

ANNUAL REPORT ON THE ACTIVITIES
FUNDED BY THE SEVENTH, EIGHTH
AND NINTH EUROPEAN DEVELOPMENT
FUNDS (EDFS)

(2008/C 286/02)

**Annual Report on the activities funded by the seventh, eighth and ninth
European Development Funds (EDFs)**

TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	1-5
Chapter I — Implementation of the seventh, eighth and ninth EDFs	6-13
Financial implementation	6-11
The Commission's annual report on the financial management of the EDFs	12-13
Chapter II — Statement of Assurance by the Court of Auditors on the EDFs	14-56
Statement of Assurance by the Court of Auditors on the seventh, eighth and ninth European Development Funds (EDFs) for the financial year 2007	I-XI
Information in support of the Statement of Assurance	14-50
Scope and nature of the audit	14-15
Reliability of the accounts	16-18
Legality and regularity of the underlying transactions	19-50
Conclusions and recommendations	51-56

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

INTRODUCTION

1. The European Development Funds (EDFs) are the result of international conventions or agreements ⁽¹⁾ between the Community and its Member States, of the one part, and certain African, Caribbean and Pacific (ACP) States, of the other part, and of Council Decisions on the association of overseas countries and territories (OCT).

1.-5. *The EDF is in effect the EU's main development aid instrument for the ACP countries. Although the Commission agrees with the Court's opinion on a number of points, we would like to point out the high risks associated with management of the EDF in view of:*

- *the significant volume of funds implemented,*
- *the weak administrations in certain partner countries,*
- *the numerous serious problems in most of the beneficiary countries, including weak governance.*

In view of these factors, the Commission has established a control strategy at different levels comprising the use of supervisors and auditors and controls not only by the contracting authorities but also directly by the Commission's delegations and central services.

This control strategy must of course take account of a risk analysis and also a cost/benefit ratio. The Commission considers that the provisions it has established are effective and that they meet the criteria established. Based on the remarks of the Court, but also on its own experience, the Commission has fine-tuned this strategy in recent years and will continue to do so in future.

The Court's report should be read in the light of the environment in which the Commission is obliged to operate and the risk inherent in this type of activity should be taken into account.

2. The Commission has responsibility for and takes charge of the management of most of the expenditure of the EDFs. The EDF's investment facility has been fully managed by the European Investment Bank ⁽²⁾ (EIB) since 1 April 2003. This facility is not covered by the Court's Statement of Assurance or the European Parliament's discharge procedure ⁽³⁾ ⁽⁴⁾.

⁽¹⁾ The Yaoundé I Convention dates back to 1964. The most recent agreement (Cotonou) dates from 23 June 2000 and was revised in Luxembourg on 25 June 2005.

⁽²⁾ Thus, under the ninth EDF, the initial allocation amounted to 13 800 million euro, of which the EIB is responsible for 2 200 million euro.

⁽³⁾ See Articles 96, 103 and 112 of the Financial Regulation of 27 March 2003 applicable to the ninth EDF (OJ L 83, 1.4.2003, p. 1). In its Opinion No 12/2002 on the proposal for this Regulation (OJ C 12, 17.1.2003), the Court stressed that these provisions reduce the scope of the European Parliament's powers of discharge.

⁽⁴⁾ A tripartite agreement between the EIB, the Commission and the Court (Article 112 of the Financial Regulation of 27 March 2003 applicable to the ninth EDF referred to above) sets out rules for the audit of these operations by the Court.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

3. Once programming is complete, EDF resources are mobilised in two stages. The Commission makes the financing decision (shown in the accounts as financial commitments) following receipt of a request from an ACP State. The Commission and the ACP State then lay down the rules for the implementation of these decisions by the National Authorising Officer (NAO) of the country concerned within the framework of a financing agreement or directly by the Commission. The NAO concludes contracts (shown in the accounts as individual legal commitments) and authorises payments, which will be checked and executed by the Commission.

4. Budget support is not subject to this system of management. Financing agreements constitute legal commitments and give rise to payments without any individual legal commitments being entered into. Once the Commission has checked that the conditions of the Cotonou Agreement and the financing agreement have been met, it makes an initial transfer of funds to the budget of the recipient country. Once transferred, these funds merge with the budget of the ACP State, where they are used and audited in accordance with the laws and procedures of the recipient country. The Commission, jointly with other main international donors, assesses both the improvements made to the management of public finances in these countries and the results in terms of poverty reduction. Before making subsequent disbursements, the Commission checks that the conditions laid down in the financing agreement have been met.

5. Within the Commission, most of the EDF programmes are managed by the EuropeAid Co-operation Office (hereafter called EuropeAid). A small proportion of the EDF projects ⁽⁵⁾ relates to humanitarian aid and is managed by the Directorate-General for Humanitarian Aid (DG ECHO).

CHAPTER I — IMPLEMENTATION OF THE SEVENTH, EIGHTH AND NINTH EDFs

Financial implementation

6. Following the closure of the sixth EDF in 2006, the seventh, eighth and ninth EDFs were implemented simultaneously in 2007. It is projected that the seventh EDF will be closed in 2008.

7. Total contributions received in 2007 from the Member States amounted to 2 679 million euro, including 39 million euro voluntary contributions to the African Peace Facility in the framework of Intra ACP cooperation ⁽⁶⁾. During the year, the Commission started calling up contributions under the ninth EDF as those due under the eighth EDF were fully exhausted.

6.-8. *In line with the Monterrey and Paris declarations, in 2007 the Commission continued its efforts to step up aid and make it more effective. 2007, like 2006, was a very successful year for implementation of the EDFs. Once again, there was a record level of contracts and payments made, a substantial reduction in old and 'dormant' commitments and progress towards the final closure of the 7th EDF. The objective for the end of 2007 was to commit all the 9th EDF appropriations, resulting in EUR 15,9 billion being implemented for 2003-2007, i.e. 100 % of the funds under the 9th EDF. This is the highest level ever in the history of the EDF.*

⁽⁵⁾ Representing 0,8 % of the 2007 payments.

⁽⁶⁾ Decision No. 2/2007 of the ACP-EC Council of Ministers of 25 May 2007 (OJ L 175, 5.7.2007, p. 35).

THE COURT'S OBSERVATIONS

8. The tenth EDF will be committed in the period from 2008 to 2013; it provides for Community aid to ACP countries for 21 966 million euro which represents a 62 % increase compared with the financial allocations of the ninth EDF.

9. **Tables 1 and 2** show the cumulative use of EDF resources managed by the Commission and the financial implementation. **Charts I and II** show the cumulative resources and decisions by sector of intervention. In May 2005, the Council decided that funds from the ninth EDF had to be committed before 31 December 2007 (7). In line with this so called 'sunset clause', virtually all funds under the ninth EDF had been committed by that date. This was achieved by the significant increase of 16,7 % of global commitments which amounted to 3 172 million euro. Net payments increased by 4,1 % and reached 2 874 million euro which is slightly lower than the initial target due to cash flow restraints at the end of the year.

10. As a result of this, outstanding payments increased from 10 281 million euro at the end of 2006 to 10 579 million euro at the end of 2007. Of total outstanding payments, 903 million euro relates to funds committed more than five years ago. Global commitments for which no individual legal commitments or payments have been made in the last two years decreased however significantly to 100 million euro at year-end. The implementation rate, as measured by the ratio of total unspent funds to annual payments, remained stable at 3,7 years.

THE COMMISSION'S REPLIES

As regards quality, in 2006 the Commission introduced total coverage by the Quality Support Group of all EDF financing proposals in the identification and assessment phases. This practice was also applied in 2007.

The Commission will continue its efforts to improve even further the implementation of the EDF and will continue to follow up the Court's recommendations in this connection.

The 10th EDF allocation of EUR 21 966 million (operational credits for the ACP, excluding the Overseas Countries Territories (OCTs)) covers a six-year period, against a five-year period for the 9th EDF (initial amount, without taking into account the transfer of the balances of the previous EDFs — see point 9 —, of EUR 13 500 million). For the sake of comparison, funds should be annualised, in which case the nominal increase is reduced to 35,6 %.

9. *This is the first time ever that an entire EDF has been committed before the entry into force of the next EDF. When the 9th EDF entered into force in April 2003, almost 2 billions EUR remained uncommitted under the 8th EDF.*

10. *The Commission's performance was exceptional in 2007. Payments increased significantly by 12 %, commitments increased by 9 % and the increase in outstanding commitments was kept down to 2,8 %.*

The implementation rate of 3,7 years corresponds to the average project implementation period.

(7) Decision 2005/446/EC of the Representatives of the Governments of the Member States meeting within the Council (OJ L 156, 18.6.2005, p. 19), as amended by Decision 2007/792/EC of 26 November 2007 (OJ L 320, 6.12.2007, p. 31).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

11. The sector of social infrastructure, including education, health, water and basic sanitation, was the principal recipient of EU aid with 852 million euro (31 % of total payments) in 2007, followed by the transport, communication and energy sector with 799 million euro (28 %). Total payments made in the area of commodity aid and general programme assistance, including food aid and food security equalled 557 million euro, of which 455 million euro (16 % of total payments) had been spent by means of general budget support programmes. Aid implementation continued to involve close cooperation with UN organisations and the World Bank (306,5 million euro, i.e. 10,7 % of payments).

The Commission's annual report on the financial management of the EDFs

12. The Financial Regulation applicable to the ninth EDF ⁽⁸⁾ requires the Commission to report each year on the financial management of the EDFs. The Court carried out a review of this report to assess whether it fairly describes the achievement of objectives, the financial situation and the events that had a significant influence on the year's activities. The review included the verification of the accuracy of the financial data presented and the follow-up of observations made previously by the Court and recommendations made by the discharge authority.

13. In the Court's opinion, the report on the financial management presents an accurate description of the achievement of the objectives for the financial year, the financial situation and the events that had a significant influence on the activities carried out in 2007. However, the summary of the Commission's follow-up to observations by the Court does not provide, in a number of cases, sufficient information on the actions taken or planned; the Court presents its analysis of the situation in **table 4**. Moreover, the information provided by the ACP States with respect to the use of Stabex funds ⁽⁹⁾ and bank balances of accounts held at banks within the ACP States remains unreliable due to the complexity of the measure and the limited control by EuropeAid which is aware of this and intended to initiate audits of the Stabex funds in all ACP countries concerned in 2007. However, audits were carried out in only four out of the 38 beneficiary countries.

13. *The Commission attaches the greatest importance to the Court's recommendations, which have all been followed up. The Commission considers that, overall, satisfactory action has been undertaken with regard to the Court's recommendations but will provide more detailed information in the future.*

Although not required under the provisions of Article 212 of the Lomé IV Convention, the Commission decided to reinforce the control of Stabex funds, by performing audits. Out of a total of 38 beneficiary countries, 10 did not register any movement of those funds in 2007, and 14 were subject to audits concerning either the reliability of the Stabex Accounts (eight countries) or projects financed through Stabex funds (six countries).

⁽⁸⁾ Articles 96 and 102.

⁽⁹⁾ The financial importance of the Stabex programme is decreasing as the measure is being phased out. At end-2007, about 100 million euro remained at security accounts held in Europe under the sole control of the Commission compared to 192 million euro at end-2006. The Commission's target is that these funds are to be paid by 31 December 2010 provided that all disbursement conditions have been fulfilled.

CHAPTER II — STATEMENT OF ASSURANCE BY THE COURT OF AUDITORS ON THE EDFs

Statement of Assurance by the Court of Auditors on the seventh, eighth and ninth European Development Funds (EDFs) for the financial year 2007

- I. Pursuant to the provisions of Article 248 of the Treaty the Court has audited
- (a) the 'Final annual accounts for the financial year 2007 of the 7th, 8th and 9th European Development Funds' which comprise the consolidated financial statements ⁽¹⁰⁾ and the consolidated report on the financial implementation of the seventh, eighth and ninth EDFs; and
 - (b) the legality and regularity of the underlying transactions within the legal framework of the EDFs in respect of the part of the EDF resources for whose financial management the Commission is responsible ⁽¹¹⁾.

Management's responsibility

- II. In accordance with the Financial Regulations applicable to the seventh, eighth and ninth EDFs, management ⁽¹²⁾ is responsible for the preparation and fair presentation of the final annual accounts of the EDFs and the legality and regularity of the underlying transactions:
- (a) The management's responsibility concerning the final annual accounts of the EDFs includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, selecting and applying appropriate accounting policies, on the basis of the accounting rules adopted by the EDF accounting officer ⁽¹³⁾, and making accounting estimates that are reasonable in the circumstances. The Commission approves the final annual accounts of the EDFs.

⁽¹⁰⁾ The consolidated financial statements comprise the balance sheet, the statement of economic outturn, the statement of cash flow and the table of items payable to the European Development Funds. The financial statements and information supplied by the EIB are not covered by this Statement of Assurance (see footnote 11).

⁽¹¹⁾ Pursuant to Articles 1 and 103(3) of the Financial Regulation applicable to the ninth EDF, the Statement of Assurance does not extend to the part of the ninth EDF resources that is managed by the EIB and for which it is responsible.

⁽¹²⁾ At the level of the Commission management includes the Members of the Institution, Authorising Officers by delegation and sub-delegation, the Accounting Officer and the leading staff of financial, audit or control units. At the level of Beneficiary States, management includes National Authorising Officers, Accounting Officers, Paying Agents and the leading staff of implementing organisations.

⁽¹³⁾ The accounting rules adopted by the EDF accounting officer are derived from International Public Sector Accounting Standards (IPSAS) issued by the International Federation of Accountants or, in their absence, International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. In accordance with the Financial Regulation, the 'Consolidated financial statements' for the financial year 2007 are prepared on the basis of these accounting rules adopted by the EDF accounting officer, which adapt accruals based accounting principles to the specific environment of the Communities, while the consolidated reports on implementation of the EDFs continue to be primarily based on movements of cash.

- (b) The way in which management exercises its responsibility for legality and regularity of underlying transactions depends on the method of implementation of the EDFs. In the case of direct centralised management, implementation tasks are performed by the Commission's departments. Under decentralised management implementation tasks are delegated to third countries and under indirect centralised management to other bodies. In the case of joint management, implementation tasks are shared between the Commission and international organisations. Implementation tasks have to comply with the principle of sound financial management, requiring designing, implementing and maintaining effective and efficient internal control including adequate supervision and appropriate measures to prevent irregularities and fraud and, if necessary, legal proceedings to recover funds wrongly paid or used. Regardless of the method of implementation applied, the Commission bears the ultimate responsibility for the legality and regularity of the transactions underlying the accounts of the EDFs.

Auditor's responsibility

III. The Court's responsibility is to provide, on the basis of its audit, the European Parliament and the Council with a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions. The Court conducted its audit in accordance with the IFAC and INTOSAI International Auditing Standards and Codes of Ethics, in so far as these are applicable in the EDF context. These standards require that the Court plans and performs the audit to obtain reasonable assurance whether the final annual accounts of the EDFs are free from material misstatement and the underlying transactions, taken as a whole, are legal and regular.

IV. In the context described under paragraph III, an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the final consolidated accounts and the legality and the regularity of the underlying transactions. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the final consolidated accounts and of material non-compliance of the underlying transactions with the requirements of the legal framework of the EDFs, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the preparation and fair presentation of the final consolidated accounts, and supervisory and control systems implemented to ensure legality and regularity of underlying transactions, in order to design audit procedures that are appropriate in the circumstances. An audit in this context also includes evaluating the appropriateness of accounting policies used and reasonableness of accounting estimates made, as well as evaluating the overall presentation of the final consolidated accounts and the annual activity reports.

V. The Court considers that the audit evidence obtained is sufficient and appropriate to provide a basis for its statement of assurance.

Opinion on the reliability of the accounts

VI. In the Court's opinion, the final annual accounts of the seventh, eighth and ninth EDFs present fairly, in all material respects, the financial position of the EDFs as of 31 December 2007, and the results of their operations and cash flows for the year then ended, in accordance with the provisions of the Financial Regulation and the accounting rules adopted by the accounting officer.

VII. Without qualifying the opinion expressed in paragraph VI, the Court draws attention to the fact that the validity of the assumptions used for the estimate of the provision for costs incurred has not been demonstrated by the Commission and that they may lead to an understatement of accrued expenditure, as well as to an overstatement of the amount of guarantees disclosed in the notes to the financial statements.

Opinion on the legality and regularity of the underlying transactions

VIII. In the Court's opinion, except for the effects of the matter described in paragraph IX, the transactions underlying the revenue and commitments for the financial year are, taken as a whole, legal and regular.

IX. The Court's audit revealed a material level of errors affecting transactions underlying payments.

X. Without calling into question the opinion expressed in paragraph VIII, the Court draws attention to the high fiduciary risk with regard to budget support resulting from the Commission's 'dynamic interpretation' of the eligibility criteria, which does not provide for countries to meet minimum standard of credible management of public finances before budget support is undertaken.

XI. The Court notes the improvements introduced by the Commission as regards its supervisory and control systems but underlines the need to continue to pursue efforts to clarify certain important elements of the overall control strategy and improve the design and/or implementation of certain systems.

18 September 2008

Vitor Manuel da SILVA CALDEIRA
President

European Court of Auditors
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THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Information in support of the Statement of Assurance***Scope and nature of the audit***

14. The aim of the work on the reliability of the accounts of the EDFs is to obtain appropriate sufficient evidence to conclude on the extent to which all revenue, expenditure, assets and liabilities have been properly registered and that the annual accounts faithfully reflect the financial positions at the end of the year. The observations regarding the reliability of the accounts, set out in paragraphs VI and VII of the Statement of Assurance, are based on an audit of the consolidated financial statements⁽¹⁴⁾ and the consolidated report on the financial implementation of the seventh, eighth and ninth EDFs⁽¹⁵⁾. The audit comprised an appropriate range of audit procedures designed to examine, on a test basis, evidence relating to the amounts and disclosures. It included an assessment of the accounting principles used, significant estimates made by management and the overall presentation of the consolidated accounts.

15. The observations regarding the legality and regularity of the underlying transactions, set out in paragraphs VIII to XI of the Statement of Assurance, are based on:

- (a) an evaluation of the supervisory and control systems at EuropeAid's central services and in five Delegations (Ghana, Guinea Bissau, Niger, Madagascar and Sudan) covering six countries;
- (b) an examination in each Delegation visited of a statistically selected sample of transactions covering all domains except budget support. A total of 90 payments and 15 individual legal commitments were audited;
- (c) for budget support, an examination of 30 payments and 15 financial commitments statistically selected. This selection represents 46,0 % and 62,1 % of total budget support payments and financial commitments respectively. The examination consisted of a desk review and, for 8 payments, a further analysis in four of the countries visited (Ghana, Guinea-Bissau, Niger and Madagascar);
- (d) an examination of 30 statistically selected payments authorised by EuropeAid's central services;

⁽¹⁴⁾ See Article 100 of the Financial Regulation of 27 March 2003 applicable to the ninth EDF: the financial statements shall comprise the balance sheet, the statement of economic outturn, the statement of cash flow, and the table of items payable to the EDF.

⁽¹⁵⁾ See Article 101 of the Financial Regulation of 27 March 2003 applicable to the ninth EDF: the reports on financial implementation shall comprise tables describing the appropriations, the commitments and the payments.

THE COURT'S OBSERVATIONS

- (e) an examination of 30 statistically selected transactions already checked *ex-post* by EuropeAid's central services;
- (f) an examination of 30 statistically selected financial commitments;
- (g) an examination of the Annual Activity Report and the declaration by the Director-General of EuropeAid and the procedure for preparing them.

Reliability of the accounts

16. As the Court already noted in its Annual Report on the EDF concerning the financial year 2006 ⁽¹⁶⁾, the accounting system used for the EDF does not have all the features necessary for efficient and effective reporting of economic information on an accruals basis. Consequently, the transformation of cash-based data into accrual-based annual accounts for the EDF requires extensive manual processing which increases the risk of error. Moreover, the financial impact of variations in currency exchange rates cannot be identified separately by the accounting system nor can it be extracted manually ⁽¹⁷⁾. The integration of the EDF into the accounting system already used by the Commission to account for budgetary expenditure was originally scheduled for 2006 but, due to technical difficulties, has been postponed on several occasions and is now planned for the start of 2009.

17. The annual accounts contain a provision for the costs incurred in the reporting period but for which no invoices have been received at the year-end. This provision is statistically estimated on a number of assumptions and amounts to 2 087 million euro, or 83 % of total liabilities. As the Court observed in its Annual Report on the EDF concerning the financial year 2006 ⁽¹⁸⁾, the validity of the assumption concerning the linearity of project expenditure has not been demonstrated by the Commission. The Court's analysis ⁽¹⁹⁾ indicates that the method used by EuropeAid may lead to an understatement of accrued expenditure. It is however not possible to quantify the impact on the consolidated balance sheet at the end of 2007.

⁽¹⁶⁾ Paragraph 15 (OJ C 259, 31.10.2007).

⁽¹⁷⁾ Its disclosure is required by IPSAS 4 — The Effects of Changes in Foreign Exchange Rates.

⁽¹⁸⁾ Paragraph 17.

⁽¹⁹⁾ As insufficient information was available relating to the situation at the end of 2007, the Court examined the validity of the method by checking the provision as at 31 December 2006 for a sample of 60 individual contracts statistically selected and relating to 18 projects in 13 ACP countries.

THE COMMISSION'S REPLIES

16. *The introduction of the new accounting system as from 2009 will overcome current limitations. The manual processing is subject to rigorous controls in order to reduce risks. The current accounting system of the EDF does not provide for the identification of the financial impact of variations in currency exchange rates, but nevertheless the net result for the financial year 2007 includes the gains and losses due to exchange rate differences.*

Moreover only 9 % of payments are executed in currencies subject to exchange rate fluctuations. Therefore, the Commission does not consider these potential exchange differences to be material in relation to the accounts as a whole.

17. *In 2007 the Commission further fine-tuned and improved its approach to calculating the provision by applying a specific implementation rate to each type of contract (grants, construction work, services and supplies).*

An individual analysis of each contract (there are around 8 000 ongoing contracts) would give rise to a disproportionate workload with respect to the mathematical approach currently used. The Commission plans to launch a study in order to reinforce the criteria used in this approach.

THE COURT'S OBSERVATIONS

18. The amount of guarantees disclosed in note 1.4 to the financial statements was 1 004 million euro as at the end of 2007. The Court found that this amount is overstated by 4,1 %.

Legality and regularity of the underlying transactions**Substantive testing of transactions****Project Commitments**

19. The Cotonou Agreement ⁽²⁰⁾ requires that financing agreements between the Commission and the ACP State or States concerned are drawn up within 60 days of the Commission's decision. The Court's audit revealed that a significant number of financing agreements (eight out of 30 Commission decisions examined) were not signed by the recipient country within this time limit.

20. Frequent errors (five errors affecting four out of the 15 individual legal commitments checked) were found concerning the legally prescribed bank guarantees in support of tenders and contracts. In the case of one individual legal commitment, a derogation to tendering rules was given although the legal condition allowing this was not fulfilled.

Project Payments

21. Out of eleven payments to UN organisations selected, the legality and regularity of two payments could not be fully audited because the Court could not obtain the underlying documentation from the UN organisations concerned ⁽²¹⁾. Therefore, the Court cannot conclude on the legality and regularity of these transactions. Furthermore, the Court draws attention to the fact that the audit of the other UN transactions was hampered by inadequate cooperation by the UN organisations and was eventually made possible only thanks to timely intervention by the Commission.

THE COMMISSION'S REPLIES

18. In 2007 the Commission made significant efforts to reinforce the quality of the information recorded in the accounting system. During the annual closure of accounts, additional verifications and corrections were made in order to establish the annual accounts. As a result, the impact on the annual accounts is very slight and is not considered to be significant.

19. The Commission and the recipient countries have not breached the 60-day rule laid down in the Cotonou Agreement, since this rule concerns the drawing up and not the signing of the financing agreements. The deadline for signing financing agreements is 31 December of year $n + 1$, year n being the year in which the Commission's financial commitment was adopted (Article 54(2) of the Financial Regulation applicable to the 9th EDF). The Commission follows the diligent practice of not only drawing up but also signing almost all financing agreements within 60 days of its decision.

20. The Commission considers that there is no financial risk since no payments are made before receipt of the bank guarantee.

With regard to the derogation, the Commission considers that it was justified on the grounds of extreme urgency.

21. The Commission fully supports the Court's request for obtaining from UN organisations necessary supporting evidence, and this principle is clearly stipulated in the FAFA. As soon as the Commission was informed by the Court of difficulties encountered in this respect, it approached its counterparts at the UN in order to find a solution and to ensure that the Court received the information required.

⁽²⁰⁾ Article 17, paragraph 2, of Annex 4.

⁽²¹⁾ United Nations Population Fund and United Nations Development Programme.

THE COURT'S OBSERVATIONS

22. The Court's audit of payments authorised by Delegations and EuropeAid's central services revealed a material level of error (27 errors affecting 24 out of 120 transactions examined) affecting the amount of the underlying transactions audited. Most of these errors are serious ⁽²²⁾ and mainly concern:

- the eligibility of the expenditure, such as payments made outside the permitted period, payment of VAT, payment in excess of the allowed budget and payment of types of expenditure not provided for by the contract (17 errors affecting 15 out of the 120 transactions examined);
- prefinancing cleared although expenditure had not yet been incurred (six errors affecting six out of the 120 transactions examined);
- payments of improper sums as a result of calculation errors, payment for quantities declared that did not correspond to reality and technical requirements for works not respected (three errors affecting three out of the 120 transactions examined).

23. Most of the errors should have been prevented or detected and corrected by the authorising officers before clearances of pre-financing or payments were authorised. Other errors are explained by inadequate controls carried out by supervisors or auditors. This indicates weaknesses in the supervisory and control systems (see paragraphs 32 to 47). While audits planned by the Commission might detect and correct some errors, the level of residual error is likely to remain material (see paragraph 39).

24. The Court's audit also revealed other recurring errors that may have an impact on the amount of the underlying transactions, mainly concerning legally prescribed bank guarantees and tender and contracting requirements (16 errors affecting 15 out of the 120 transactions examined). Errors which do not have an impact on the amount of the underlying transactions have also been identified, such as premature payments, the lack of visibility given to the EDF's financial support and expenditure allocated to the wrong programme estimate (six errors affecting six out of the 120 transactions examined).

THE COMMISSION'S REPLIES

22. *The control system established by the Commission to verify the legality and regularity of the expenditure is based on the work of external auditors and supervisors and on internal controls. The Commission is aware that this system entails a certain residual risk of error. However, since it is impossible to verify all the transactions given the costs involved in such control measures, the Commission will continue to improve its system based on a cost/effectiveness ratio providing reasonable assurance.*

23. *Most of the cases referred to relate either to payments made on the basis of an auditors' report and cost statements drawn up by the contracting authority, or clearances of advances that can subsequently be corrected.*

24. *Two cases relate to extensions of guarantees covering contracts being performed. There was therefore no residual risk. In all the other cases, the guarantees were provided after the contract had been signed, but no payment was made before receipt of the guarantees. There was therefore no financial risk.*

In April 2008 the Commission published a manual on the visibility of the EU for external actions.

⁽²²⁾ For the Court, errors are classified as 'serious' if their rate exceeds 2 %.

THE COURT'S OBSERVATIONS

Budget support commitments

25. The Cotonou Agreement states that direct budgetary assistance (budget support) shall be granted where public expenditure management is sufficiently transparent, accountable and effective⁽²³⁾. The Commission interprets this condition dynamically⁽²⁴⁾. In its view, the weaknesses affecting public finance management at the time of the financing decision do not preclude the launch of a budget aid programme, provided that the will for reform exists and the reforms planned are deemed to be satisfactory. The European Parliament has questioned the Commission's 'dynamic interpretation' of the eligibility criteria for budget support and stated that budget support should only be undertaken in countries that already meet a minimum standard of credible management of public finances⁽²⁵⁾.

26. The Court's audit showed that in five out of the 15 commitments examined⁽²⁶⁾, budget support is provided to ACP States where the requirements of the Cotonou Agreement for public expenditure management to be sufficiently transparent, accountable and effective are not met. The Court found serious weaknesses in the internal oversight of the budget, accounting systems, public procurement or anti-corruption measures. Important matters of concern are the failure to produce timely audited accounts and the ineffectiveness of external control which, as the Court has already underlined, are essential to demonstrate transparency and accountability. Providing budget support in these conditions implies a very high fiduciary risk. In its Annual Report on the

THE COMMISSION'S REPLIES

25. The Commission is aware that the 'dynamic interpretation' approach has been questioned by the European Parliament in its review of the follow-up to the 2006 discharge recommendations, as noted in the Court's observations. Nevertheless, the Commission continues to consider that this approach is useful and appropriate on a country-by-country basis as it allows the Commission to better support improvements in Public Finance Management (PFM) systems and in so doing enhances the overall development impact of budget support for the beneficiary. Apart from being methodologically difficult, establishing ex-ante benchmarks applicable to all countries would reduce the Commission's capacity to support PFM reforms both where such benchmarks would not be met as well as where they would be met. The Commission's approach, therefore, focuses on a comprehensive diagnostic review using the Public Expenditure and Financial Accountability (PEFA) methodology, the need for a credible and relevant reform strategy and the monitoring of its satisfactory implementation. Thus, as most other donors (including the Bretton Woods Institutions), the EC uses the initial PFM diagnostic as the baseline against which progress is benchmarked in the implementation of the reform strategy. Whilst the Commission acknowledges that its assessments of PFM reform progress need to be more structured and formalised, it notes that the increasing evidence produced, as more PEFA assessments become available, will allow it to better inform its assessment of a country position and its pace of progress. Finally, the Commission recalls that eligibility is verified throughout all programme phases and that in the particular case of countries in fragile situations, the Commission manages the ensuing risks by typically requiring the existence of an International Monetary Funds (IMF) programme addressing basic issues such as cash management and treasury control.

26. The Commission does not agree with the Court's assessment regarding the four countries in question. As indicated in paragraph 25, all commitments in those States in fragile situations mentioned by the Court were made following an evaluation of sufficient positive progress in PFM systems, backed by IMF assessments. The countries concerned have subsequently continued to show progress in PFM and have remained on track for further budget support.

The Commission did not understand the Court's recommendation as a request to set minimum standards applicable to all countries and, as outlined in paragraph 25, does not consider it appropriate. During 2007, the Commission continued to apply the dynamic approach, which it considers the appropriate one.

⁽²³⁾ Article 61(2)(a).

⁽²⁴⁾ See paragraphs 28 and 29 of Special Report No 2/2005 concerning EDF budget aid to ACP countries (OJ C 249, 7.10.2005).

⁽²⁵⁾ European Parliament report of 22 April 2008 on discharge in respect of the implementation of the budget for the Sixth, Seventh, Eighth and Ninth European Development Funds for the financial year 2006, point 32.

⁽²⁶⁾ The 5 commitments relate to Burundi, Central African Republic, Guinea-Bissau and Haiti. Budget support commitments for these countries in 2007 amount to 83,7 million euro i.e. 24,9 % of budget support commitments.

Anti-corruption measures are analysed in the context of Financing Agreements (FAs) and monitored in the framework of Delegations' PFM Annual Reports.

THE COURT'S OBSERVATIONS

EDF concerning the financial year 2006 ⁽²⁷⁾, the Court recommended that compliance with the Cotonou Agreement should be benchmarked against baseline requirements. This recommendation has not been acted upon.

27. In several cases (seven out of 33 financing agreements examined), provisions of the financing agreements for budget support were incomplete or unclear; they did not contain the general conditions for budget support, or ambiguously defined the method for the calculation of the amounts for disbursement; or referred to commitments made by government without defining a due date and the consequences when these commitments are not met.

Budget support payments

28. The Court's audit of budget support payments revealed a material level of error (four errors affecting four out of 30 payments examined) affecting the amount of the underlying transactions audited. The cases identified concern calculations of amounts for disbursement based on a positive conclusion as regards progress in public finance management which is not consistent with the underlying assessment of the situation and the use of a calculation method not provided for by the Financing Agreement. In three other cases, payments were made without up-to-date reports concerning public finance management being available. This implies a risk that eligibility conditions were not met.

THE COMMISSION'S REPLIES

27. *The Commission invokes the legal application of the Cotonou Agreement in all its FAs and assessments of tranche releases. The Commission nevertheless recognises that it is preferable that the eligibility criteria are explicitly mentioned in financing agreements and the general conditions therein, in line with the Guidelines on the Programming, Design and Management of GBS (General Budget Support). The Commission will therefore seek to further improve the quality of financing agreements under the 10th EDF. On the establishment of dates for the assessment of disbursement conditions, the timing included in the FA is only indicative.*

28. *In each of the four cases cited by the Court, the Commission sought to arrive at an informed decision based on a reasoned interpretation of the provisions of the respective Financing Agreements.*

In two out of the three cases (Botswana and Namibia) reports concerning the PFM situation were available in accordance with the guidelines on GBS, and eligibility was demonstrated. In the case of New Caledonia (2007BS-EE16) the commitments referred to by the Court are accompanying measures and not conditions for disbursement.

⁽²⁷⁾ Paragraph 55.

THE COURT'S OBSERVATIONS

29. In a significant number of cases (six out of 30 payments examined), the Commission did not demonstrate in a structured and formalised way whether the payment conditions relating to public finance management were respected. Situations encountered include assessments of progress being unreasonably optimistic or based on outdated or inappropriate information, conclusions not supported by the underlying information, reliance put on future occurrences rather than on events that had taken place and the inaccurate appraisal of indicators.

Activity Report by the Director-General of EuropeAid

30. The activity report by the Director-General of EuropeAid presents the policy achievements, the management performance of the services and the main results of the controls. The report also reflects the Commission's follow-up of recommendations made by the Court of Auditors, the Internal Audit Service (IAS) and the Internal Audit Capability (IAC) of EuropeAid.

31. The activity report includes specific indicators concerning legality and regularity ⁽²⁸⁾. The indicators do not however include financial information such as coverage of audits, error rates detected by the various controls, the amount of recovery orders issued and the amounts actually recovered. It is therefore unclear on what basis the Director-General of EuropeAid declared that he had obtained reasonable assurance that the control procedures put in place gave the necessary guarantees concerning the legality and regularity of the underlying transactions. The Court's audit revealed a material level of error and weaknesses in the supervisory and control systems.

THE COMMISSION'S REPLIES

29. *The Commission agrees that it is necessary to demonstrate in a structured and formalised way that payment conditions related to PFM are respected.*

The primary tool used by the Commission to assess a PFM system is the PEFA assessment, which is complemented by other information on the most recent progress in PFM reforms (often in concert with other development partners).

When making a payment, the Commission will base the decision on all the available information. In addition, Delegations are required to submit an Annual PFM Report, providing information on recent and planned reforms. Nevertheless, the Commission agrees that for some of the payments cited, Delegations could have been more explicit about the information they used to make their assessments.

As regards the observation related to being unreasonably optimistic in making assessments, the Commission takes into account PFM progress being made, the credible and relevant commitment to future reforms, the results of dialogue with partner countries and development partners, and the provision of complementary assistance. Thus, the Commission balances the progress made, the political commitment to reform and the remaining areas of concern to arrive at an informed decision.

31. *EuropeAid's AAR 2007 and its annexes included legality and regularity indicators as for instance the results of ex-post controls and the implementation of the Annual Audit Plans. Results of recovery activities carried out by EuropeAid services as well as of other controls were available to the Director General.*

The reasonable assurance of the Director General is not derived in a mechanical way from one single indicator. The declaration is based on the appreciation of a number of elements, including: regular management supervision activities, results of regular assessments of the functioning of the internal controls, regular reporting from the Authorising Officers by sub-delegation, implementation of the action plans stemming from the recommendations of the different control bodies, results of ex-post controls.

⁽²⁸⁾ EuropeAid Annual Activity Report 2007, p. 57.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Supervisory and control systems***Overall control strategy***

32. Following the Commission's Action Plan towards an Integrated Internal Control Framework and the Court's recommendation ⁽²⁹⁾ regarding the establishment of EuropeAid's overall control strategy, the description of the key management and control systems has been developed in internal control templates included in the activity report by the Director-General of EuropeAid. Whilst this constitutes significant progress, it does not contain yet important elements such as key indicators supporting the level of assurance to be obtained, the coverage of some controls and the coordination between *ex-ante* and *ex-post* controls.

33. The number of Commission staff compared to the funds committed is decreasing ⁽³⁰⁾. In addition, no significant increase of staff is foreseen despite the forecasted substantial increase of commitments under the 10th EDF. Whilst it is, of course, legitimate to assure an efficient use of human resources, there is a risk that shortage or inadequate distribution of staff or unavailability of specific skills and knowledge has an impact on the quality of the controls, verifications and monitoring. Concerns in this respect have been expressed by the European Parliament ⁽³¹⁾. In addition, the increase of budget support within the EDF creates the need for specific skills and knowledge, and the Court notes that EuropeAid's Internal Audit Capability (IAC) has recommended that a human resources policy in relation to budget support is developed to incorporate objectives on numbers, skills and knowledge of budget support staff.

32. *EuropeAid is committed to improve the presentation of these elements of its control strategy.*

33. *The Commission agrees with the Court that adequate staffing, both in terms of number and skills, represents a challenge.*

⁽²⁹⁾ See Opinion No 2/2004 of the Court of Auditors of the European Communities on the 'single audit' model (and a proposal for a Community internal control framework) (OJ C 107, 30.4.2004), the Annual Report on the activities funded by the sixth, seventh, eighth, and ninth EDFs concerning the financial year 2005 (OJ C 263, 31.10.2006, p. 205), paragraph 40, and the Annual Report on the activities funded by the sixth, seventh, eighth, and ninth EDFs concerning the financial year 2006, paragraph 54.

⁽³⁰⁾ 4,8 staff per 10 million euro committed in 2004 and 4,2 in 2007.

⁽³¹⁾ European Parliament resolution of 24 April 2007 with observations forming an integral part of the decision on the discharge for implementation of the budget of the Sixth, Seventh, Eighth and Ninth European Development Funds for the financial year 2005 (OJ C 74 E, 20.3.2008) and European Parliament resolution of 22 April 2008 with observations forming an integral part of the decision on the discharge for implementation of the budget of the Seventh, Eighth and Ninth European Development Funds for the financial year 2006.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Implementing organisations

34. The Court found that small entities which manage programme estimates ⁽³²⁾, and beneficiaries of grant agreements are often characterised by weak internal control systems. These entities, for instance, often have no appropriate accounting system to record project expenditure. In addition, the audits mandated by implementing organisations often fail to detect issues affecting the legality and regularity of transactions.

Supervisors

35. For important works, supply or service contracts, an external supervisor is designated to direct and/or monitor the execution of the contract. In some cases, the Court's audit has shown that the quality of the controls carried out by supervisors was inadequate which affected the legality and regularity of transactions.

ACP States

36. The Commission continued its efforts to increase the capacity of the National Authorising Officer (NAO) administrations by providing technical assistance, equipment and training in order to enable effective control of EDF expenditure by NAO administrations. Nevertheless, the lack of involvement by the ACP States in many cases means that Delegations can place only limited reliance on the controls performed by the NAO administrations, resulting in a heavier workload for Delegation staff to ensure the adequacy of controls.

Authorising officers in Delegations and central services of EuropeAid

37. The Court found weaknesses in the quality of some of the checks made by authorising officers, notably in relation to the authorisation of clearances of prefinancing and the scrutiny of documentation justifying expenditure, including the work and results of auditors, as well as in the follow-up of audit findings. There is also an insufficient presence of Delegation staff in the field, for instance to monitor supervisors.

34. *To improve the quality of the internal control systems of the management units, the Commission has produced guides for them and provides regular training (in 22 countries in 2007). It is also studying the possibility of creating accounting and financial management tools for all users.*

Since February 2006, Terms of Reference concerning verification of expenditure have formed an integral part of grant agreements (Annex VII). The Terms of Reference strictly define the scope and methodology to be applied by the auditor authorised by the recipient organisation, and contribute to improving controls.

35. *The Commission has asked its Delegations to reinforce control of the work carried out by supervisors. It will examine the possibility of introducing a mechanism designed to ensure that the quality of the controls carried out by the supervisors meets the requirements concerning the legality and regularity of transactions, and to increase the effectiveness of the supervisory tasks.*

36. *The Commission is continuing its assistance and training drive. In 2007, 1 430 participants from 22 ACP countries received full training on the EDF's financial and contractual procedures.*

37. *To ensure compliance with the provisions of the Financial Regulation relating to the validation of expenditure by the authorising officer, the Commission uses standard financial circuits and control lists for each transaction performed, thereby contributing to the standardisation and quality of the transactions.*

The Commission will remind authorising officers of the principles of clearance of advances. With regard to the monitoring of audits, the authorising officers are careful to issue recovery orders whenever necessary.

⁽³²⁾ Public or semi-public agencies or departments of the State or States concerned or the legal person responsible for executing the operation.

THE COURT'S OBSERVATIONS

38. Audits of expenditure which are initiated by Delegations and EuropeAid's central services and entrusted to private audit firms are a key component of the Commission's supervisory and control systems and are designed to contribute to the provision of assurance over EDF expenditure.

39. The annual audit plan contains mandatory and risk based audits. Due to insufficient documentation on the risk analysis, there is a lack of clarity over the process by which the risk analysis is performed and whether this process is consistently performed by Delegations. The overall level of implementation of the annual audit plan, specifically at Delegations, is low, at 55 % of all audits planned being started within the year, the others being postponed or sometimes cancelled. This is partly due to the Delegations' limited capacity to organise and follow up audits. Furthermore, even when audits were launched, the cycle is a lengthy one with final reports being produced a significant amount of time after the expenditure has been incurred. Such weaknesses in the system may be to the detriment of the overall level of assurance available as compared with that which was planned.

40. The Commission has made an important step forward in the area of audits by issuing in October 2007 new terms of reference applicable to all audits. Though the effects of these have yet to be seen due to such recent implementation, there are positive signs that they should enable more consistent reporting from auditors, in particular with regard to the form of the audit opinion given and the materiality threshold which is applied.

Monitoring by the central services of EuropeAid

41. The main tool for monitoring the Delegations is the External Assistance Management Reports (EAMRs), six-monthly management reports prepared by the Delegations. They are a periodic information source which enables the devolved Delegations to send EuropeAid's central services the most important items of information on internal organisation, project implementation and external audits. Subsequently, EuropeAid's central services provide feedback to the Delegations. Issues regularly reported by Delegations concern the lack of capacity and resources at NAO administrations (see paragraph 36) and staff constraints (see paragraph 33).

THE COMMISSION'S REPLIES

39. *The process by which risk analysis is to be performed is clearly indicated in the Operational Guidelines for the Annual Audit Plan and Risk Analysis. The Commission agrees that the process of the documentation of the risk analysis should be reinforced.*

The Annual Audit Plan identifies the audits to be launched, which are generally linked to the verification of project expenditure. Some of these audits will be launched and received in the same year (n + 1) while some others in the following year (n + 2), depending on the pace of implementation of the project/programme and the audit process itself.

This results in adjustments to the initial plan, and each audit cancelled or postponed requires proper justification. This does not automatically imply that all the audits not started during the year are postponed. The implementation rate of the 2007 audit plan as results from such adjustments is 77 %. This is in line with previous years' plans, which have a life-cycle of 2 years.

Assurance is guaranteed by the fact that no payment subject to an audit is executed before receiving and taking into account the results of such an audit.

THE COURT'S OBSERVATIONS

42. There has been no centralised management information relating to the coverage and results of the audits initiated in 2007 by the Delegations. This means that the level of assurance that can be derived from these audits is much reduced compared with what could be obtained if a robust management information system were in place. An existing computerised tool, CRIS audit, has been modified in order to facilitate its use, which was made mandatory in January 2008. This recent implementation has not yet allowed for an assessment of its effectiveness but the signs that it will prove useful as a system for monitoring progress are positive. Certain refinements still need to be made to allow for the assessment of audit coverage of expenditure and the use of this system in collating, analysing and acting upon audit findings and recommendations to enable ongoing assessment of issues and to ensure that prompt and timely action is taken where necessary.

43. For years, audits mandated by EuropeAid's central services have been subject to rigorous control and a synthesis report is produced annually to collate information from these with a view to putting in place improvements to systems where necessary. A similar exercise was undertaken during 2007 to address the audits mandated by Delegations which represent the majority of audits. The approach to this is methodical and covers main areas of interest, such as adherence to the terms of reference. The report produced contained much factual information on numbers and classification of findings.

Verification by the central services of EuropeAid

44. Verifications by EuropeAid's central services include missions to verify the functioning of the Delegations' internal control systems, transactional *ex-post* controls and audits initiated by EuropeAid's central services.

45. In 2007, EuropeAid's central services carried out one monitoring mission to a Delegation consisting of an examination of the set-up and functioning of the supervisory and control systems. The mission was well designed and provided practical recommendations for improvements to control systems but this is the only mission of this kind that has taken place. In 2007 EuropeAid was developing a standardised methodology for these missions. In this process, two pilot missions were carried out during which priority was given to operational issues rather than the functioning of the supervisory and control systems.

THE COMMISSION'S REPLIES

42. *EuropeAid has developed appropriate tools to conduct audits while several mechanisms contribute to their quality control as well as to the consolidation and use of the systemic audit findings.*

The planning and follow-up of audit results are both ensured by the Delegations and Headquarters. No payment subject to an audit is authorised before receiving and taking into account the results of such audit. Results of previous audits are taken into account when establishing the Annual Audit Plan.

EuropeAid follows the implementation of the AAP at central level and, since 2005, has been performing a review of audit reports issued during the year. The objective of this review is to contribute to the monitoring of audit activity at Headquarters and in the Delegations and to further improve the audit system based, inter alia, on an analysis of the typology of audit findings.

45. *EuropeAid adopted a standardised methodology for these missions in March 2008.*

THE COURT'S OBSERVATIONS

46. EuropeAid's transactional *ex-post* control system provides an effective mechanism for the identification of errors affecting formal aspects of transactions but is less effective at identifying errors which have an impact upon the amount of the payment. As mentioned in the Annual Report concerning the financial year 2006, the transactional *ex-post* control can therefore make only a limited contribution to the overall assurance on systems and procedures, and the legality and regularity of the underlying transactions. The Court's review of a sample of transactions checked *ex-post* also revealed that these checks had in some cases not been appropriately documented, that some errors had not been detected and that findings were not always followed up in as timely a manner as they could have been.

47. Risk-based audits initiated by EuropeAid's central services identify a high level of error. The documentation of the risk analysis is not sufficient to demonstrate that EuropeAid has selected all high risk subjects for audit.

Internal audit

48. The principal objective of EuropeAid's IAC is to assess and evaluate the internal control system. The IAC performs its function effectively. The Court observes nevertheless that the risk analysis of the IAC does not sufficiently take account of EuropeAid's risk register and that the audit programme is not sufficiently flexible to adapt to modifications over time of the perceived risk. In 2007, the IAC completed audits on budget support, pool and trust funds; the identification process; selected internal control standards in selected Delegations and risk management in Delegations as well as a number of follow-up audits. The conclusions of the IAC are generally consistent with the Court's findings.

49. The Commission's Internal Audit Service (IAS) carried out an audit on *ex-post* control activities ⁽³³⁾ in EuropeAid. Its conclusions corroborate the Court's findings regarding the overall control strategy (see paragraph 32) and the planning and monitoring of audits (see paragraphs 38 and 42).

THE COMMISSION'S REPLIES

46. *Setting up a transactional ex-post control system and defining its characteristics are both based on an appreciation of residual risk and of the interaction with the other components of the control system. Ex-post transactional controls provide an additional layer of assurance for the appreciation of the elements which are subject to such control.*

This covers payments, recoveries and clearance of pre-financing transactions carried out by the Commission. The study of each transaction entails a systematic checking of the applicable contractual conditions.

The documentation requested for each type of transaction selected is clearly set out in the ex-post transactional control manual.

47. *The Commission agrees that the process of the documentation of the risk analysis should be reinforced.*

48. *The IAC risk analysis forms the basis for its own annual audit plan. In addition, the risks in EuropeAid's risk register are considered in relation to the impact they have on the area to be audited. While the IAC risk register might consider an area to be high risk that area might not appear in the audit plan for a particular year because the business process is not yet within the working practice of the DG or the management cycle for certain programmes. The IAC risk register is updated several times a year to take into account any evidence of changes to the risk environment of EuropeAid.*

49. *The IAS audit was carried out at a time when the control strategy was being prepared for formalisation. Its conclusions could not take into account the developments that occurred afterwards.*

⁽³³⁾ Transactional *ex-post* controls and financial audits.

THE COURT'S OBSERVATIONS

50. The IAS also performed a final follow-up audit on NGOs funding in EuropeAid and an audit of the eligibility of costs under the financial and administrative framework agreement (FAFA) with the United Nations. The latter confirmed that the design of the FAFA is appropriate, but also that the control mechanisms still need to be effectively and further implemented at both project and partner levels, for instance by strengthening controls on payments and ensuring an appropriate coverage of verification missions ⁽³⁴⁾.

Conclusions and recommendations

51. Based on its audit work, the Court concludes that EDF accounts for the financial year ending 31 December 2007 are, in all material respects, reliable but the Court draws attention to the observation in paragraph 17 concerning the provision for costs incurred.

52. Based on its audit work, the Court concludes that:

- (a) except for the effects of the matter described in paragraphs 19, 20 and 27, the transactions underlying the revenue and commitments of the EDFs are free from material error. Furthermore, the Court draws attention to the high fiduciary risk for the cases mentioned in paragraphs 25 and 26;
- (b) the transactions underlying the payments of the EDFs are affected by a material level of error.

53. The Court's assessment of the supervisory and control systems for the European Development Funds is that they are partially effective. **Table 3** gives an overview of the Court's assessment of EuropeAid's supervisory and control systems ⁽³⁵⁾.

THE COMMISSION'S REPLIES

50. *Significant progress has been made by EuropeAid since completion of the IAS audits carried out in 2006 and the beginning of 2007 on the FAFA:*

- *the formal analysis of the compliance of the UN agencies with the internationally recognised standards was conducted (97 % coverage),*
- *in line with the increase in the Commission's contributions to the UN, there was a significant increase in the number of UN verification missions (39 in 2007 compared with 7 in 2005-2006),*
- *the planning of these verifications is carried out annually,*
- *their results are consolidated,*
- *the Commission and the UN have signed common guidelines aimed at improving the quality of reporting.*

53. *Given the financial and human resources available to it, the Commission considers that it has set up control systems which provide reasonable assurance.*

⁽³⁴⁾ Annual report to the discharge Authority on internal audits carried out in 2007 (presented by the Commission (SEC(2008) 2361 final of 30.7.2008)).

⁽³⁵⁾ See chapter 8, External aid, development and enlargement, of the Annual Report of the Court of Auditors on the implementation of the budget concerning the financial year 2007 for an assessment of the supervisory and control systems of DG ECHO.

THE COURT'S OBSERVATIONS

54. EuropeAid has continued to remedy some shortcomings mentioned by the Court in its previous Annual Reports. EuropeAid has developed new terms of reference for audits and implemented a management information system, CRIS audit, relating to the coverage and results of the audits. The Court welcomes the efforts made by EuropeAid to develop a control strategy but there remains a lack of clarity as to the certain important elements, in particular concerning the coverage of some controls, the coordination between *ex-ante* and *ex-post* controls and key indicators supporting the overall assurance to be given by the Director General.

55. There is a need to continue to pursue efforts to improve the design and/or implementation of some systems. The following recommendations should be considered in this context:

- (a) EuropeAid's control strategy should include key indicators supporting the level of assurance to be given by the Director-General, the coverage of some controls, the coordination between *ex-ante* and *ex-post* controls, as well as the human resources required;
- (b) a review should be carried out to assess whether EuropeAid's central services and the Delegations have the level and type of human resources required to ensure the quality of controls;
- (c) the management of implementing organisations should be better supported. This should involve greater presence of Delegation staff in the field, supporting accounting systems and training especially for projects implemented by programme estimates;
- (d) checks performed by the Delegations before authorising payments should better scrutinise the payment requests and intensify the focus on the reality, eligibility and accuracy of the expenditure. The quality of the work performed by supervisors and auditors should be better monitored;
- (e) the implementation of CRIS Audit should allow monitoring of the audit coverage and the audit results. Qualitative information as to the recommendations made and the improvements which should be put in place to address the findings is vital to ensure that the ultimate objectives of commissioning audits are met;

THE COMMISSION'S REPLIES

54. *The Commission welcomes the Court's recognition of the continuous progress made during the previous years.*

55.

- (a) *EuropeAid is committed to improve the presentation of these elements of its control strategy.*
- (b) *The Commission agrees with the Court that adequate staffing, both in terms of number and skills, represents a challenge and is ready to carry out the review.*
- (c) *EuropeAid will develop several tools in order to improve the management of implementing organisations and will introduce new terms of reference for audits of new programme estimates.*
- (d) *To ensure compliance with the provisions of the Financial Regulation relating to the validation of expenditure by the authorising officer, the Commission uses standard financial circuits and control lists for each transaction performed, thereby contributing to the standardisation and quality of the transactions.*
- (e) *The entry into force of the new CRIS-Audit module on the 1 January 2008, by linking the amount of the contract to be audited to the audited amount, will facilitate the calculation of the audit coverage, as well as the analysis of audit findings, as per their typology.*

The Commission agrees with the Court's recommendation and yearly collates and analyses audit results with a view to learning lessons and to introducing appropriate improvements.

THE COURT'S OBSERVATIONS

- (f) transactional *ex-post* controls should include a better examination of supporting documentation to ensure that transactions are not affected by errors of eligibility and occurrence as well as to verify whether checks performed before the payment was authorised were adequate;
- (g) the standardised methodology for monitoring missions should be finalised and the number of such missions increased. The new methodology should maintain the focus on the examination of the set-up and functioning of the supervisory and control systems.

56. As regards budget support, the following recommendations should be considered:

- (a) compliance with the Cotonou Agreement should be benchmarked against baseline requirements, such as the availability of timely published and audited accounts, to be met before budget support is granted;
- (b) the performance indicators used should permit clear evidence of progress in public finance management to emerge where appropriate. This could be achieved by strengthening indicators which measure progress of results over time in combination with process indicators on the performance of one-off events;
- (c) in order to set out its conclusions as regards progress in public finance management in a structured manner, the Commission should ensure that the data used as a basis for disbursement decisions is reliable and should rely more on measurements of events that have already taken place than on predictions of future occurrences;
- (d) EuropeAid should ensure, before the start of a budget support programme, that there is a clear and complete assessment of the public finance management and that the recipient country has a credible and relevant reform programme to address all significant weaknesses over a foreseeable timetable;

THE COMMISSION'S REPLIES

- (f) *The Commission is continuously working to further improve its system and will pay specific attention to the issue of the detail of supporting documentation on programme estimates.*
- (g) *EuropeAid adopted a standardised methodology for these missions in March 2008 and the number of monitoring missions is planned to be increased.*

56.

- (a) *As stated in paragraph 25, as part of the dynamic approach, the Commission uses the initial PFM diagnostic and the programme of reform as the baseline against which progress is benchmarked on a country-by-country basis and considers the setting of common minimum standards to be uniformly applied for all countries as inappropriate.*
- (b) *Compared to other sectors, it is more difficult and complex to define result indicators for PFM. The Commission nevertheless favours the use of result indicators, where available, that measures the effect of reforms, but also uses process indicators and measures to monitor the progress in the implementation of reform programme.*
- (c) *When assessing eligibility, the Commission takes into account a balance between past performance and future commitments. At the same time, the Commission agrees that when assessing disbursements the emphasis should be placed on demonstrating achievements.*
- (d) *The Commission agrees that PFM systems need to be assessed before the provision of BS and the Commission prefers to carry out such an assessment within the PEFA framework. It is expected that in all countries receiving BS from the EDF, PEFA assessments will have taken place before the end of 2008. In most of cases, governments already have PFM reform programs in place which may have to be adapted according to the findings. In case new programs need to be drawn up, the Commission has to be convinced of the government's commitment to develop and implement required PFM reform measures, before BS is provided.*

THE COURT'S OBSERVATIONS

- (e) the quality of Financing Agreements should be improved by including general conditions in all cases, unambiguous stipulations and clear requirements for progress of public finance management;

- (f) a human resources policy should be developed on the basis of an analysis of the skills and knowledge needed in relation to the management of budget support in view of its increasing importance.

THE COMMISSION'S REPLIES

- (e) *The Commission will seek to ensure that FAs will include General Conditions and that the assessment of PFM eligibility will be carried out in a structured and formalised manner. Specific PFM performance indicators within variable tranches need to be clear and precise allowing to measure progress over time.*

- (f) *In addition to adapting personnel recruitment to the specific needs of BS programs, the responsible Commission services are carrying out a significant number of training courses for EC staff from Delegations and HQs, on specific issues related to BS (PFM, macro-economic, performance measurement, sector specific courses, etc.).*

Table 1 — Cumulative use of EDF resources managed by the Commission at 31 December 2007

(million euro)

	Situation at end of 2006		Budgetary implementation during the financial year 2007				Situation at end of 2007				
	Global amount	Implementation rate ⁽²⁾	7th EDF	8th EDF	9th EDF	Global amount	7th EDF	8th EDF	9th EDF	Global amount	Implementation rate ⁽²⁾
A — RESOURCES ⁽¹⁾	37 269,8		- 71,9	- 211,0	341,8	58,8	10 583,0	10 839,3	15 906,4	37 328,7	
B — USE ⁽³⁾											
1. Financial commitments	34 107,2	91,5 %	- 71,9	- 211,0	3 455,1	3 172,2	10 583,0	10 839,3	15 857,1	37 279,4	99,9 %
2. Individual legal commitments	28 699,1	77,0 %	- 5,5	35,0	3 317,3	3 346,9	10 517,2	10 484,6	11 044,2	32 046,0	85,8 %
3. Payments	23 826,0	63,9 %	96,7	483,4	2 293,9	2 874,0	10 340,8	9 605,5	6 753,7	26 700,0	71,5 %
C — OUTSTANDING PAYMENTS (B1-B3)	10 281,2	27,6 %					242,2	1 233,8	9 103,4	10 579,4	28,3 %
D — AVAILABLE BALANCE (A-B1)	3 162,6	8,5 %					0,0	0,0	49,3	49,3	0,1 %

⁽¹⁾ Initial allocations to the 7th, 8th and 9th EDFs, interest, sundry resources and transfers from previous EDFs.

⁽²⁾ As a percentage of resources.

⁽³⁾ 9th EDF amounts include Members states voluntary contributions to the African Peace facility (financial commitments: 39,1; individual legal commitments: 37,0; payments: 29,2).

Source: Court of Auditors, based on the EDF Reports on financial implementation and Financial statements at 31 December 2007.

Table 2 — Financial implementation in the financial years 2003-2007 inclusive

(million euro)

	2003	2004	2005	2006	2007
1. Financial commitments	3 395,8	2 375,2	3 035,1	2 718,7	3 172,2
2. Individual legal commitments	2 742,7	2 746,3	2 652,0	3 072,6	3 346,9
3. Payments	2 179,5	2 197,8	2 489,1	2 761,9	2 874,0

Source: Court of Auditors, based on the EDF Reports on financial implementation and Financial statements at 31 December 2007.

Table 3 — Assessment of supervisory and control systems

System concerned	Key internal control								Overall assessment	
	Controls performed before transactions are authorised	Monitoring missions		Ex-post controls	External audits			Internal audit		
		Quality	Quantity		Quality	Quantity/ implementation of the audit plan	Follow-up of individual audit findings/Effective recovery proce- dures			Overall monitor- ing by central services of audits commissioned by Delegations
Central services Europe-Aid	Effective	Effective	Not effective	Partially effective	Effective	Effective	Effective	Partially effective	Effective	Partially effective
Delegations	Partially effective	N/A	N/A	N/A	Partially effective	Partially effective	Effective	N/A	Effective	Partially effective

Legend:

	Effective
	Partially effective
	Not effective
N/A	Not applicable: does not apply or not assessed

Results of transaction testing

	Project payments	Budget aid payments
Sample estimate of the proportion of transactions affected by an error	30 %	30 %
Error rate	Above 5 %	Between 2 % and 5 %

Table 4 — Follow-up of key Statement of Assurance observations

	Court observation	Action taken	Court analysis	Commission reply
1.	<p>The control strategy should be established and made operational by the end of 2007. As already indicated by the Court, it should establish clear and consistent objectives, ensure coordination and set the type and intensity of checking. This should necessarily entail a balancing act between the costs of the various controls and the accompanying benefits, whilst taking account of the tolerable risk of errors in the underlying transactions. The control strategy should include a well-structured and documented risk analysis that formally involves the Delegations in a fully participative manner.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(a)).</p>	<p>EuropeAid has formalised its overall control strategy and included it in the activity report by the Director-General of EuropeAid. It presents a description of the control processes for each of the various management modes. There remains a lack of clarity as to certain important elements of the control strategy, in particular the coverage of some controls, the coordination between <i>ex-ante</i> and <i>ex-post</i> controls and key indicators supporting the overall assurance to be given by the Director General.</p>	<p>EuropeAid's control strategy should include key indicators supporting the level of assurance to be given by the Director-General, the coverage of some controls, the coordination between <i>ex-ante</i> and <i>ex-post</i> controls, as well as the human resources required (Annual Report concerning the financial year 2007, paragraph 55(a)).</p>	<p><i>EuropeAid is committed to further improving the presentation of these elements of its control strategy.</i></p>
2.	<p>The management of projects financed by work programmes should be better supported. This should involve greater presence of Delegation staff in the field supporting accounting systems and training. Carrying out more audits at an early stage of the implementation of projects would also help to monitor and, where necessary, improve the quality of the control systems implemented by beneficiaries.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(b)).</p>	<p>EuropeAid has pursued its efforts to improve the quality of projects managed in the form of programme estimates. To that end, it has produced a new practical guide and specific training courses are held regularly in the ACP countries.</p>	<p>The management of implementing organisations should be better supported. This should involve greater presence of Delegation staff in the field, supporting accounting systems and training especially for projects implemented by programme estimates. (Annual Report concerning the financial year 2007, paragraph 55(c)).</p>	<p><i>EuropeAid will develop several tools in order to improve the management of implementing organisations and will introduce new terms of reference for audits of new programme estimates.</i></p>
3.	<p>Checks performed by the Delegations before authorising payments should better scrutinise the payment requests and intensify the focus on the reality, eligibility and accuracy of the expenditure. The quality of the work performed by supervisors should be better monitored.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(c)).</p>	<p>No specific actions were taken by EuropeAid. The number of errors revealed following the Court's audit of individual payments corroborates the observation that the financial control exercised by the Delegations needs to be strengthened.</p>	<p>Checks performed by Delegations before authorising payments should better scrutinise the payment requests and intensify the focus on the reality, eligibility and accuracy of the expenditure. The quality of work performed by supervisors should be better monitored. (Annual Report concerning the financial year 2007, paragraph 55(d)).</p>	<p><i>The Commission is aware that improvements need to be made to the control of the execution of certain types of contract, and is examining the possibility of introducing a mechanism designed to ensure that the quality of the controls carried out by the supervisors meets the requirements concerning the legality and regularity of transactions. It will remind authorising officers of the principles of clearance of advances.</i></p>
4.	<p>The quality of the controls performed by external auditors should be enhanced by ensuring that the new terms of reference include a clear definition of the purpose of the audit; the materiality threshold to be applied; the sampling; the nature of the audit procedures to be performed; guidance on how errors should be treated; and how conclusions are to be reported upon. These standard terms of reference should also be used for all external audits initiated by the Delegations.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(d)).</p>	<p>In October 2007, EuropeAid has issued new terms of reference applicable to all audits. Though the effects of these have yet to be seen due to such recent implementation, there are positive signs that they should enable more consistent reporting from auditors, in particular with regard to the form of the audit opinion given and the materiality threshold which is applied.</p>	<p>Satisfactory action has been undertaken.</p>	
5.	<p>The central monitoring of the external audits organised by the Delegations should be improved so that the results can be effectively communicated to all relevant levels of management. This should be enhanced by the availability, by the end of 2007, of a management system that provides information on the audit process and facilitates access to relevant audit results</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(e)).</p>	<p>Modifications were made to the computerised tool, CRIS Audit, in order to facilitate its use, which was made mandatory in January 2008. Certain refinements still need to be made to allow for the assessment of the audit coverage and the use of this system in collating, analysing and acting upon audit findings and recommendations.</p>	<p>The implementation of CRIS Audit should allow monitoring of the audit coverage and the audit results. Qualitative information as to the recommendations made and the improvements which should be put in place to address the findings is vital to ensure that the ultimate objectives of commissioning audits are met. (Annual Report concerning the financial year 2007, paragraph 55(e)).</p>	<p><i>The entry into force of the new CRIS-Audit module on 1 January 2008, which links the amount of the contract to be audited to the audited amount, will facilitate the calculation of the audit coverage, as well as the analysis of audit findings, according to typology.</i></p> <p><i>The Commission agrees with the Court's recommendation and yearly collates and analyses audit results with a view to learning lessons and to introducing appropriate improvements.</i></p>

	Court observation	Action taken	Court analysis	Commission reply
6.	<p>Verification of the Delegations by EuropeAid's central services should be enhanced by increasing the number of missions.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(f))</p>	<p>The missions are well designed and provide practical recommendations for improvements to control systems. However, the number of missions has not been increased.</p>	<p>The number of monitoring missions should be increased. They should maintain the focus on the examination of the set-up and functioning of the supervisory and control systems. (Annual Report concerning the financial year 2007, paragraph 55(g)).</p>	<p><i>The standardised methodology for monitoring missions was finalised in March 2008. The number of such missions is to be increased in 2008.</i></p>
7.	<p>As the transactional <i>ex-post</i> controls are restricted in scope, they can only make a limited contribution to the overall assurance on systems and procedures and the legality and regularity of the underlying transactions. Moreover, they are carried out with much delay.</p> <p>(Annual Report concerning the financial year 2005, paragraphs 33 and 42).</p>	<p>The scope of the transactional <i>ex-post</i> controls still excludes aspects related to legal commitments as well as detailed supporting documentation of expenditure of work programmes.</p>	<p>Transactional <i>ex-post</i> controls should include a better examination of supporting documentation to ensure that transactions are not affected by errors of eligibility and occurrence as well as to verify whether checks performed before the payment was authorised were adequate. (Annual report 2007, paragraph 55(f)).</p>	<p><i>The Commission is continuously working to further improve its system and will pay specific attention to the issue of the detail of supporting documentation on programme estimates.</i></p>
8.	<p>Compliance with the Cotonou Agreement should be benchmarked against baseline requirements, such as the availability of timely published and audited accounts. A clear, formal presentation of the conclusions reached would require the parameters of the 'dynamic interpretation' to be made explicit, thus enabling the appropriateness of disbursement decisions to be assessed</p> <p>(Annual Report concerning the financial year 2006, paragraph 55(a)).</p>	<p>EuropeAid did not define baseline requirements. The Court's audit revealed that in 5 out of the 15 commitments examined, budget support is provided to ACP States where the Court considers that public expenditure management is not sufficiently transparent, accountable and effective. For the cases identified, the vigorous application of the Commission's dynamic interpretation of the budget support conditions of the Cotonou Agreement implies a very high fiduciary risk.</p>	<p>Compliance with the Cotonou Agreement should be benchmarked against baseline requirements, such as the availability of timely published and audited accounts, to be met before budget support is granted (Annual Report concerning the financial year 2007, paragraph 56(a)). EuropeAid should ensure, before the start of a budget support programme, that there is a clear and complete assessment of the public finance management and that the recipient country has a credible and relevant reform programme to address all significant weaknesses over a foreseeable timetable. (Annual Report concerning the financial year 2007, paragraph 56(d)).</p>	<p><i>During 2007 the Commission continued to apply the dynamic approach, which it considers appropriate.</i></p> <p><i>Before the start of a budget support programme, the Commission will continue to ensure that there is an assessment of the public finance management, preferably within the PEFA Framework, and that the recipient country has a credible and relevant reform programme to address significant weaknesses over a foreseeable timetable. This will warrant a rigorous application of the dynamic interpretation of the conditions of the Cotonou Agreement and a management of risk consistent with the Commission development objectives.</i></p> <p><i>Finally, the Commission disagrees with the Court's assessment regarding the five commitments in question.</i></p>
9.	<p>In order to set out its conclusions in a structured manner, the Commission should ensure that the data used as a basis for disbursement decisions rely more on measurements of events that have already taken place than on predictions of future occurrences;</p> <p>(Annual Report concerning the financial year 2006, paragraph 55(b)).</p>	<p>The 2007 audit revealed that in a significant number of cases, the Commission did not demonstrate in a structured and formalised way the respect of the Cotonou Agreement relating to public finance management. The explanation in some of these cases is that reliance put on future occurrences rather than on events that had taken place and the inaccurate appraisal of indicators.</p>	<p>In order to set out its conclusions as regards progress in public finance management in a structured manner, the Commission should ensure that the data used as a basis for disbursement decisions is reliable and should rely more on measurements of events that have already taken place than on predictions of future occurrences. (Annual Report concerning the financial year 2007, paragraph 56(c)).</p>	<p><i>When assessing eligibility, the Commission takes into account a balance between past performance and future commitments. At the same time the Commission agrees that when assessing disbursements the emphasis should be placed on demonstrating achievements.</i></p>
10.	<p>The indicators used should permit clear evidence of progress in public finance management to emerge where appropriate. This could be achieved by including indicators which can be measured over time, and compared from one period to the next, as opposed to indicators which rely on the performance of a one-off event.</p> <p>(Annual Report concerning the financial year 2006, paragraph 55(c)).</p>	<p>The current audit has revealed a frequent lack both of a clear analysis of the public finance management weaknesses at the start of the programme and of a structured approach to measure public finance management progress subsequently. As a result, it is more difficult to assess progress thoroughly and objectively.</p>	<p>The performance indicators used should permit clear evidence of progress in public finance management to emerge where appropriate. This could be achieved by strengthening indicators which measure progress of results over time in combination with process indicators on the performance of one-off events. (Annual Report concerning the financial year 2007, paragraph 56(b)).</p>	<p><i>Compared to other sectors, it is more difficult and complex to define result indicators for PFM. The Commission nevertheless favours the use of result indicators, where available, that measure the effect of reforms, but also uses process indicators and measures to monitor the progress in the implementation of reform programme.</i></p>

Charts illustrating the consolidated seventh, eighth and ninth EDFs as at 31 December 2007

Chart I: Cumulative resources

Total = 37 328,65 million euro ⁽¹⁾

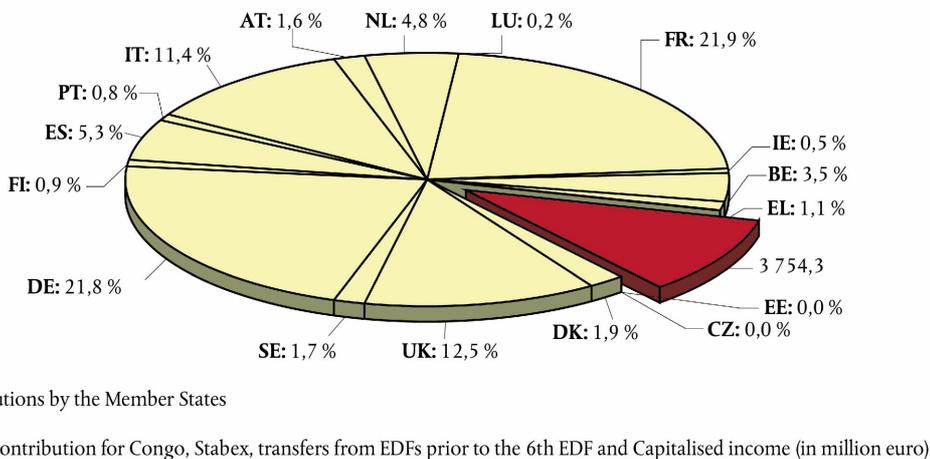
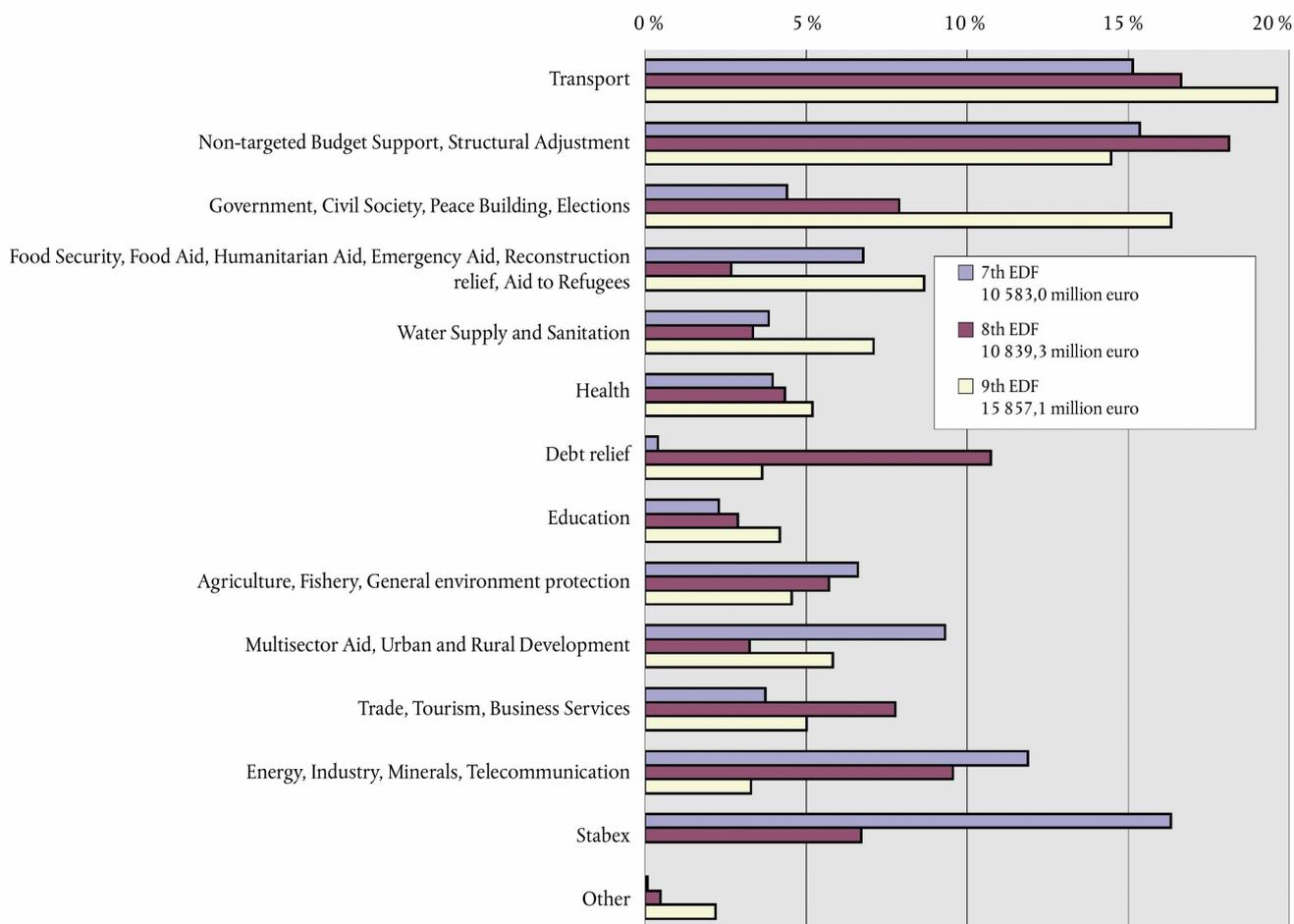


Chart II: Cumulative decisions

Total = 37 279,4 million euro ⁽¹⁾



Source: Court of Auditors, on the basis of the data in the accounting system.

⁽¹⁾ The difference between the cumulative resources (37 328,65 million euro) and the cumulative decisions (37 279,37 million euro), equals the available balance to be allocated (49,28 million euro).