

**Realigning Execution of the European Social Fund Budget:
Implementing the European Commission's
Integrated Internal Control Framework in a EU Structural Fund (B)**

DG EMPL's Internal Administrative Context

The organizational structure of DG EMPL follows a common pattern within the European Commission. Individual contributors (such as legal officers, policy officers, programme managers, external auditors, financial officers, administrative assistants, and socio-economic analysts), are grouped into "units". The units are grouped into "directorates", with each directorate typically made up of four units. At the apex of this hierarchical organizational structure is the director-general. The directorate-general also includes staff roles that report directly to the director-general – for example, the "internal audit capability," i.e. DG EMPL's internal auditor.

The directorates within DG EMPL, and their component units, perform three different kinds of functions. One is policy-development related to employment, social affairs, and equal opportunities. A second is to administer the ESF and monitor Member States' policies. A third is to perform internal management functions, while interfacing with other parts of the Commission, such as DG BUDG.

As the first year of the 2007-13 budget execution cycle drew to a close, DG EMPL's structure included four policy-development directorates, three ESF and policy-monitoring directorates, a directorate for resources and communication, and a directorate for audit and controls. The three ESF and policy monitoring directorates were organized along geographical lines, with each unit responsible for three Member States. The Directorate for Resources and Communication was responsible for such administrative functions as annual management planning and reporting, internal control coordination, budgeting, financial coordination, personnel, procurement, information technology, and communication. The Directorate for Audit and Controls was responsible for the DG EMPL's external auditing of operational programmes, ex ante auditing of budget execution for activities under the Commission's direct management, and for representing the directorate-general in its relations with "control authorities," including the European Court of Auditors (ECA).

The structural novelty introduced during 2007 was a realignment of functions relating to external auditing of operational programmes and the evaluation of policies. In establishing Directorate for Audit and Controls, the policy evaluation function was transferred to a newly created staff office, reporting directly to the apex. According to the first Director for Audit and Controls, Victorija Smatko,

The Commission's Internal Audit Service came and reported that we needed more coverage and more audit staff. We needed to change the structure. The idea was to separate the evaluation services from audit services. We separated the audit unit into an audit unit and evaluation unit.

More importantly, functional responsibility for auditing of operational programmes was transferred from the geographical directorates to the new Directorate for Audit and Controls. By definition, external audit became functionally centralized. Correspondingly, functional responsibilities for ESF budget execution were no longer decentralized exclusively to the geographical directorates, but were instead shared between them and the audit directorate. The job title of "external auditor" became more prevalent, as the number of positions within the audit directorate grew markedly. Reflecting on these developments, the director for resources and communication, Marie Donnelly, commented:

We have gone through a radical re-alignment of our management structures here. It is correct to have a management structure whereby you have your operational units within geographical directorates. And it's correct to have your auditor separate because that's their function, to be separate. But then of course you're confronted with the organisational challenge of ensuring communication and co-operation.

DG EMPL's Internal Control

By the end of the second year of the 2007-2013 ESF budget execution cycle, DG EMPL had put into place a more elaborate and integrated framework for internal control of the directorate than during the previous cycle. One feature of this integrated framework was a quarterly reporting system, with roles played by heads of unit and the higher-level directors. Reports came to be prepared by heads of unit, which flowed through directors up to a director-level management committee. In 2008, the quarterly reporting system was fine-tuned, according to Marie Donnelly: "We've changed the quarterly reporting system this year to make it exclusively exceptions-based. It means you don't get ten pages of text explaining all the wonderful things people did during the quarter, as opposed to what they didn't do."

While the reporting entities were parts of the directorate general, the substance of most of the reporting done by the geographical directorates was about operational programmes. The purpose of reporting was not only to share information, but also to provide assurances about the control of ESF budget execution and to highlight issues requiring management attention and action.

Another part of the integrated internal control framework was developing and reviewing formal opinions about operational programmes. The audit directorate's functions included providing "audit opinions." The geographical directorates' functions included providing "management opinions."

Management and audit opinions were considered as complementary “building blocks of assurance” about the correct use of funds provided by the ESF budget for operational programmes. Yet they provided assurance in different ways. Audit opinions provided assurance about operational programs by verifying their compliance with control and audit standards, whether generally accepted or provided by the Commission. Management opinions provided assurance about operational programs by taking a holistic view of their implementation. According to Marie Donnelly:

We have a mechanism which relies on what we call a holistic appreciation. Whatever information we have, we will take it on board. We take information from our own auditors, we take it from the Court of Auditors, we take it from national auditors. Desk officers (within geographical units) know what’s going on in the Member State – including from attending monitoring committees and on-side visits to projects....We would certainly know the personalities in the managing authority. We meet them frequently.

Responsibility for providing assurances in the form of management opinions rested, in the first instance, with heads of geographical units. Their signatures were on the management opinions, in the same way that the director-general’s signature was on the annual activity report submitted to the Commission. Even the word template for providing assurances was the same. “Every Head of Unit signs ‘to my knowledge,’” as one insider put it.

This allocation of responsibility was coherent with these officials’ signature authority for disbursement of funds to Member States, as part of the financial management of the ESF budget. Specifically, the heads of geographical units were designated as authorising officers by sub-delegation. In effect, they had the responsibility and authority for approving payments. Likewise, they were to play important roles in actions to interrupt payments, suspend payments, or impose financial corrections.

Management opinions flowed up the reporting chain to the geographic director level, in the first instance. Reviews of management opinions were also made by the deputy director-general to whom all of the geographic directors reported. As one participant in this process remarked, “This makes sure that the management opinions are justified. It also ensures that there is a harmonisation of approaches across all geographical units.”

Management opinions were then reviewed by a top executive board whose members were all involved in execution of the ESF budget. The board included the directors of the geographical directorates, the director for resources and communications, and the director for audit and controls. Marie Donnelly, who coordinated the review process, described the review process’s key features as follows:

We have 5 or 6 headings that they have to fill in that gives their appreciation. And that was the basis for our discussion. A discussion could run like -- what’s happened over the last number of years? Is the level of error progressively going up? Or is it progressively going down? That kind of dialogue took place with each and every one of them.

In the words of a lower-level middle-ranking observer of the process:

It is like a peer review. Marie Donnelly manages these peer reviews. She made it more interactive with the Geo units. They had to justify much more what they did with problematic programmes. It can be difficult for Geo desks to admit problems without this management pressure. She had a large management impact.

The top management board conceived its role as making all-things-considered decisions as to whether DG EMPL enjoyed full assurance about the correctness of budget execution for any and all operational programmes, or had reservations about them. In this way, top management sought to enable the director-general to play his prescribed role in the integrated internal control framework. That role included providing assurance to the Commission that the ESF budget was being correctly executed, with the main formal vehicle being DG EMPL's annual activity report.

Reviews of operational programmes were designed to bring to light any differences between management opinions that came up from the geographical units, on the one hand, and the audit opinions that came up from the audit and controls directorate, on the other. The intention was for management opinions and audit opinions to each have their own integrity, since assurances were based on different kind of information and methodologies. According to Donnelly:

You could have a situation where our auditors will say that the system is acceptable, but because we know from the monitoring committee or other information that there's something going wrong, our overall appreciation might be that the system is not acceptable. We tend to follow the auditors, but we take more into account that the audit view.

For the all-things-considered assessment by top management to have integrity, the reports emanating from the two hierarchical chains had to be examined together, with explicit discussion – or, so, DG EMPL concluded after its internal control framework and systems were examined by the Commission's Internal Audit Service (IAS). As recalled by Donnelly:

The IAS said to us that our building blocks of assurance weren't very clear, weren't very transparent, and that we should revisit them. We had parallel tracks. The Head of Unit (for the Geodesk) wrote their individual assessment, and the Head of Unit for Audit wrote their assessment, and the two of them came together by some sort of process into a conclusion. IAS had said to us that the process was not transparent and didn't necessarily allow for a full re-evaluation of all of the circumstances. What we've done now is merged the parallel tracks. By taking all of that into a single channel, we integrate information coming from the Court of Auditors, from our own evaluation processes. Now there's a full sharing of information and the issues are confronted across the table. We then say, "Yes, it was right, no it

wasn't right, marginal", or whatever the case may be, and take it on from there. That was as a direct response to the IAS recommendation.

The internal control framework was not concerned exclusively with reporting in the literal sense. It was also concerned with coordinating follow-up action across the directorate-general. Such follow-up action, when called for, was meant to change situations within Member States -- for example, to repair deficiencies in an operational programme's control and audit systems, for the sake of limiting the occurrence and seriousness of errors in the use of EU money. Follow-up action was also meant to alter the position taken by DG EMPL in relation to operational programmes. For instance, the head of unit for the Member State concerned would ideally come to accept that a deficiency in question had been repaired, possibly leading to a marked change in the level of assurance that could be given to upper management as documented in a management opinion. In such a scenario, upper management might see reason to improve its overall appreciation of the operational programme. Such a change in assessment would have ramifications for how the directorate-general responded to Member States' applications for interim payments, how it interacted with Commission and EU control authorities, and how it wrote up its annual activity report.

A practical challenge facing DG EMPL was to keep the follow-up process itself under control. The operational programmes within the directorate-general's purview were numerous, with several in most of the 27 Member States. While heads of unit within a geographic directorate might be able to keep tabs on operational programmes without a formalized tracking system, the same wasn't true of upper management. As Donnelly remarked:

Sometimes it can be a lot, quite frankly. So many operational programmes, action plans -- you can't keep it in your head, you have to have a system that'll do it. We've had to build a new database system to allow us to track it. And it's what we call our A-REP system.

The initial concept of the A-REP system emerged from the work of an internal task force, charged by the deputy director-general who oversaw the geographical directorates, to look at difficulties in following-up audits. Chartered in July 2007, the task force -- led by a policy officer within one of the geographic directorates -- soon recommended creating an IT system that would record audit findings and make them readily available to the Geo desks and upper management. This recommendation was approved, and responsibility for managing the A-REP project was assigned to the policy officer who had headed the task force, Jeroen Jutte. He recalled:

I got the task of creating the IT System. We could have hired consultants -- but instead we put a team together and created a system ourselves. We started programming in November 2007. The essence of the system was relatively immediately in place, and working on-line since early 2008.

An initial functionality of A-REP was to record the Directorate of Audit and Control's audit reports on operational programmes. Once recorded, a negative audit report would

automatically come to the attention of the Geo desk responsible for the operational programme concerned. The standard procedure was for the Geo desk to inform the management authority in the Member State of the audit findings, setting the stage for discussions that would normally lead, first, to agreement on an action plan and, then, to an assessment of the action plan's implementation. As functionalities were added, emails were sent automatically to Geo units, on a three-week cycle, reminding them to keep tabs on follow-up steps to negative audit reports. The system's functionalities grew to provide senior management with visibility of the progress of follow-up actions, in the form of a report generated twice a month. According to Jeroen Jutte: "Any comments we have received about A-REP, we have taken on board. So we are continuously building on it. It has been approved by IAS, which is a big deal."

Giving Assurance to the Commission

DG EMPL's integrated internal control framework is nested within that of the Commission as a whole. A major component of the Commission's integrated internal control framework (IICF) is known as activity-based management, which includes a planning and reporting phase during an annual cycle. The reporting phase's artefact is the annual activity report (AAR). The AAR is signed off personally by director-generals. Within an AAR, a director-general reports on management issues, including internal control of activities and budget execution. The Commission's control authorities, including DG BUDG, IAS, and the Secretariat-General (SG), expect directors general to provide written assurance, via the AAR, on the proper governance of the activities and spending under the directorate-general's institutional responsibility. Directors general are obliged to disclose their own reservations about the governance of the activities and spending concerned, not only to undergird their trustworthiness as agents of the Commission and European Union institutions, but to feed other parts of this complex role system with information that might be relevant to their assessments and actions. It is normally expected that, when reservations are made, the directorate-general will also indicate planned actions for changing the situations that gave rise to them.

Preparing DG EMPL's AAR on the first year of the 2007-2013 execution period was coordinated by the Directorate for Resources and Communications. Because the exercise was meant to be completed during the first quarter of 2008, in order to allow time for a peer-review of the AAR at Commission level, time pressures were considerable. Marie Donnelly recalled, "It was a very intense exercise. Day and night, I would say, for six weeks. Day *and* night."

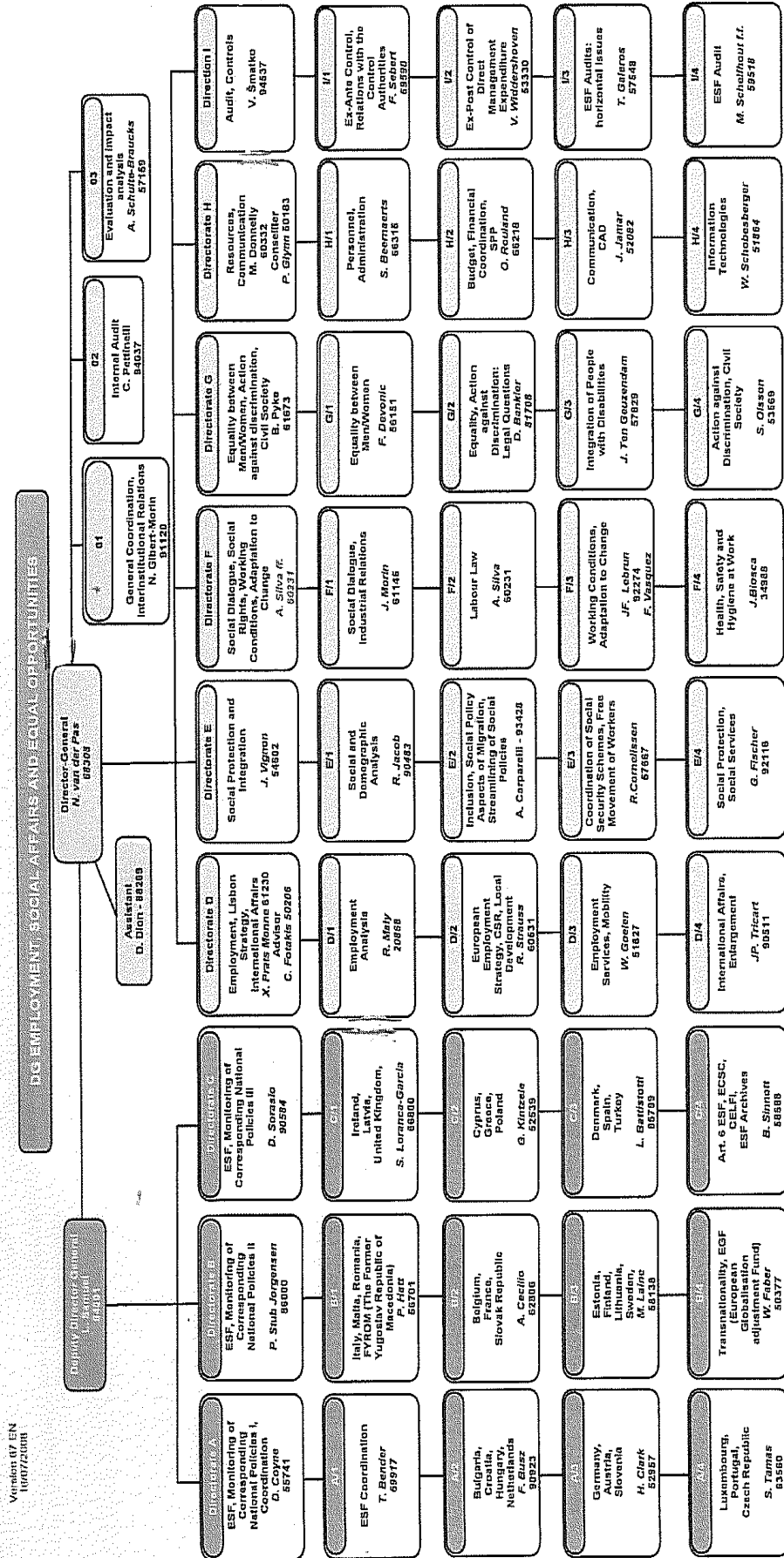
DG EMPL decided that a key feature of its annual activity reports would be reservations about the governance of particular operational programmes, when full assurances could not be provided to the Commission. A preparatory step was to decide whether to put an operational programme "in reserve." Marie Donnelly recalled this part of the process:

Where we took reserves in the annual activity report, that was done initially by the Geo directorates. We have three Geo-Directorates, we have an audit director and myself, and the five of us sat for two days with each and every one of the heads of units and went through each and every one of the operational

programmes that we have in the DG, to ensure that we have consistent standards, that we look to the issues, that we reviewed them, and so on. That was a five-day exercise.

The stating of reservations in the AAR also played a role within DG EMPL. As remarked by a section head within a unit of the resources and communications directorate: "We will never have a declaration of assurance with "zero problems". But we aim to do something to correct problems, and we do it ASAP. I think we are progressing."

Appendix 1 DG EMPL Organization Chart (7/2008)



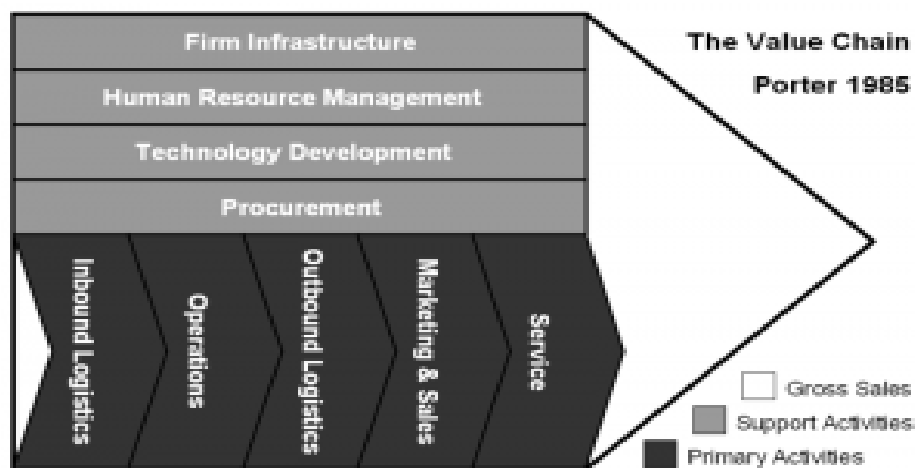
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Appendix 2

Value Chain Analysis

The enterprise of executing the ESF budget during a seven year programming cycle is inherently complex. Seen as a system of activities, this enterprise can be represented and analyzed as a functional hierarchy, with any given activities playing a functional role and with all activities a given level contributing to the performance of higher-level activities. (A work breakdown structure, http://en.wikipedia.org/wiki/Work_breakdown_structure, is an example of a functional hierarchy.)

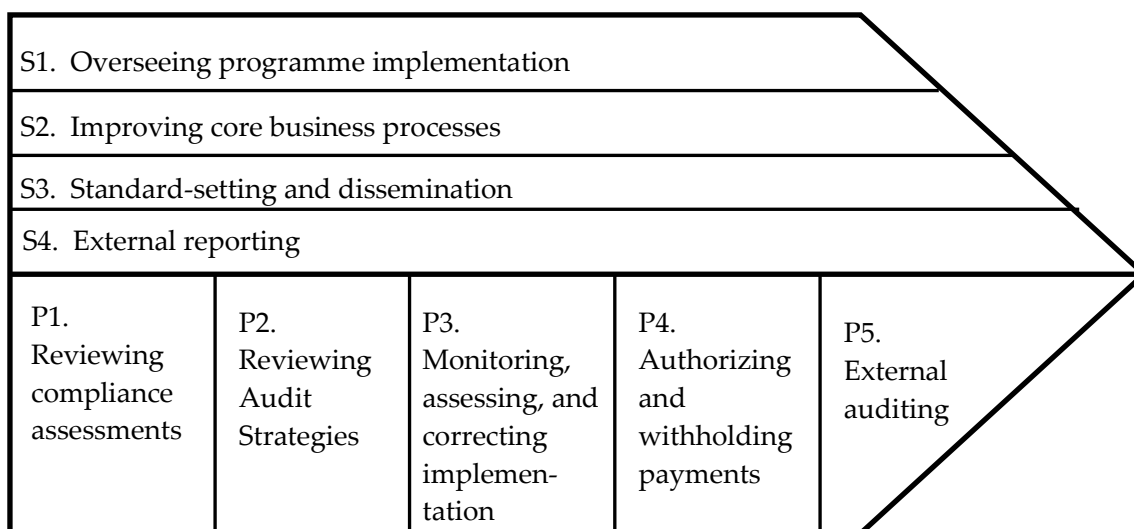
When the unit of analysis is an enterprise of the scale and complexity of executing the ESF budget during a programming cycle, functional hierarchies are often represented as a value chain, a concept first developed by Michael Porter: http://en.wikipedia.org/wiki/Value_chain.



In Porter's original formulation, rooted in a manufacturing setting, an enterprise's activities are grouped in two classifications: primary and support activities. Primary activities create a stream of final outputs as delivered to the buyer or end-user. Support activities play an enabling role in the effective operation of the primary activities, but not exactly as a regular flow of inputs. For example, technology development was included among the support activities in Porter's original formulation, because its contribution to primary activities is episodic. (See above.)

The enterprise of executing the ESF budget during a programming cycle, conceived as a system of activities, can be described in value chain terms by distinguishing primary and support activities, as well. Authorizing payments to base-level providers is accomplished through a primary activity. Developing the A-REP information technology tool, discussed in the body of the case, was accomplished through a support activity.

The writers of this teaching case have settled on representing the execution of the ESF budget over the programming cycle as follows:



In what follows, this enterprise is described in some detail, drilling down to identify how its component activities are performed. The Directorate-General's 2007 Annual Activity Report is reflected in this analysis. The 2007 AAR is available at http://ec.europa.eu/atwork/synthesis/aar/aar2007/doc/empl_aar.pdf.

A. Primary Activities

P1 – Reviewing Compliance Assessments

- In this activity, DG EMPL reviews blueprints for the roles and relationships of all the organizational entities involved in delivering the ESF Operational Programme, known as Compliance Assessments.
 - Reviews of Compliance Assessments are performed once during each of the EU's seven year financial programme, in the first year of that cycle.
 - This activity is performed iteratively, as DG EMPL has the option of requesting corrective actions before giving its approval to the Compliance Assessment.
- The parts of DG EMPL that takes the lead in reviewing Compliance Assessments are the Geographical Directorates (A, B, and C).
- For more information, see Council Regulation, Articles 58-61 and Article 71.

P2 – Reviewing Audit Strategies

- In this activity, DG EMPL reviews Audit Strategies prepared by Member States.
 - This activity is performed once during each of the EU's seven year financial programme, in the first year of that cycle.
- This activity is performed iteratively, as DG EMPL has the option of requesting corrective actions before giving its approval to the Audit Strategy
- The part of DG EMPL that takes the lead in reviewing Audit Strategies is Directorate I, for Audit and Controls, specifically Unit I/4, ESF Audit.
- For more information, see Council Regulation, Articles 62, 72, and 73.

P.3 - Monitoring, Assessing, and Correcting Implementation

- In this activity, DG EMPL conducts a range of activities to fulfil its ongoing supervisory responsibilities for operational programmes, apart from auditing and financial management.
- A sub-activities include
 - Formulating “management opinions” about internal control of each operational program. The approach to performing this annual task is to develop a “holistic appreciation of whether a given operational programme conforms to the principle of sound financial management (within the meaning of the EU Financial Regulation). The conclusions of management opinions include a risk assessment of the operational programme, following a four-fold graduated classification scheme. (See 2007 AAR, page 60-67.)
 - Checking interim reports and cost claims provided by Member States.
 - Participating in monitoring committees, joint with Member States, for particular operational programmes.
- The parts of DG EMPL involved in this activity include the Geographical Directorates (Directorates A,B, and C).
- For more information, see Council Regulation, Articles 63 and 66-68.

P.4 – Authorizing and Withholding Payments

- In this activity, DG EMPL determines whether to accept applications for payment from Member States, including applications for interim and final payments
 - This activity is performed on an ongoing basis, with the close-out cycle exhibiting certain special features
 - The procedural standard for processing applications is the four-eyes principle, set out in the Financial Regulation
- The sub-activities include
 - Executing decisions to suspend payments and impose financial corrections on Member States
 - Re-authorizing payments after corrections have been implemented
 - Authorizing payment of the balance during close-out of the financial programmes
 - Final reports are analysed to verify conformity of the implemented actions / deliverables with the contractual provisions.
 - These analyses include cross-checking the final accounts and the final report on the implementation of the action to verify the coherence of the costs declared with the action actually implemented.
 - Checking final cost claims to verify the eligibility of the costs, arithmetical checks, conformity with the initial budget, co-financing rate, etc.
 - Conducting on the spot checks prior to payment of the balance

- The parts of DG EMPL involved in this activity include the Geographical Directorates (Directorates A,B, and C); Heads of Unit are Authorising Officers by Sub-delegation.
- For more information, see Council Regulation, Articles 86, 89, 91, 92, and 98.

P.5 – External auditing

- In this activity, DG EMPL conducts audits of the primary activities within the Member States part of the enterprise for delivering the Operational Programme. The audit objects include internal control systems and transactions (equivalently, systems and substantive audits).
- The sub-activities include audit planning, conducting the audit, and audit reporting.
 - The audit planning methods include risk analysis – audits focus on programmes thought to be subject to financial corrections, with a negative audit follow-up or with recurrent systematic errors detected in previous payment checks.).
 - The audit methods include checking transactions on a sampling basis
- The parts of DG EMPL involved in this activity include Direction I (Audit, Controls).
- For more information, see Council Regulation, Articles 62 and 73.

B. Support Activities

S.1 – Overseeing Program Implementation.

- In this activity, senior management reviews internally-generated reports on implementation of operational programmes and resolves issues on which DG EMPL must take a position in relation to the Commission, Court of Auditors, and Member States
- The sub-activities include
 - Reviewing management opinions on operational programmes including risk classifications
 - Reviewing reports submitted on a quarterly or other basis
 - Recommending suspension of payments and financial corrections, for EC approval
 - Ensuring a common and shared understanding of methodological approaches for ESF audits with all actors involved, including Member States and the European Court of Auditors
- The officers of DG EMPL involved in this activity include the Directors for Resources (H), Audit (I) and Geographical Areas (A,B,C)

S.2 – Improving Core Business Processes

- In this activity, projects and programmes are performed in order to maintain or strengthen any or all of the business processes that perform important roles within the value chain
- Sub-activities (in 2007) include:
 - Conducting a self-assessment of DG EMPL's compliance with the EC's Internal Control Standards
 - Developing a new audit management database (A-REP system) to support systematized follow-up of recommendations and observations (EMPL, ECA, OLAF) by all operational and support units concerned.
 - Professional training on audit, evaluation, report writing, etc; creation of an e-library for in-house reference on audit, evaluation, fraud prevention and related subjects; participation in professional networks and technical working groups on audit and evaluation.

S.3 – Standard-setting and Dissemination

- In this activity, parts of DG EMPL gives direction to other parts of the Directorate-General and to actors within the Member States in the form of standards, such as Guidelines for the Compliance Assessment of the management and control systems, Guidance Notes on Auditing, Guidelines on the use and implementation of the flat rate for overheads, Guidelines on statistical sampling, Guidelines on financial corrections for public procurement irregularities, and Guidelines on annual summaries
- Sub-activities include
 - Providing advice and formal guidance to MS on issues such as management checks and sampling for audits
 - Drafting and finalization of guidance documents on sampling and systems assessment methodology
 - Providing training seminars to the Member States' Audit Authorities on statistical sampling, risk analysis, role of the audit authority, compliance assessment, audit strategy, and reliance on the work of other auditors.
 - Providing advice and formal guidance (through meetings, workshops and guidelines development) on issues such as management checks and sampling for audits
- The parts of DG EMPL involved in this activity include Direction I (Audit, Controls).

S.4 – External Reporting

- In this activity, DG EMPL reports to the Commissioner with portfolio responsibility for this area on follow-up of audit recommendations, OLAF cases, relations with the Court of Auditors.
- An annual activity report is prepared, vetted through peer review, and finalized.