



Third level control of the North Sea Region Interreg Programme – Findings and lessons learned from the third level control in May 2011

Background

In May 2011 the audit unit of the Directorate General Regional Policy undertook a “third level audit” of five UK project partner organisations, participating in 5 different projects in the North Sea Region (NSR) Interreg programme. The checks were carried out as on-the-spot checks.

The purpose of the audit was to assess the effectiveness and reliability of first level control processes and management verifications within the UK. In addition, the audit mission’s objective included verifying the extent to which the rules of Article 13 of Commission Regulation No 1828/2006 had been observed. More specifically the mission included checking for the existence of an adequate audit trail in order to obtain assurance that the work carried out during management verifications guarantees the legality and regularity of the expenditure.

The preliminary results of the checks carried out suggested that the EC auditors could not confirm that the management verifications carried out by the First Level Controllers were adequate. A number of significant findings were made during the third level audit. These findings have, so far, led to an interruption of payments to UK project partners. The interruption will be lifted again once the European Commission (EC) has found that the follow up actions required have been carried out satisfactorily. One of the requirements is that the JTS must provide additional guidance and training to beneficiaries and First Level Controllers (FLC) as regards the scope of checks to be performed. This paper will outline the main findings with a view to learning from these findings and is one of several action points in this process.

Finding 1:

Insufficient First Level Control verification of compliance with public procurement rules

The EC auditors found that for two of three projects where public procurement contracts have been awarded, the FLC had not performed any verification of public procurement procedures. The auditors came across examples in which the FLC indicated compliance with procurement rules despite the fact that audit interviews revealed that no verifications had actually been made. In practice this means that some checklists were erroneously filled out.

Needless to say, it is of utmost importance that any responses made in the First Level Controller’s checklist must be based on real and thorough verifications. The JTS and relevant control bodies will carry out sample checks in future across the entire programme in order to obtain assurance that the checks have a sound basis, i.e. are based on actual verifications made. If you are in doubt about the rules, please re-read appendix 1 of the manual for first level control which is a COCOF document providing useful examples of how a verification can be made.

In this category the EC auditors also found examples of missing procurement documentation for e.g. the award of audit service contracts and project management services contracts. For contracts of this nature the threshold value will often be (far) below the EC Directive thresholds but the FLC must nevertheless check and verify that:

1. National rules and the internal procedures of the beneficiary have been complied with.
2. Verify on the spot that all supporting documents covering all steps of the procurement procedure are kept on the file

If there are doubts as to the compliance with tendering procedures then the FLC must report on this explicitly in the checklist for first level controllers (Appendix 6 and 7 of the First Level Control manual) and indicate the amount which is being questioned so that this can be taken out until full clarification as to the legality and regularity of the expenditure has been established.

In many cases your organisation will already have procurement procedures in place, which ensure adherence to the EC and National rules. In those cases your job is to ensure that these procedures are in fact followed and **document** that you have played by the rules. Often all procedures are adhered to but nobody bothers to file the documentation and this is where trouble begins.

Finding 2:

Overhead costs not properly justified or not verified by FLC

The checks carried out by the EC auditors identified problems with missing documentation of the declared overhead costs as well as problems with insufficient verifications made of this cost type.

As with any other costs, overhead costs are only eligible if they can be documented. The fact that someone in your organisation e.g. the CEO decides that a particular overhead percentage should be used **is not** sufficient documentation. What you need is an actual calculation of your costs and a re-calculation on a regular basis to ensure that the percentage used is still correct and based on real costs. Your FLC plays a key role in checking that these basic rules are adhered to. It is, in other words, a clear responsibility of any FLC to carry out sufficiently robust checks in order to verify the overhead costs reported.

The FLC verification must comprise all aspects of the following components:

1. The overhead costs are based on **real and defrayed indirect costs only**; i.e. no use made of artificial flat rates or any other standard rates
2. The FLC is required to certify 100% of each expenditure claim by checking its legality and regularity in full. Sample-checks can also be made if the underlying principles for selection of the sample are explained, cf. p. 11 of the manual of the first level control.
3. The indirect costs included in the overhead cost calculation are in fact only cost items of an overhead cost nature and only cost items relevant for the project in question.
4. The FLC is required to verify that the pro rata key used is fair, transparent and well documented.
5. The FLC is required to verify that the costs have been reported under the relevant heading
6. All FLCs must keep documentation of the verifications made until the end of 2023

If a beneficiary fails to provide proper and full documentation for all aspects of the overhead costs then the FLC will have to state explicitly in the checklist the amount that can be accepted and the amount which must be deducted until it can be verified satisfactorily.

It is important to bear in mind that the FLC needs time to carry out these tasks. He/she is not doing you a favour by turning the control process into a tick-box exercise in which no actual checks are carried out. Use your FLC as an additional quality assurance and not as a rubber stamp.

Follow up activities from the JTS:

With a view to assessing whether the identified overhead costs deficiencies are isolated cases of omission and not of a systemic nature, the JTS will put in place systematic quality checks which will continue until the quality of the FLC has improved so that the quality check does not identify any further ineligible expenditure.

The JTS will issue a guidance note on overhead costs for project partners and FLCs as well as reviewing the appropriateness of the questions in the checklist used for the verification of overhead costs.

This paper will be circulated to all designated FLC in this programme.

Finding 3:**Selection of First Level Controller**

As indicated under finding 1, the award of audit service contracts (as with the award of any other contracts) is also subject to tendering procedures. The EC auditors found examples of missing documentation for whether applicable public procurement provisions were adhered to when selecting the FLC of the project partner or Lead Partner.

Action to be taken

The checklist used by the Designation Bodies when designating or rejecting a FLC will be amended in order to make it explicit that there must be a check of whether required tendering procedures have been adhered to before a FLC is designated.

Finding 4:**Insufficient verification of compliance with publicity, state aid, environmental and other relevant rules**

Although the EC auditors acknowledged that the checklist used by FLC when doing their control does in fact cover these issues, the EC auditors noted that the FLC verifications of these aspects are rather limited.

Examples of findings from the EC auditors were :

1. An FLC states s/he was unable to confirm compliance with rules
2. An FLC states that as far as s/he is aware there is no non-compliance

Most FLC's find controlling these aspects challenging and slightly outside their normal line of duty. However, when an FLC applies for being designated s/he indicates that s/he is familiar with all relevant EU regulation, national regulation and programme rules. Therefore there is no excuse for doing insufficient verifications of these aspects. In cases where the FLC is uncertain of his/her competences within a given field, it is important not to duck the issue, but to seek help from relevant professionals within the field.

Action to be taken:

Needless to say, it is of utmost importance that any responses made in the First Level Controller's checklist must be based on actual and thorough verifications. The JTS and relevant control bodies will carry out sample checks in future across the entire programme in order to obtain assurance that the checks have a sound basis, i.e. are based on actual verifications made. If you are in doubt about the rules, please reread appendix 1 of the manual for first level control which is a COCOF document providing useful examples of how verifications covering these aspects can be made.

Finding 5:**Unbudgeted VAT claimed under other cost categories**

During the checks carried out by the EC auditors problems were identified with claiming irrecoverable VAT outside the budget heading "irrecoverable VAT". These are basic mistakes and ensuring they do not occur should be standard accounting practice.

Action to be taken:

As with all cost categories it is important to note that all cost items are correctly reported on. Irrecoverable VAT can only be claimed under the correct heading "irrecoverable VAT". Likewise, it has to be noted that Irrecoverable VAT can only be claimed to the extent that there is a budget set aside for this category of costs. FLC must verify that this is the case when doing the management verifications.

Finding 6:**Incomplete audit trail**

The EC auditors experienced difficulties in following the audit trail and reconciling expenditure items under separate budget lines to the invoices, identifying proof of payments and linking expenditure to relevant activities as part of the project. The EC auditors identified examples of missing supporting documentation such as e.g. missing invoices, proof of payments and other supporting documentation.

It is important to emphasise that a complete audit trail does not stop at the invoice. In addition to documenting that the cost has incurred, you must be able to explain its relevance to the project. A trip to Hamburg may constitute eligible expenditure, but only if you can explain that the trip was relevant to the project, e.g. that a

partner meeting took place or that the purpose was your participation in a particular conference relevant to the project. A programme for the meeting/conference/seminar, a list of participants, minutes etc. are examples of supporting evidence which can serve as supplementary documentation.

Action to be taken:

As we discussed at the recent Lead Beneficiary seminar in Copenhagen in September 2011, it is important that project managers and Finance Managers remember that an audit trail must be complete. This means that it is not sufficient only to have proof of the invoice and proof of the payment. The audit trail must also include proof of relevance of the costs and the FLC must verify that this is the case when doing the management verifications.

The JTS will put in place systematic quality checks to ensure that the audit trails are complete. These quality checks will continue until the quality of the audit trail has improved so that the quality check does not identify any further shortcomings in this respect.

Finding 7:

Potential revenue generation

The EC auditors noted that the FLC did not address the potential issues of state aid or revenue generation in relation to the projects. It was noted that the FLC checklist does not cover these aspects in the questions.

Action to be taken:

The JTS will review the checklist to ensure that the issues are properly addressed during the FLC verifications.

Finding 8:

Insufficient FLC verification of eligibility of project expenditure

The EC auditors noted that the FLC – in some cases - did insufficient checks in order to verify the legality and regularity of the expenditure claimed including checking the fulfilment of conditions for the grant and that the grant was used for the purpose of the project.

A verification of the eligibility of project expenditure must always include checks of the original invoices, proof of actual payments and clear evidence as to how the cost item in question is related to the project and is reported correctly under the right heading.

It is stipulated in the Manual for First Level Control that the First Level Controllers should control and confirm 100 % of each expenditure claim. However, it is also stated in the Manual for First Level Control that it is possible to apply sample checks if these provide reasonable assurance regarding the entire amount of expenditure, cf. p. 11 of the Manual for First Level Control.

In this connection it is important to note that if the sample checks raise doubts about the overall eligibility of expenditure, the sample must be expanded until an opinion can be made without reasonable doubt. The method applied for selection of samples must always be described and justified. In such cases, the project controller can ask for more information. The controller confirms, inter alia, that the expenditure presented is eligible, has been incurred for the purpose of implementing the operation and corresponds to the activities agreed between beneficiary and the Lead Beneficiary.

Action to be taken:

The JTS will address all the findings from this third level control in the UK at the next series of First Level Control seminars in all the countries participating in the programme.

The JTS will put in place systematic quality checks of the scope of the management verifications made by the FLC. These quality checks will continue until the quality of the FLC has improved so that the quality check does not identify any further ineligible expenditure.

Finding 9:**Insufficient quality control from the JTS**

The EC auditors noted an example in which the JTS's quality control was insufficient. This concerned reimbursement of a beneficiary's overhead costs despite the fact that there was no budget approved under the heading overhead costs. This was an error and will be avoided in future due to new monitoring procedures.

Action to be taken:

The JTS will stop monitoring spend on project level and instead monitor project expenses on beneficiary level. In future all project spend will be checked against the individual budget available for each beneficiary. Any overspend will lead to reductions in the claim for ERDF until a budget change allowing for the reimbursement has been approved.

Finding 10:**Lack of verifications of staff costs**

During their checks the EC auditors came across one example in which the FLC did not perform any check of the hourly rate calculation for the staff working on the project.

To verify the legality and regularity of the staff expenditure claimed the FLC is required to check the accuracy of the staff costs claimed to the project.

The check must encompass a verification of the completeness of time sheets and a reconciliation of the hourly rate calculations which must be checked against valid and duly signed employment contracts.

Action to be taken:

The JTS will put in place systematic quality checks to ensure that the management verifications made by the FLC on staff costs are reliable. These quality checks will continue until the quality of the FLC has improved so that the quality check does not identify any further ineligible expenditure.

Finding 11:**Absence of FLC verifications of publicity requirements etc.**

The EC auditors came across one particular example in which the FLC did not perform any check to ensure adherence to publicity rules. To verify the legality and regularity of the project expenditure the FLC has to verify compliance with the rules in this area.

Action to be taken:

The JTS will address the findings from this third level control in the UK including finding 11 at the next series of First Level Control seminars in all the countries participating in the programme.

In addition, the JTS will put in place systematic quality checks to ensure that the management verifications made by the FLCs also include a verification of compliance with applicable EC and national laws and regulations with a particular emphasis on the publicity requirements

Finding 12:**Insufficient FLC verification of the eligibility of expenditure**

The EC auditors noted a potentially ineligible participation fee for attending a conference which was not evidently related to the project. Likewise the EC auditors identified travel costs incurred outside the eligible area and outside the geographical eligibility limits set out in section 5.2.3.3 of the operational programme. Also in this respect it is crucial that the FLC verifies whether all costs declared can be clearly linked to the purpose and objective(s) of the project as well as verifying that all activities fulfil the requirements laid down in section 5.2.3.3 of the operational programme.

Action to be taken:

The JTS will address the findings from this third level control in the UK including finding 12 at the next series of First Level Control seminars in all the countries participating in the programme.

In addition, the JTS will put in place systematic quality checks to ensure that the management verifications made by the FLCs also include a verification of a compliance with the rules on the eligible area.