the external audit firms and the framework contract, working methods, allocation of responsibilities etc.

2. FULL REPORT

2.1. Introduction

2.1.1. Reason for the Engagement

As part of its 2010-2012 strategic audit plan, which is prepared in cooperation with the IACs, the IAS had foreseen separate audits on the control strategy and internal control systems put in place by DG INFSO concerning, on the one hand, on-the-spot controls, and on the other hand, fraud prevention and detection. As part of its annual updating of the strategic plan, the two audits have been combined in one audit, in order to reduce the audit burden on the DG INFSO in 2011.

Control strategy - on-the-spot controls

The objective of the audit was to assess the internal controls underpinning the DGs' on-the-spot controls processes, focussing particularly on:
— the on-the-spot audit strategy and planning processes;
— the methodology, guidelines and procedures and coordination with the other research DGs and executive agencies;
— implementation/execution of the audit plan by the ex-post audit units directly and by the external audit firms (outsourced audits);
— monitoring and reporting arrangements;
— monitoring the effectiveness of the audit certification process;
— measures to ensure the quality of the work undertaken;
— the follow-up given to audit results including the monitoring and implementation of corrective actions.

Fraud prevention and detection

The objective of the audit engagement was to assess the adequacy and effective application of the fraud governance, risk management and internal control processes for fraud prevention and detection in DG INFSO.

The objective was based on the "proactive" approach to fraud prevention and detection also referred to as the "fraud audit" approach. In this approach, the search for fraud takes place when there is no fraud allegation or internal control weakness that would suggest that fraud is occurring.

The scope of the audit encompasses both preventive and detective controls:

— **Prevention** encompasses controls to reduce opportunity and decrease motive: fraud awareness programme, ethics policies, training.

— **Detection** encompasses controls that indicate possibility of fraud: exception reporting, advanced data search, ex-ante controls, ex-post control audit, ongoing risk assessment, whistle-blowing hotline.

Although the focus of the audit was on fraud prevention and detection controls, it also covered fraud correction controls set up in order to ensure that identified instances of fraud or irregularities are effectively managed.

The scope of the audit engagement comprises the internal control system components of DG INFSO as the COSO model defines them[6]:

- Control environment
- Risk assessment
- Control activities
- Information and Communication
- Monitoring

This audit was conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing.*

2.1.2. Description of Audited Activity/Process

Ex-post audit strategy and planning

The RCS have adopted common audit strategies for FP6 and FP7. The FP7 audit strategy introduces several common coordination mechanisms to ensure a consistent approach across the RCS. These include *inter alia* the following working groups and committees: CAR - "Coordination group for external audits in the research family", ESC - "Extrapolation Steering Committee", JAC – "Joint Assessment Committee". Common guidelines and procedures, such as the Audit Process Handbook (APH), common checklists, templates, etc. and common IT tools, including SAR WIKI (sharing audit reports, procedures, documentation coordination committees), SAR EAR (monitoring extrapolation cases), SAR PAA (planning coordination) have been developed.

In DG INFSO, unit S5 is responsible for the overall planning and reporting on the audit activity, and for performing on-the-spot audits. Unit S5 is responsible, *inter alia*, for supervising the audits performed by the External Audit Firms (EAF), and for the desk review of the certificates on methodology (CoM/CoMAv). About 75% of DG INFSO's on-the-spot ex-post audits are outsourced to EAF.

Corrective mechanisms:

Audit adjustments are implemented by the operational directorates, either through off-setting of the adjustment against the next payment, or through recovery. In addition, systemic errors identified are extrapolated to non-audited contracts of the audited beneficiary. The Extrapolation Steering Committee (ESC) confirms the systemic nature of the errors detected during the audits, thereby launching the extrapolation procedure. Beneficiaries cooperate in this extrapolation procedure on a voluntary basis. Unit S5 is the single point of contact for the submission of revised cost claims by the beneficiary.

Audit certification

The system of audit certificates has been introduced in FP6. Beneficiaries were required to submit an audit certificate prepared by an independent external auditor for cost claims responding to certain criteria. For FP6 the certifying auditor was requested to provide an

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[6] The scope of the audit engagement was defined based on a common audit programme on fraud prevention and detection developed by Auditnet, the network of Heads of IACs (the Internal Audit Capabilities) of the DGs of the European Commission, chaired by the Director General of the IAS.

audit opinion about the correctness of the financial data reported in the cost claim (Form C).

Under FP7, the system has been modified and audit certificates on financial statements (CFS) are based on "agreed upon procedures". In order to reduce the administrative burden on the beneficiaries, the requirements for the number of cost claims for which a certificate had to be submitted were reduced, so that it is estimated that 80% of the transactions for which an audit certificate was needed in FP6 would no longer require an audit certificate (CFS) in FP7. In addition to strengthen the simplification process, ex-ante systems of certification were introduced[7]: two new types of ex-ante certificates on the methodology may be submitted: the Certificate on Average Personnel Costs (CoMAv) and the Certificate on the Methodology for Personnel and Indirect Costs (CoM). The acceptability of the methodology certificates is decided by an inter-service JAC Committee, after a desk review carried out by DG INFSO.

On 24 January 2011, the Commission adopted a decision on additional measures for the simplification of the research framework programme. This decision puts forward simplification measures, including more flexible acceptability criteria for the use of average personnel cost methodologies and the removal of the obligation to submit a CoMAv in the case of average personnel costs, which becomes optional.

Fraud prevention and detection

DG INFSO was the first to develop a comprehensive Anti-Fraud Control Strategy that addresses the main risks and that was also used as reference and later triggered the development of anti-fraud strategies of the other research DGs. RCS exchange information and experiences with respect to fraud prevention and detection in the context of the FAIR committee.

DG INFSO has developed the PLUTO database to carry out advanced data searches for fraud detection purposes.

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[7] AAR on external audits 2010 p7

2.1.3.   Key Figures

Key figures ex-post audits DG INFSO (31.12.2010)

<u>Source: Ex-post unit 02</u>

| | Number of audits closed | Number of participations audited | EC share of the cost accepted by the Financial Officer (€) | EC share of the accumulated adjustments in favour of the EC | | | | |
				Amount (€)	Annual error rate %	Cumulative error rate %	Representative error rate %	Residual error rate %
FP5	1	1	NA	NA	NA			
FP6	74	171	54.236.360	5.379.310	4,4%*	3,94%*		2,22%
FP7	90	208	35.164.964	1.612.251	1,96%*	1,96%*		
Non Research	15	18	NA	NA	NA			
TOTAL	180	402						

* risk-based excluded

			cost level	cost level
FP5	1	1	292.469	292.469
Non Research	15	18	9.711.253	740.005

The key figures concerning the corrective mechanisms are the following:

Implementation of the ex-post audit results for FP7

| | | | | | Status of implementation | | | | |
| Results from external audits | | | | Implementation done | | | Ongoing | | |
Audit closing year	Audits Closed	Periods with adjustments in favour of the EC	Adjustments in favour of the EC €	Total implementation done €	Offset from payments €	Recoveries €	Waived or no financial impact* €	Forecast of revenues issued €	Forecast of revenues to be issue
2010	90	121	1.612.251	929.592	903.370	18.599	7.623	86.047	596.612
2009	6	1	23.607	23.607	23.607	0	0	0	0
TOTAL	96	122	1.635.858	953.199	926.977	18.599	7.623	86.047	596.612

Implementation of the ex-post audit results for FP6

				Status of implementation					
Results from external audits				Implementation done			Ongoing		
Audit closing year	Audits closed	Periods with adjustments in favour of the EC	Adjustments in favour of the EC €	Total implementation done €	Offset from payments €	Recoveries €	Waived or no financial impact* €	Forecast of revenues issued €	Forecast of revenues to be issue
2010	74	120	5.379.310	4.119.674	1.547.441	2.572.233	0	0	1.259.636
2009	180	307	17.614.761	16.807.142	7.816.048	8.923.437	67.657	0	807.619
2008	156	171	4.191.311	3.709.380	1.409.415	2.253.395	46.570	0	481.931
2007	54	85	1.516.196	1.516.196	979.143	485.020	52.033	0	0
2006	6	3	54.684	54.684	869	53.815	0	0	0
TOTAL	470	686	28.756.262	26.207.076	11.752.916	14.287.900	166.260	0	2.549.186

The key figures concerning the certificates on methodology are the following (source RTD, unit M2):

Type of certificate	Eligibility requests		Certificates				
	Submitted	Accepted	Submitted	Accepted	Rejected	Withdrawn	Pending
COM - Average personnel costs and indirect costs	114	70	23	7	9	2	5
COM - Real personnel costs and indirect costs			19	12	2	2	3
COMAv - Certificate Average personnel costs	NA		85	46	9	23	17
Total			127	65	20	27	15

2.2. Audit Findings and Recommendations

Ex-post audit activity

TITLE: COMMON AUDIT STRATEGY AND COORDINATION ISSUES	ACCEPT: Y
REPORT FINDING NUMBER: 1	PRIORITY: VI

AUDIT FINDING:

Coordination

• FP7 is managed by 8 Research Commission Services (RCS), each performing their own ex-post audits, selecting their own representative sample and sometimes auditing common beneficiaries. It is essential that there is good communication between the RCS and coordination of audit plans. The IAS notes that DG INFSO has made a number of proposals for improving coordination, particularly as regards the representative sample. However, although coordination mechanisms have been established between the RCS, these are not always effective in practice, due in part to the present accountability framework and are not always able to prevent planning "clashes". Given that many beneficiaries receive grants from different services, it is inevitable that some beneficiaries are being audited several times. As at March 2011, some 137 planning clashes were registered. It should be noted though that this includes all FPs, all types of audits and follow ups.

• The IAS notes that DG INFSO does not consider that these coordination problems have had a major impact so far on being able to derive representative error rates on a timely basis (the lack of a sufficiently critical mass to audit being cited as the main reason). However, looking more widely across the research domain as a whole, the IAS considers that there are indeed problems of coordination between the RCS and that the present governance structure may be a contributing factor.

Consistency of approach – error rates

• Reliable representative error rates are a key part of a sound control strategy and should be obtained as soon as possible in the programming period to shape and direct subsequent corrective work and provide assurance for the AAR declaration. These are not yet available because of problems of coordination/constraints and/or the need to have a critical mass of cost claims to sample. Each RCS selects a MUS representative sample of 161 cost claims. However, there is little alignment between them in terms of timing and number of samples with the result that representative error rates are only available at different times for comparative and assurance purposes. The lack of a representative error rate was one of the reasons for some of the RCS not making a reservation on FP7 in the 2010 AARs.

• In addition, the IAS identified some differences in the error rate calculation between the RDGs. The Residual Error rate (RE) calculation differs across the RCS. DGs RTD, MOVE and ENER calculate the RE based on all non-audited contracts for an audited beneficiary, DG INFSO calculates the RE based on all extrapolation cases for which a revised cost claim has been received and accepted. DG ENTR calculates the RE based on all extrapolation cases that have effectively been implemented.

Cost effectiveness

- The increased focus on obtaining a positive DAS for the research area, by reducing the errors in the cost claims submitted by beneficiaries to below the prevailing materiality threshold of 2% has placed more and more emphasis on ex-post audit to identify and correct errors in the cost claims. Indeed, the main action to deal with AAR reservations on the errors in FP6 has been to carry out even more audits to correct errors and "clean" the budget. Across the research domain generally, there is an increasing concern about the cost-effectiveness of continually increasing the audit effort in order to reduce further the error rate and the cost effectiveness of having multiple MUS samples across the RCS. Increased audit activity corresponds to an increased cost of control and an increased burden on beneficiaries at a time when the focus is on trying to simplify and ensure policy objectives are achieved. A request to the discharge authorities for a tolerable rate of error for the research family higher than the current 2% materiality threshold to alleviate the control burden has not yet been agreed.

Scope for improving the effective coordination of the combined ex-post audit activity

There are two areas which could have a major impact on resolving the present coordination problems and the ensuring cost effectiveness..

- Firstly, the adoption of a single materiality level, covering the representative sample for all the research family, in line with the guidelines concerning reservations in the AAR. Each RCS is accountable for its own spending and sets/reports its own materiality level (through individual DG/AOSD representative error rates) and hence a high number of claims to be checked, irrespective of the size of its budget and complexity of the operations it finances and despite there being a common overall audit strategy for the research policy area. DG RTD reported these cross cutting coordination risks to the Commission's horizontal services in January 2010 and SG and DG BUDG raised in turn the possibility of a single audit structure for the research family, to be discussed in the Research Task Force. Pending the outcome of these discussions, they recommended that coordination be strengthened within the RCS. The Research Task Force addressed the issue of a single audit service in its report of July 2010, but concluded that the current structure should be kept until a decision is taken during the preparation for the next framework programme.

- Secondly, a less radical step would be to have a single-sample system for providing assurance for all RCS. This was discussed in the Research Clearing Committee (RCC) as recently as 13 April 2011 and agreed as a priority because its absence presents a reputational risk for the Commission. It was then discussed in the CAR group May 2011, which concluded that the single sample system would have clear advantages and would be feasible, but would require further confirmation as to whether the system would be in line with the current accountability framework in the Commission. In this respect, one option would be to introduce a single declaration of assurance for all RCS together. The other option would be to maintain a system with separate declarations of assurance for each AOD. This was discussed in the RCC meeting as recently as 16 June 2011, including DG INFSO's alternative proposals.

- Neither of these issues is new. Both have been raised previously as possible solutions to dealing with the coordination and cost effectiveness problems noted. The IAS is very aware that the RCS do not all agree and that DG RTD is probably most affected, but its audit has confirmed that these problems do exist and need to be resolved.

CURRENT RISK - RATING: HIGH

Unless the current coordination problems experienced generally in the research area, are addressed, there is a risk that further inefficiencies will persist, as will a burden on auditees, without a proportionate increase in assurance, particularly when coupled with the increasing cost of ex-post controls.

AUDIT RECOMMENDATION NO 1:

In view of the coordination problems noted and increasing cost burden, the IAS considers there is scope for rationalisation of the ex-post audit approach in the research area and recommends the following:

DG INFSO should, in conjunction with the other RCS and horizontal services, appraise the costs, benefits and accountability implications of consolidating the control strategies for the research policy area. To avoid the inefficiencies caused by auditing separate representative samples by each DG, the aim should be to have a single representative sample for the research area as a whole, giving each service assurance based on a common level of materiality. To ensure that each RCS meets its own accountability and assurance needs, the central representative sample relating to each RCS could be augmented as necessary.

In addition, to address specific risks, each RCS should draw its own specific risk based sample. The planning of these audits should be centrally coordinated in order to avoid several audit visits to the same beneficiary.

This appraisal should include the options of a single audit service and of a 'control architect' to oversee the existing structure, responsible for coordination, overseeing the work of the external audit firms and the framework contract, allocation of responsibilities etc.

TITLE: DG INFSO AUDIT STRATEGY AND PLANNING	ACCEPT: Y
REPORT FINDING NUMBER: 2	PRIORITY: I

AUDIT FINDING:

Lack of a documented DG specific strategy

The FP6 and FP7 audit strategies define broad principles for the ex-post audit activities. DG INFSO has prepared a draft audit strategy for the non-research programmes from 2011 onward, but has not yet formalised its own audit strategy for both research and non research activities, tailored to its own specificities and which sets out:

- the rational for the existing balance between representative and risk based audits;

- details on the number of the samples to be drawn, when, and the coverage expected (per year or for the whole period);

- the result of the risk analysis and the decision to carry out risk based audits (level of risk covered, expected coverage in term of budget);

- KPIs for monitoring the performance of its audit activities and the quality of its deliverables such as timely delivery of audits, targets by strand (corrective vs representative), targets on the number of audits to be launched, etc.;

- planning prioritisation of and allocation of resources to the different types of audits and other activities of the unit, including horizontal tasks.

Gaps in the audit planning process

- The "Work plan" and "Audit plan 2011" documents do not sufficiently detail the annual planning of the audit activity with specific targets (by strand of audits or subcategory of the corrective strands for example), beneficiaries to be audited, capacity planning, deadlines for different tasks. The IAS acknowledges that DG INFSO follows a rolling forward planning approach for capacity planning which it considers to be more flexible and better suited to its circumstances, but considers that this could still allow tasks to be scheduled more evenly throughout the year, by auditor and could still incorporate the horizontal tasks. The IAS also notices that the planned auditor days/activities are not based on actual records as there is no method of recording time actually spent.

- For planning purpose, the risk assessment of the beneficiary population is based simply on the criterion "High Dependency on EU funds". Therefore, the overall risk assessment of the whole population is not sufficiently wide to prioritise audit planning.

Monitoring process and reporting on progress on audit work

- DG INFSO's audit monitoring tools do not yet include the quantitative indicators to facilitate monitoring of the progress of the audit plan. In addition, they do not allow the DG to follow up the financial implementation status of the audit results (e.g. amount of liquidated damages). This is performed based on a monthly report extracted from Phoenix. In addition, there is no monitoring of the actual time spent on audit activities compared to plan and aimed at helping to detect potential delays.

Execution of the audit plan in practice

- The number of audits closed by DG INFSO in recent years is significant and reflects the

priority attached to this work. However, despite this, it still takes a considerable time to close *individual* audits. DG INFSO has set a target of around 200 audits in total to be closed every year. The average time to close an audit was about 323 days for the outsourced audits and 310 for the in-house audits. However, the timing varies significantly for the different batches. For some early audits (BA 52, BA 59), requiring the resolution of complicated legal issues, it took between 600 and 700 days, while the latest batches in 2010 ranged from 210 to 270 days. For in-house audits, 106 were launched in 2010 and 31 closed by the end of the year. As at the 20th of June 2011, 41 audits had been closed. An ECA[9] review of a sample of 30 audit files found that the average time between the date of the audit and the letter of conclusion exceeds 10 months.

- For the audits performed by the EAF, certain milestones are defined in the audit manual and/or the framework agreement with the EAF. However, there are no such milestones for in-house audits to help monitor progress and prioritise resources. Coupled with the considerable time it sometimes takes to request additional information or confirm findings with auditees, this contributes to the long closure times.

CURRENT RISK - RATING: MEDIUM

The lack of a formal annual planning/strategy document, coupled with the gaps in the audit planning process, needs to be seen in conjunction with the absence of a quality assurance and improvement programme noted in Audit Finding Number 4. For an already established audit service such as DG INFSO's, such gaps pose a risk to its reputation and credibility, particularly given that ex-post audits are such a key part of the overall control strategy.

More specifically, without these key elements in place and in particular the absence of key milestones for in-house audits, there is a risk to the continued effective management of the function and to the delivery of the planned assurances.

AUDIT RECOMMENDATION NO 2:

DG INFSO should define its DG specific audit strategy, within the framework of the common RCS FP7 audit strategy, taking into account all its activities.

In addition the IAS considers that the planning documents could be improved by, for example:

- setting specific targets, prioritization setting and audit coverage targets;

- formalising criteria/procedure for allocating audits per year and per sample to reach the targets as defined in the common audit strategy;

- setting internal milestones, together with KPIs, for completing the different steps in the audit process (e.g. time between mission and requesting additional information to the beneficiary, between the mission and the draft report, between the draft report and the letter of conclusion, etc.) and ensure that these are effectively monitored in practice;

- reducing the time necessary to conduct and close audits;

- formalising and apply risk-based criteria upfront when the overall annual planning is prepared (including audit certificates in the criteria);

- strengthening the process by formal approval by management.

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[9] PF 4330

TITLE: ERROR RATES	ACCEPT: Y
REPORT FINDING NUMBER: 3	PRIORITY: I

AUDIT FINDING:

- In its 2010 AAR DG INFSO reported that the cumulative residual error rate for FP6 (2.2%) is close to the materiality level and expected to fall below 2% in the course of 2011, once all ongoing audits are closed and all initiated extrapolation exercises have been completed. Although the number of audits related to FP7 closed on statistically representative transactions was not significant enough to allow a reliable estimation of the detected error rate, DG INFSO considers that the current error levels experienced in closed FP7 audits do not appear to exceed those noted in FP6.

- Currently the Residual Error rate for FP6 is calculated based on the representative error rate, and the potential effect of the correction of all errors in audited amounts and of systematic errors on the non-audited amounts of audited beneficiaries. It assumes that all errors detected in audited amounts are also corrected or will be corrected and that all non-audited amounts of audited beneficiaries are free from systematic errors, either because there are no systematic errors detected, or systematic errors will be recovered through the extrapolation procedure.

- It should be noted that calculation of residual error differs between the RCS. DGs RTD, MOVE and ENER calculate the residual error based on all non-audited contracts for an audited beneficiary, DG INFSO calculates it based on all extrapolation cases for which a revised cost claim has been received and accepted and DG ENTR calculates it based on all extrapolation cases that have effectively been implemented.

- The systematic error rate calculation used by DG INFSO is different from the one used by DG RTD (see also Report Finding No 1). DG RTD calculates the systematic error rate by calculating the ratio between the sum of all negative systemic errors (EC share) and the sum of all negative systematic and non-systematic errors (EC share) identified in the representative sample. DG INFSO calculates the systematic error rate by netting positive and negative systematic errors (EC share), and calculating the ratio between the sum of the resulting net negative systematic errors (EC share) identified in the representative sample for which extrapolation has been initiated and the total amount of audited population.

CURRENT RISK - RATING: MEDIUM

The reporting of error rates is particularly sensitive in view of the objective to obtain a positive DAS. Consequently, inconsistencies in approach between the RCS can pose a risk to the perceived reliability of these rates amongst key stakeholders/external users.

AUDIT RECOMMENDATION NO 3:

DG INFSO should coordinate with the other RCS and the central services to bring more consistency to the reporting of error rates for the research area as a whole. In addition, there should be an agreement on whether adjustments should be reported at the level of cost claims or audit participations and the reporting systems adapted accordingly.

TITLE: CONTINUOUS QUALITY IMPROVEMENT OF THE AUDIT FUNCTION	ACCEPT: Y
REPORT FINDING NUMBER: 4	**PRIORITY: I**

AUDIT FINDING:

DG INFSO has put in place a number of procedures to ensure the quality of the audit activity, both concerning audits managed in-house and audits performed by the External Audit Firms (EAF). These arrangements include inter alia the review of audit files, draft and final reports, supervision in periodical meetings, use of audit manuals, checklists, standard templates, definition of the scope of work, use of audit manuals and reporting and supervision arrangements for the audits carried out by the EAFs.

DG INFSO also has a quality improvement practices in place with regular internal training sessions for auditors and monthly technical meeting to update the audit staff with the most recent guidelines and interpretations. The IAS acknowledges the audit process is constantly under review and discussed in the CAR meetings, during the MASR with the external auditors and workshops. Audit procedures are reviewed and refined, particularly in the area of risk based audits. In addition, DG INFSO closely monitors the work of the EAFs during joint missions.

However, these measures have not yet been translated into a proper quality assurance and improvement programme, which, given that the audit function has been operational for several years, could bring it to the next level of maturity and strengthen existing procedures and credibility. Areas where the current approach could be improved include:

- Definition of the audit standards the DG intends to comply with[10];

- The need for an audit charter or equivalent document which clearly addresses issues such as the purpose, authority, responsibility, position within the organisation and independence;

- Conducting periodic internal reviews through self-assessments or peer reviews;

- Being externally and independently assessed to assess compliance with standards and identify improvements;

- Appropriate and effective arrangements for relying on the work of other auditors, which are in line with recognised auditing standards. The ECA has reached similar conclusion in its preliminary findings on its work on the research area ex-post audit functions, carried out in the framework of the DAS 2010.

CURRENT RISK - RATING: MEDIUM

The absence of a quality assurance and improvement programme needs to be seen in conjunction with the gaps in the planning process identified in Audit Finding No 2. DG INFSO already has a well established audit function and to formally embrace such quality aspects should allow it to move to the next stage of maturity and demonstrate a very clear commitment to maintaining high standards. Failure to do so could pose a risk to its reputation and credibility, particularly given the importance of the function in the overall control strategy.

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[10] Although on some specific points, the APH refers to standards issued by the International Federation of Accountants (IFAC) or the American Institute of Certified Public Accountants (AICPA)

AUDIT RECOMMENDATION NO 4:

DG INFSO should develop a comprehensive quality assurance and improvement programme. Recognising the established nature of the DG's audit function, the components of this programme should be left to the DG to decide. However, the IAS recommends consideration be given to:

- Clearly defining the international audit standards it should comply with;

- The need for an audit charter or equivalent document which defines the purpose, authority, responsibility and position;

- Developing appropriate KPIs to monitor performance and quality;

- Periodic internal assessments of the audit function by means of self-assessments and/or peer reviews;

- Periodic external quality assessments in order to evaluate the quality of the audit activities and its compliance with the international audit standards;

- Additional procedures for increasing quality assurance for relying on the audit conclusions of the EAFs;

- Strengthen the arrangements in place for the supervision of audit files and ensure the respect of internal procedures for documenting audits;

- Further development of the auditor training programme and encouraging auditors to obtain an audit certification.

Corrective Mechanisms

TITLE: CORRECTIVE MECHANISMS (EXTRAPOLATION, SANCTIONS AND PENALTIES)	
	ACCEPT: Y
REPORT FINDING NUMBER: 5	PRIORITY: I

AUDIT FINDING:

Corrective mechanisms are a key component of the control strategy and extrapolation is the main tool for cleaning the budget from systematic errors. A common IT tool (SAR-EAR) was developed to support the process and in 2010, DG INFSO strengthened the reporting, monitoring and follow-up procedures for implementing audit results. In addition, DG INFSO is very actively using the Commission's EWS for flagging beneficiaries. The EWS is incorporated in the other IT tools and procedures used by the DG in the project managing cycle (for example at negotiation stage and in the financial units before validation of payments, etc).

Delays in issuing guidelines

Audit adjustments and extrapolation measures are already established procedures, but the finalised guidance on FP6 was only issued in February 2009 while guidance for FP7 has yet to be issued. The ECA has also found that the guidance is not complete, highlighting the risk that the definition of systematic errors may be misinterpreted. DG INFSO considers that due to the specific nature of each particular case any such guidance can only be very general.

In addition, although recommended in a previous IAS audit[11], guidance on the application of financial penalties and sanctions has yet to be issued. However, the IAS notes that DG INFSO has produced guidance on liquidated damages and has systematically applied this process since April 2009.

Extrapolation process

Extrapolation is a long, complex and very resource intensive process. As at mid June 2011, 2,600 DG INFSO participations have been identified as potentially subject to extrapolation, relating to 1,388 DG INFSO projects. For 1,221 (47%) of those, DG INFSO is the lead DG for the extrapolation (for most of the remaining it is DG RTD).

As at end of June 2011, 436 extrapolation cases had been closed (correction implemented) in favour of the Commission representing 5,7M€. For only 26 participations, the extrapolation process was considered to be not applicable and for 83 no decision is yet taken.

As at 9 June 2011 the average time since the start of the 1713 on-going cases amounted to 664 days. Of the open cases, 1380 (i.e. 81%) have been open for more than a year, 892 (52%) more than 2 years and 202 (12%) more than 3 years. For FP6 audits, the average time from initiation of the extrapolation in SAR-EAR to its final implementation (being it netting off in the next payment, recovery, etc) is 372 days and the average time from initiation in SAR - EAR to implementation date in Phoenix is 273. For FP7 audits, very few extrapolations have been made so far, with the average time taken being 180 and 150 days respectively.

A large number of different parties is involved in the extrapolation process. In addition, the

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[11] DG INFSO's Internal Control System for managing the 7th Framework Programme – Design" dated 29-05-09

process is essentially a voluntary one, as beneficiaries cannot be forced to cooperate. The IAS noted that the approach for updating SAR-EAR is not consistent across the DGs. As at 31.05.2011 only 28 cases out of 131 DG INFSO files are closed in SAR-EAR whilst in Phoenix, for 103 cases extrapolation have been implemented.

EWS

The IAS notes that DG INSFO is one of the lead DGs in using the EWS. However, the guidance issued in May 2010 on the use of EWS lacks defined criteria to support decision to flag beneficiaries and for selecting the level of flag. In its testing, the IAS noted a lack of audit trail to support changes to the status of certain beneficiaries in the database.

Liquidated damages

Although systematically applied, the procedures for applying the liquidated damages are not clearly understood by all users and there have been technical problems with the underlying IT systems, which have prevented the process from being completed in practice. In certain cases the procedures have had to be re-launched. A monitoring tool has been developed aimed at alerting possible breakdowns in the workflow process, but the process is not actually subject to any specific monitoring aimed at ensuring the completeness of the i-flows launched/implemented.

CURRENT RISK - RATING: MEDIUM

Delays in issuing guidelines means there is a risk that incorrect procedures could be applied, which may serve only to further delay what are already long corrective processes.

AUDIT RECOMMENDATION NO 5:

DG INFSO should ensure the relevant and clear guidelines are available on time.

When using EWS, DG INFSO should set appropriate indicators to flag beneficiaries. Updates to status should be properly documented.

In applying liquidated damages, DG INFSO should ensure the completeness of the i-flows launched/implemented.

Audit certificates

TITLE: AUDIT CERTIFICATES	ACCEPT: Y
REPORT FINDING NUMBER: 6	PRIORITY: I

The system of audit certificates introduced in FP6 has been modified by an audit certificate system based on "agreed upon procedures" and the requirements for the number of cost claims for which a certificate had to be submitted were reduced to reduce the administrative burden. In addition, two new types of ex-ante certificates on the methodology which may be submitted prior to the costs being claimed have been introduced: the Certificate on Average Personnel Costs (CoMAv) and the Certificate on the Methodology for Personnel and Indirect Costs (CoM). The acceptability of the methodology certificates is decided by an inter-service Joint Assessment Committee (JAC), after a desk review at the DGs.

AUDIT FINDING:

Low take-up rates of the certificates on methodology

- Take up rates for both types have been very low. Initial estimates of the potential number of CoMAv were about 5000, and for all RCS only 46 have been accepted to date. Initial estimates for CoM were about 700, but only 19 have been accepted (for DG INFSO as at end of 2010 only 8 participating beneficiaries were certified) The main reasons given for the low take up of CoMAv are the strict acceptability criteria for average personnel cost methodologies and their late adoption, and the restrictive eligibility criteria for the CoM, implying that only a limited number of larger beneficiaries are eligible. The take-up of the CoM /CoMAv system has been significantly below expectations. Previously, CoMAv was compulsory for average personnel costs, but after simplification it became optional. The incentive for the beneficiaries to apply for a CoMAv is low. Furthermore, SMEs' owner managers and physical persons have to use flat rates now and are not allowed to use average personnel costs anymore. Hence, the take up probably will not increase significantly. Similarly, the take up for CoM unlikely to increase significantly either.

- The IAS notes that as part of the January 2011 Commission decision on additional simplification measures more flexible acceptability criteria were introduced.

- The FP7 audit strategy includes very little on the link, if any, between the audit certification process and the control strategy more generally. However, it does impact on the controls exercised in practice (although for the overall control strategy this impact is limited in view of the low take-up of the CoM/CoMAv), leading for example to a reduced audit scope (i.e. focus on compliance with the approved methodology) where a CoM or CoMAv has been accepted. However, the audit certification process in general (including Cost Financial Statements) is not used to drive/influence the risk-based selection of audits with the risk of a potential disconnect between the ex-ante audit and ex-post part of the control strategy. The impact on audit strategy and the controls process is not clearly stated, neither in DG INFSO's own strategy, nor in the overall FP7 strategy.

Monitoring effectiveness of the audit certificates system

- At present, DG INFSO has no real assurance on whether the audit certification system is working as intended. In fact, in the framework of the DAS 2010, the ECA identified that 27 out of 33 cost claims examined (which were accompanied by an audit certificate) still contained errors and 14 were assessed as serious. Nine cost claims with errors and 3 with

serious errors concern FP7[12]. Although a desk review is made by operational units, there are no on-the-spot audits on cost claims supported by audit certificates to check whether the process actually works in practice. It should be noted that certificates have been submitted since the beginning of 2009, to date, efforts to assess in a timely manner, the reliability of the audit certification system (CFS, CoM, CoMAv) under FP7 are still at an early stage, pending the build up of a critical mass to examine. The IAS was informed after the end of the fieldwork that an analysis of the reliability of CFS is currently ongoing comprising about 70 audited CFS.

CURRENT RISK - RATING: MEDIUM

The audit certificates process was intended to be an important part of the overall control strategy for the research area. Unless the process is effectively monitored and assessed there is a risk that DG INFSO will not be in a position to adjust and refine that control strategy accordingly. Risks may not be properly addressed and assurances may be compromised and scarce control resources used inefficiently. However, the IAS acknowledges the need for there to be a critical mass to examine.

AUDIT RECOMMENDATION NO 6:

DG INFSO should, in cooperation with the other RCS, assess and monitor the reliability and effectiveness of the different elements which make up the overall system of audit certificates (CFS, CoM, CoMAv). The results should be used to inform the control strategy and the preparation of the next framework programme.

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[12] PF-4350 (INFSO), PF-4351 (RTD)

Fraud Prevention and Detection

TITLE: FRAUD PREVENTION AND DETECTION ACCEPT: Y
REPORT FINDING NUMBER: 7   PRIORITY: I

AUDIT FINDING:

Good cooperation and initiatives

DG INFSO was the first among the RCS to issue its own Control and Anti-Fraud Strategy in March 2010. It is currently being updated to take account of recent anti-fraud initiatives and measures to improve the general control system. Significant efforts have been taken recently to refine methods and tools in the area of risk based audits (development of a specific risk-based audit programme and a risk-based audit manual) in which aspect the DG plays the leading role among the RCS. The investigations into fraudulent networks, undertaken in close collaboration with OLAF, are widely seen as major achievements in the fight against fraud. DG INFSO has also undertaken additional work in the refinement of the approach for risk-based audits, in the use of new tools for data-mining and detection of plagiarism and in the establishment of guidelines for the ex-ante control.

DG INFSO is strongly committed to promoting and supporting ethical values and principles and to raise awareness of staff as regards irregularities and fraud. In 2009, it organised specific ethics awareness sessions for senior and middle managers and for other staff. It also published a guide on ethics and integrity, has a dedicated ethics mailbox, appointed ethics correspondents in the Resource Directorate and has a specific ethics page on its intranet. Training on ethics is mandatory for all newcomers. Fraud awareness training is also provided to staff on detecting anomalies in projects.

DG INFSO has made significant efforts to improve ex-ante preventive, detective and corrective controls for mitigating the risk of fraud. Guidelines have been published, for example, on the use of EWS, negotiation and payment, the termination of FP7 Grant Agreements, etc, to help operational staff in applying anti-fraud measures. Also, guidance has been issued on handling exceptions at different stages of the project to help detective controls and fraud indicators and red flags were published to help operational staff detect anomalies.

Common fraud prevention and detection strategy

The IAS notes that the RCS exchange information and experiences with respect to fraud prevention and detection in the context of the FAIR committee. The analysis[13] of detected fraud cases indicates that fraud schemes, red flags and preventive and detective measures are largely common to the RCS. However, despite the fact that all RCS work under the same legal framework for the management of the research framework programmes, have essentially the same processes, control systems and guidance material for the selection, management and funding of similar projects, and have largely common beneficiaries, **there is no common fraud strategy for the research area as a whole.** The recently adopted Commission Communication on the Commission's anti-fraud strategy recommends that, where applicable, implementation should be based on specific **sectoral anti-fraud strategies.** In addition,

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[13] "Compendium of anonymised cases – Research", OLAF

despite the fact that DG INFSO has developed in cooperation with OLAF and uses the PLUTO tool for more that 2 years now, DG RTD developed CHARON database independently and/or there is no link between PLUTO and CHARON.

Ex-ante anti-fraud measures

The IAS recognises the efforts made by the ex-post audit unit to the improvement of ex-ante controls, but noted some areas for improvement as follows;

- the tool for detecting plagiarism, developed by DG INFSO's external audit unit, is not systematically used as it is not technically possible to compare all pairs of documents found in the PPM database. The external audit unit is currently investigating technical plagiarism detection solutions and will be pilot testing with selected project officers;

- despite being perceived as very effective detective and preventive mechanisms, on-the-spot technical reviews have been significantly reduced, mainly as a result of simplification measures and budget limitations;

- although financial/project officers perform additional ex-ante checks not provided for in the regulation to obtain assurances before payment, these are not disseminated across the different units in DG INFSO, nor formalised in any manual of procedures;

- despite improved measures for detecting and preventing fraud, progress on the detection of double funding is lagging behind mainly because of the lack of integrated IT tools/databases across the RCS. Some checks are made by certain POs, but these are very limited in practice.

Fraud Risk Assessment

DG INFSO plans to build upon the initiative already made with OLAF by attempting jointly to identify more risk indicators through testing algorithms on the whole database of beneficiaries.

Fraud risk assessment is clearly integrated into every audit and is embedded in the risk-based selection. However, fraud risk assessment is not currently integrated into overall planning to the extent it could be. Fraud risk was actually assessed in the annual High Level Risk Assessment as low.

CURRENT RISK - RATING: MEDIUM

Without the common steer of an overall sectoral fraud strategy (and where DG INFSO can clearly play a major role in view of its innovative action so far), there is a risk that the RCS might fail to identify, prevent and detect significant and common fraud risks. This could have a major reputational impact, particularly given generally well-perceived anti-fraud efforts already made in key areas of the research domain.

The specific anti-fraud measures taken already by DG INFSO are welcomed, but the lack of specific fraud prevention and detection checks coupled with decreased in-depth/on the spot ex-ante controls on key areas in the ex-ante control processes may lead to fraud not being prevented or detected.

AUDIT RECOMMENDATION NO 7:

- Looking forward, and building upon its own best practices, which have been recognised by OLAF and the ECA, DG INFSO should work with the other RCS to develop a common

fraud strategy for the research area as a whole.

- In the light of the current update of DG INFSO's Anti-fraud Strategy, specific actions should be considered to disseminate the documents and better communicate the respective responsibilities as regards anti-fraud measures to operational staff.

- DG INFSO should consider providing the flexibility to PO for organising on the spot visits with the financial officer at sufficiently early stage of projects life cycle (for example the stage of the negotiation) on a case-by-case basis and should consider increasing the frequency and regularity of the on the spot project reviews during the implementation of the projects.

- DG INFSO should also assess the specific risk concerning double funding and ensure it is properly addressed through effective preventive and detective controls in all stages of the grant management process.

ANNEX 1: AUDIT METHODOLOGY

1. Audit Methodology

This audit engagement was conducted in conformance with the IAS Guidelines and Mutual Expectations Paper and the *International Standards for the Professional Practice of Internal Auditing.*

A letter announcing the audit on the Control strategy – On-the-spot controls was sent to DG INFSO on 8 October 2010. A letter announcing the inclusion of Fraud prevention and detection in the scope of the audit was sent to DG INFSO on 7 February 2011. The opening meeting to discuss mainly logistical and practical arrangements took place on 19 January 2011. Preliminary meetings to discuss the planning of the audit and the internal organisation of the DG INFSO, and to collect relevant information, were held with the designated DG INFSO contact person and representatives of the ex-unit 02 (currently unit S5). In addition, the IAS attended meetings organised by the ECA in the framework of the ongoing audits on the ex-post audit function and the ex-ante certification of costing methodologies. The kick-off meeting with the Director-General of DG INFSO and DG RTD took place on 10 March 2011.

The preliminary survey was conducted in order to gain an insight into the design and management of the processes and activities concerned and identify the specific objectives and scope of the audit. It involved the review of relevant information, a synthesis of previous audit work and meetings with DG INFSO's staff.

Audit programmes and interview checklists for key relevant personnel were developed to evaluate the adequacy of the internal control system and risk management processes of the items mentioned in the scope. Interviews were carried out with staff in units 02 (currently unit S5) and a selection of operational and administrative and financial units. These interviews, together with supporting documents and relevant information obtained from the auditee formed the basis for the evaluation of the adequacy of the internal control systems.

Following the evaluation of the adequacy of the internal control system, tests of transactions were performed in order to verify the application in practice of the strong internal controls. The testing has been performed on the basis of a judgemental sample of 6 audits to understand the processes of ex-post audit and resulting corrective actions (including extrapolation, recoveries and liquidated damages).

The IAS organised a formal validation meeting with the auditee on 30 June 2011. A "Findings Validation Table" (consisting of findings and indicating risks, draft recommendations and ratings) was issued by the IAS one week prior to the meeting.

2. Follow-Up

In accordance with the IAS's follow-up policy, an audit follow-up engagement is planned to be conducted within one year from the issuing of the final report.