

Communication to the Commission on the provision of an internal audit capability in each Commission Service (31 October 2000)

Caption: This communication, forwarded to the Commission on 31 October 2000, sets out the basic conditions for the establishment of an internal audit capability in each Commission Service, as provided for in the White Paper on the reform of the Commission.

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Conditions for the provision of an internal audit capability in each Commission Service

Communication to the Commission from Vice-President Kinnock in agreement with Mrs. Schreyer

Introduction

This Communication sets out the basic conditions for the provision of an Internal Audit Capability in each Commission Service, as foreseen in Action 81 of the Commission's Reform White Paper.

Internal audit is defined as an independent appraisal within an organisation, which operates as a service to management by measuring and evaluating the effectiveness of the internal control system. Therefore, the objective of the Internal Audit Capability will be (1) to assist the Director General and management within the DG in controlling risks and monitoring compliance; (2) to provide an independent and objective opinion on the quality of management and internal control systems; and (3) to make recommendations in order to improve the efficiency and effectiveness of operations and to ensure economy in the use of DG resources (security for money and value for money).¹

Audit Capabilities

Internal Audit Capabilities will be a new internal audit function created in each Commission Service. They will not be an extension of the current 'audit' units within DGs, which have previously carried out on-the-spot control checks of beneficiaries and as such are management control units and will therefore be subject to review by the new Audit Capabilities.

It is clear that guidance on the provision of the DGs' Internal Audit Capability is necessary to start establishing an internal audit culture in the Commission and therefore to ensure rapid progress in the design and implementation of each Service's internal control systems. Particularly, in the context of action plans emanating from the ongoing internal control self-assessment exercise, Audit Capabilities will play an important part in the monitoring and, through their advice, the application of DG-specific plans to improve management including financial management and internal controls. The process of introducing internal audit capabilities is the primary responsibility of the Directors General, within the framework of the White Paper, taken account of the input of the IAS. The DGs' annual activity reports for 2000, foreseen to be presented in April 2001, will need to clearly set out such progress in the Reform process.

The Commission has already committed itself to ensuring that the new Internal Audit Service can – and will – operate in accordance with the internationally established professional internal auditing standards². In line with this commitment the conditions set out in this Communication for Audit Capabilities, which are derived from these standards, are essential to the setting up and operation of an Internal Audit Capability.

This Communication deals in section one with the DGs' need to have an Internal Audit Capability and reviews the responsibility of Directors General for internal control (point 1.1.) and describes how the Internal Audit Capability will provide assurance and consultancy services to the Director General in this context (point 1.2.). Section one also describes how Audit Capabilities will add value to their DG (point 1.3.) and establishes a distinction between the activities of the Internal Audit Capability and other control activities of the DG (point 1.4.). In section two this Communication sets out the conditions for the provision of an Internal Audit Capability (point 2.1.), provides details on the operation of the Internal Audit Capability (point 2.2.) as well as gives options for very small Commission Services (point 2.3.). Finally, section three presents a number of accompanying measures to strengthen the DGs' Internal Audit Capabilities. The annexes provide examples of how Internal Audit Capabilities can add value to the operations of their DG and how DGs may approach their initial audit needs and risk assessment.

This Communication is primarily concerned with the setting up of Internal Audit Capabilities and does not affect the rights and duties of the Commission's central Internal Audit Service in relation to all Commission's Services, including Internal Audit Capabilities.

1. The need for an internal audit capability

1.1. The Director General's Responsibility for Internal Control

The Reform White Paper established that a Director General's responsibilities cover the entire management process, including all necessary control activities, starting from the definition of objectives to delivering results. This includes ensuring the legality, regularity and effectiveness of the financial decisions taken, a responsibility that will be shared with the Financial Controller only until the devolution of the centralised ex-ante visa to operational services.

The Director General's responsibility for internal control should be understood as the responsibility for *“a process [...] designed to provide reasonable assurance regarding the achievement of the following primary objectives: the reliability and integrity of information; compliance with policies, plans, procedures, laws and regulations; the safeguarding of assets; the economical and efficient use of resources and the accomplishment of established objectives and goals for operations or programmes”* (Source: Institute of Internal Auditors).

Directorates General will need to establish effective internal control systems appropriate to their circumstances which comply with Commission-wide obligatory minimum standards for internal control defined by the Commission's Central Financial Service. The systems will necessarily differ between DGs due to the different activities covered. For example, particular attention will need to be given to big spending DGs, the management of external aid and structural funds, as well as to the particular internal control issues relating to small or non-spending DGs such as DG COMP or the Legal Service. This is why the Commission decided in the Reform White Paper to set uniform minimum standards rather than to impose a harmonised framework on all services.

The transition to the new systems of financial management, control and audit in the DGs will need to be carefully managed in order to provide legal and financial security and to avoid any disruption in the implementation of financial interventions. The objective for the transition period is for Directors General to ensure that their DG's financial management, control and audit systems are progressively strengthened. The decentralisation of financial control activities designed to strengthen financial management, control and audit in operational Services will be concomitant with the maintenance of the central ex-ante visa as long as required by the Financial Regulation.

1.2. The Internal Audit Capability's Assurance to the Director General

Action 82 of the Reform White Paper states that each Director General is accountable for sound and efficient resource management both in decision-making and through the application of internal controls which ensure that the objectives of the DG are being met. Accordingly Action 82, lays down that each Director General will sign a declaration in her/his annual activity report that adequate internal controls have been put in place and that, on the basis of the analysis made in the report, resources have been used for the intended purposes. By signing this annual report, the Director General confirms that the information presented is accurate and complete, that the resources were used as intended and that the internal control procedures in place give adequate assurance as to the legality and regularity of the underlying operations, both financial and non-financial.

The creation of an internal audit function will be of prime importance to Directors General in assuming their full responsibility for internal control.

The primary objective of the Internal Audit Capability will be to add value to their DG by providing assurance³ to the Director General as to the effectiveness of internal controls over the activities of the DG, including financial activities and Commission funds paid to external beneficiaries and advice on how to improve DGs' internal controls. Action 81 of the White Paper provides that the Internal Audit Capabilities will undertake independent reviews of the use made of the budget by the DGs and undertake systems, programme and performance reviews. Therefore, the Internal Audit Capabilities will carry out systems-based reviews of the internal control systems of the DG and, within that context and depending on its financial responsibilities, reviews of the controls of management and use of Commission funds paid to external beneficiaries. An independent Internal Audit Capability operated in accordance with professional

internal auditing standards will therefore, through audits as well as through value added consultancy services (advisory function), be one of the cornerstones for enhancing the robustness of the DGs' financial management and control systems. Clearly, any advice provided will not confer executive responsibility on the Internal Audit Capability and will in no way exempt management from their own responsibilities.

The DGs' Internal Audit Capabilities will range from a cell to a fully-fledged unit, depending on the scale of each DG's financial and other operational responsibilities, and will be directly attached to the Director General to ensure their independence and authority within the DG.

1.3. How an Internal Audit Capability will Add Value to the DG

The Commission has conceived the IAS and Internal Audit Capabilities as tools that help in modernising the Institution and running it more effectively, in particular by providing the inputs necessary to cope with continuous change. Hence, the Internal Audit Capabilities should not be regarded as having only a controlling role through the examination of compliance issues, but rather as providing a helping hand to Directors General and managers also on matters related to the economy, efficiency and effectiveness of the performance of the DG. In addition to identifying problems, Internal Audit Capabilities will also suggest to management solutions to likely future challenges at an early stage (see annex 1 for practical examples).

It is also important to recognise that the roles, responsibilities and objectives of internal audit and external audit are different. The primary role of the external auditor is to provide an independent opinion to stakeholders on the financial statements drawn up on an annual basis. In comparison, an internal auditor, being part of the organisation, has to deal with the challenge of highlighting problems to management, making recommendations for achievable solutions and following their implementation. Internal auditors do not have any power to force the auditees to follow their recommendations, the only way to achieve results is when the auditee trusts in the auditor's knowledge and professionalism and thereby the quality of recommendations made by the auditor. This is why the behavioural part of internal audit training is also of particular importance. Only through competence, objectivity and a professional approach will an internal auditor earn respect and trust and find the right tone vis-à-vis his/her Director General and the DG's management.

The DGs' Internal Audit Capabilities are likely to fall into two categories: belonging to services with important financial responsibilities or to services with no or small financial responsibilities. For example, services in the latter category might nevertheless face substantial internal control issues (e.g. the handling of highly sensitive information) and their staff would therefore also require internal auditing skills. Alternatively, auditors with external audit or accounting backgrounds working elsewhere in the Commission may require more specific internal audit skills. It is therefore important for all auditors to be provided with internal audit training throughout 2001 (see section 6.2). Auditors in IAS and Internal Audit Capabilities will be encouraged to obtain a formal auditing qualification.

In line with the provisions of action 81 the annual work plan of the Internal Audit Capability will be prepared by its Head and approved by the Director General. The Director General may wish to take into consideration requests from operational Units in the annual work plan, but should ensure the independence of the Internal Audit Capability within this process and the feasibility of nevertheless carrying out the proposed risk-based plan. The White Paper also provides that the plan will be communicated to the Commission's Internal Audit Service with a view to avoiding duplication and to ensure the optimal use of resources. Finally, under the overall responsibility of DG BUDG, Finance/Resource Units should continue to prepare and coordinate management's replies to audit reports of the Court, whereas the Internal Audit Capability will be responsible for liaising with the Court of Auditors on audit matters such as work programmes and control issues emanating from the Court's reports. It is therefore essential for the Internal Audit Capability to receive copies of all Court reports and other relevant exchanges with the Court in relation to their DG. However, the final decision as to the organisational structure and content of the scope of activities carried out by the Internal Audit Capability must rest with the Director General.

1.4. Responsibility for On-the-Spot Control Checks

Internal audit must be outside of all the primary functions of the DG – whether managerial, financial or operational – as the Internal Audit Capability, to provide an effective service, has to be independent of the activities it reviews. The Director General must not assign responsibilities to internal audit for conducting important control checks, as any checks performed on a routine basis by internal audit would inevitably compromise an objective review by the Internal Audit Capability of this area.

The White Paper provides that in the future, responsibility for on-the-spot control checks of beneficiaries and systems-based reviews will rest squarely with operational DGs. To date the Financial Controller carried out a wide range of activities other than ex-ante visa and internal auditing, including on-the-spot control checks on beneficiaries to ensure compliance with rules and regulations as well as systems-based reviews of decentralised managers outside of the Commission. These control checks and systems-based reviews have also been carried out by operational DGs as part of the control activities put in place by their management to ensure that the DGs' objectives are achieved:

- (a) in line with sectoral legislation requirements (in the field of indirectly managed Community funds such as clearance of accounts in DG AGRI);
- (b) in the context of closure of accounts operations (in the field of direct management by the Commission before a final payment or a recovery order has been issued).

In the past the term 'audit' has been used by DGs in the context of such on-the-spot control checks. For example in the area of direct management, these checks have usually been linked to financial transactions, and thereby should have fallen into the area of 'control' as part of the DGs' operational management structure. Clearly, such control activities and their operations, as any operational activity, will be the subject of audit reviews by the Internal Audit Capability, which by definition must be independent of the activities it examines.

According to recent information from the European Court of Auditors⁴, to date none of the DGs reviewed have a genuine internal audit function in the sense of an independent and objective assurance activity in relation to the DG's own internal control systems. In fact, a considerable part of the activities of the existing 'audit units' consisted of control checks of the above nature. However, some of the existing 'audit units' also carried out checks of beneficiaries or decentralised managers in Member States independently from day-to-day project management considerations, and on the basis of assessed risk, to examine the beneficiaries' internal control systems. Staff that have been previously allocated to this type of activity have a particular expertise similar to that required for the Internal Audit Capability and therefore they could form part of the initial staffing for an Internal Audit Capability.

Given that 'audit' must be independent of any operational activity, there is a clear incompatibility between the DGs' Internal Audit Capability and the frontline controls over the management of funds paid directly to final beneficiaries or, in the case of indirectly managed funds, through Member States. Therefore, it follows that the DGs' capacity for on-the-spot control checks should be organised within operational units and/or Resource Directorates/Units, depending on the financial circuits adopted by the Director General.

The control structures ultimately adopted by the DGs will also be the subject of audit reviews carried out by their Audit Capabilities and this may include the possibility for the Internal Audit Capability to accompany any control visit carried out by the control structures to check the effectiveness of the control system put in place and the methodology used. The Internal Audit Capability may also add value by advising on matters such as the design of the on-the-spot control methodology and appropriate sampling techniques. To this end the DG's control structure will need to provide the Internal Audit Capability with regular information on the results of their work.

2. Conditions for the provision of an internal audit capability in each service

2.1. Conditions for the Setting Up and Management

The critical condition for an effective Internal Audit Capability is adequate status and independence within the Directorates General and the widest possible remit. A prerequisite is therefore visible and overt top management level support and commitment of resources to an Internal Audit Capability that should operate in a professional manner and in accordance with the following Commission Standard:

Each DG and Service is required to have an Internal Audit Capability, which operates in accordance with internationally established professional internal auditing standards and best practice. These professional standards require that the Internal Audit Capability should be independent of the activities it reviews and therefore have no executive responsibilities. Each DG must have an Internal Audit Capability charter, which will be approved and signed by the Director General. The principles and objectives contained in the charter should be clearly understood by all levels of management and staff within the DG⁵.

The draft charter, which is annexed to the Internal Audit Planning and Co-ordination Group's final report⁶, could serve as an example for the charter of an Internal Audit Capability. This charter will cover the strategic objectives of the Internal Audit Capability such as the mission, independence, scope of activities, authority and relations with other review services, such as the Internal Audit Service, key procedures (including planning and reporting) and professional and ethical standards.

Directors General must take account of the following conditions for the establishment and operation of Audit Capabilities:

2.1.1. Independence

C.1. The Head of the Internal Audit Capability reports to the Director General. Regular meetings with the Director General help to ensure independence vis-à-vis operational Units.

C.2. The Internal Audit Capability must be independent of the activities it reviews and therefore has no executive responsibility. There should be no conflicts of interest. The Internal Audit Capability opinions and recommendations should be objective and free from bias.

2.1.2. Scope of Operation

C.3. The Internal Audit Capability's scope will cover all of the activities of the DG in relation to the management and control of risks; the monitoring of control systems, including financial, operational and management controls; and the assessment of the performance of the DG.

C.4. The Internal Audit Capability has unrestricted access to people, systems, documents and property within the DG, as it considers necessary for the proper fulfilment of its responsibilities.

C.5. The Internal Audit Capability must be consulted about the development of new systems and changes to existing systems, both manual and automated, that may affect the DG's internal control system. It is advisable that the views of the Internal Audit Capability are given at an early stage and on a continuing basis where major or complex systems are involved or where there are significant implications for the internal control system.

2.1.3. Management, Staffing and Training

C.6. The Internal Audit Capability should be competently managed and operated in accordance with

internationally established professional internal auditing standards and best practice. With regard to its objectives, it should be adequately staffed in terms of numbers, seniority and experience. Internal Audit Capability staff must be properly trained to fulfil their responsibilities.

2.1.4. Reporting and Follow-up

C.7. The findings and recommendations resulting from the Internal Audit Capability's work must be promptly reported to the auditee and discussed in the framework of a contradictory procedure before a final report is issued. This process should take no longer than one month. Accepted recommendations need to be followed up to ascertain whether appropriate action has been taken.

C.8. Where significant findings or recommendations are not accepted or where implementation of recommendations appears unsatisfactory the Head of the Internal Audit Capability will draw the matter to the attention of the Director General ensuring that risks resulting from inaction are recognised and accepted. However, it is for the Director General to ultimately decide whether or not to accept and implement audit findings and recommendations.

2.1.5. Independent Assessment

C.9. The performance of the Internal Audit Capability should be measured and assessed by the Director General at least every three years and corrective action taken if necessary. The Commission's Internal Audit Service will also review the performance of Internal Audit Capabilities.

Since the formal process of establishing a DG's initial audit needs and risk assessment of its systems may in many cases take several months to complete, a Director General will therefore wish to establish an Internal Audit Capability without delay and prior to the results of the formal audit needs assessment, given the need to sign the annual declaration on the DG's internal controls foreseen early in 2001. In line with the provisions in Action 81 the DGs will need to establish their Audit Capabilities before the end of this year. Under Action 87 the IAS will carry out a review made by the Commission's services in the change process and DGs will be able obtain advice from the IAS on the establishment of the Internal Audit Capabilities as part of this review.

2.2. Operation of the Internal Audit Capability

The likely coverage of the Internal Audit Capability's annual work plan will not depend solely on the size of the budget managed by the DG. The concept of internal control goes beyond financial control issues as the DGs' internal controls are likely to comprise all procedures put in place by management to achieve the DG's objectives. Therefore, the Internal Audit Capability will need to determine the DG's audit needs by identifying all systems and the risks attached to them (see Annex 2).

The Director General will need to make a pragmatic decision on the initial staffing levels for the Internal Audit Capability, which takes into consideration the DG's operational and financial responsibilities, in terms of their diversity and complexity, as well as the adequacy of the already existing control systems as indicated in the results of the internal control self-assessment exercise. Eventually, the level of assurance the Internal Audit Capability will be able to provide to the Director General will depend – apart from the DG's actual audit needs – on its professional expertise, skills, experience and organisation. To reach a critical mass each Internal Audit Capability should be staffed by at least two professionally qualified or experienced auditors, one of which should have internal audit experience.

Following this initial audit needs assessment an annual work plan will be proposed by the Head of the Internal Audit Capability to the Director General for approval and signature. Auditees will be normally informed in advance of any audit. After completion of an audit review the Head of the Internal Audit Capability will transmit a draft report to the auditee who will normally comment on findings and

recommendations; the Head of the Internal Audit Capability will issue to the auditee and the Director General the final report, which takes into consideration these comments. The finalisation of the report should not take longer than a month from transmission to the auditee of the draft report. Any comments of the auditee, which the Head of the Internal Audit Capability could not agree with in the report's final version, should be appended.

In providing an overall assurance to the College on the institution's internal controls the Commission's Internal Audit Service will also depend on the work carried out by the Audit Capabilities. To be able to make full use of their work, the IAS will need to periodically assess their quality and professionalism. This will be facilitated by a regular exchange of information on their work plans (i.e. coverage) and progress on implementation (e.g. through periodic activity reports). Audit Capabilities will be required to provide the IAS with their annual work plans as well as quarterly activity reports in a format to be defined by the IAS before the end of 2000.

The IAS will also use the Audit Capabilities' work to inform its own work plan. Through the exchange of work plans the IAS will ensure co-ordination and thereby the optimisation of audit resources.

2.3. Options for the Setting Up

Action 81 of the White Paper clearly states that each DG will create an Internal Audit Capability and that this function will depend on the scale of the DG's financial and operational responsibilities and the inherent risk. Therefore, the majority of DGs will have an in-house Internal Audit Capability. Directors General may wish to explore whether an in-house team could be reinforced by external means, e.g. contractors and National Experts, including the provision of specialist skills such as computer auditors. Services from an external provider may also be purchased to cover on-the-spot control checks of beneficiaries, thereby freeing control staff in operational and/or Finance Units, which may be transferred to provide, if available, more specialised resources to the Internal Audit Capability.

However, for those Services with reduced financial and operational responsibilities the cost of providing an effective and sustainable in-house Internal Audit Capability may be considered to be prohibitive. It is recommended that Services who consider themselves to be in this position, perform a cost-benefit analysis in relation to the assessment of their audit needs. Directors General may wish to use specialist external assistance in assessing their audit needs and carrying out a cost-benefit analysis. In general terms, it is considered that an in-house Internal Audit Capability, which consists of less than two auditors may not be fully effective or viable. Only for those Services whose audit needs require a small number of auditors should the Directors General give consideration to the following alternative options for the provision of an Internal Audit Capability:

O.1. Pooling of audit and evaluation resources in a joint Audit and Evaluation Capability to increase operational efficiency. In this particular instance, the Director General will need to be prudent in defining the two functions to avoid a conflict of interest.

O.2. Provision of an audit service from an Internal Audit Capability of a larger DG, possibly from within the same family of DGs.

O.3. Different Services to pool available resources and form a consortium to jointly arrange an Internal Audit Capability, which would provide a service to all members of the consortium. A committee, including a representative from each member of the consortium, could be established to supervise the Internal Audit Capability and ensure fair treatment in use of resources. Those DGs who have a strong interdependence, such as the RELEX family, may wish to explore the possibility of such pooling of audit resources.

O.4. The Internal Audit Capability to buy in certain services, on a need basis, from an external provider of audit services. In this circumstance Directors General must take into account factors such as sensitivity and

confidentiality of the work of the DG.

The final decision as to the provision of an Internal Audit Capability rests with the Director General.

3. Accompanying measures for the strengthening of internal audit capabilities

The Communication on “Reform of Financial Management and Control” of 11 April 2000 confirmed that the Commission’s new central Internal Audit Service will in the future provide general audit guidance to Internal Audit Capabilities in DGs (e.g. on working methods) and that, when setting standards for internal controls in DGs, the Central Financial Service will be assisted by the Internal Audit Service in defining roles and responsibilities for the Internal Audit Capabilities.

The Communication also emphasised the need for targeted training for all actors involved in financial management, control and audit. It specified that Internal Audit Capabilities would progressively have the possibility to draw upon the same sources of financial information and informatics tools as the Internal Audit Service. Hence, the following measures will be adopted to accompany the establishment of Internal Audit Capabilities:

3.1. Creation of a Network of Commission Auditors

A network consisting of Heads of Internal Audit Capabilities and the Head of the IAS, called AUDITNET, will be created to exchange best practice and to discuss matters of mutual interest in areas such as methodologies, specific training needs, recruitment including defining competency profiles, audit management software and use of specific computer audit tools, co-ordination between Internal Audit Capabilities, as well as general audit and Commission issues. As part of the AUDITNET meetings, open to all auditors, should be held on a regular basis to disseminate technical matters.

The IAS should take a leading role in operating this high level network through maintaining its secretariat. However, the chair for individual forums should be held by the DGs’ Internal Audit Capabilities.

3.2. Professional Training for Auditors

Training and development is a key element of achieving and maintaining professional standards and the Head of each Internal Audit Capability will be responsible for ensuring that staff receive appropriate training and practical experience necessary for them to carry out their duties effectively. Training and development should be a continuous process and should cover a range of needs. Records of individual’s training needs plans and achievements should be maintained. Certification of training achievements should be obtained where appropriate. The Head of the Internal Audit Capability will need to regularly review the training requirements and co-ordinate training with other Internal Audit Capabilities and the IAS.

As an area of priority in the present reform context the new AUDITNET will assist the IAS in establishing a training needs assessment for auditors in the Internal Audit Capabilities and the IAS and an action plan for the provision of internal audit training. DG ADMIN will assist the IAS in co-ordination and provision of training. It is likely that the substantive training needs cannot be met internally and that the necessary resources have to be made available to buy in expert services from outside.

3.3. Recruitment of Qualified Auditors

It is unlikely, despite plans for increased training, that Internal Audit Capabilities and the IAS will find sufficient numbers of appropriately skilled and experienced audit staff in the near future to enable them to provide high quality results. Therefore, to establish Internal Audit Capabilities the Directors General will need to make a pragmatic decision on the staffing levels, which take into consideration the DGs’ operational

and financial responsibilities and takes account of the current availability of internal resources. However, to reinforce staffing within Internal Audit Capabilities the DGs will need to determine precise staffing requirements latest by the end of November 2000, so that the A6/A7 and A4/A5 external competitions for the recruitment of professionally qualified audit staff can be arranged through DG ADMIN early in 2001. To facilitate the establishment of Internal Audit Capabilities, prior to an external competition taking place, DGs can recruit Temporary Agents, with appropriate skills and experience, on the basis of Art.2b. contracts (see Conditions of Employment for Other Servants).

3.4. Provision of Performance Indicators and Guidelines on Working Methods

Before the end of 2000 the Internal Audit Service will provide Internal Audit Capabilities with basic guidelines on working methods (incl. risk assessment, planning and reporting).

The IAS will provide Internal Audit Capabilities by March 2001 with a set of overall quality requirements as well as more specific criteria and indicators for performance measurement of Internal Audit Capabilities. This will enable Directors General to measure the performance of their Internal Audit Capability and to take corrective action if necessary.

3.5. Audit Software

The effectiveness of audit management as well as quality and productivity of audit can be improved by the use of specialised applications software. Typical applications cover areas such as time recording, budgetary control, automation of the audit needs assessment, strategic and short-term plans, and recording of audit findings. Standard documentation encourages conformity of audit methodologies and facilitate review; presentation graphics can enhance the appearance of reports; specific computer assisted audit tools can include risk assessment and data analysis.

A progressive standardisation of modern audit software will enable sharing of relevant information among Internal Audit Capabilities as well as between Internal Audit Capabilities and the Internal Audit Service and enable greater efficiency and effectiveness in the planning process and ensure that scarce resources are used to optimum efficiency. As an area of priority the AUDITNET will assist the IAS in establishing a needs assessment for audit software in the Commission.

3.6. Access to the Commission's Information Systems

Given the growing importance of audit reviews of cross-DG processes and systems (e.g. of risks within families of DGs) Internal Audit Capabilities will be given access by April 2001 to the Commission's information systems, including greater access to SINCOM, R3, the Early Warning System, the Datawarehouse, SYSPER, etc. The IAS will take stock of progress in its Annual Internal Audit Report.

4. Action to be taken

It is proposed that the Commission:

- (1) endorse the conditions for the provision of Internal Audit Capabilities in all Commission Services as set out in this Communication (C.1.-C.9.); and
- (2) endorse the accompanying measures proposed in this Communication.

ANNEX 1

Examples for how an Internal Audit Capability may add value to the DG's management

1. If the Director General has decided that all payments should be processed by the DG within X working days the Internal Audit Capability would not have responsibility for ensuring that operational units are

complying with this rule (this would be a control task). Instead, the Internal Audit Capability would examine the functioning of the control system that the Director General has put in place to monitor on a routine basis whether payments are being processed within the agreed time schedule. This could be done, for instance, through (1) the audit of operational units' clearance of invoices, (2) the audit of controls over the receipt by the DG of invoices and their authorisation for payment through the SINCOM system, as well as (3) the audit of the DG's system to monitor outstanding invoices.

2. System-based auditing should be understood as the structured analysis and evaluation of internal controls of an organisation's business in relation to its objectives. If for example a DG intends to acquire an electronic scanner for its archives, it may be more appropriate for management to seek the advice of the Internal Audit Capability in relation to the new archiving systems rather than only to the purchase of the scanner. In a systems-based context the Internal Audit Capability should also provide advice on the attached risks and cost, as well as on the necessary control mechanisms to ensure its effectiveness. However, the Internal Audit Capability would not question management's decision to acquire the scanner or be involved in the actual purchase.

3. If for a certain management process no control system exists, the DG's management may want to obtain the Internal Audit Capability's opinion on the likely effectiveness of any proposed controls as well as their efficiency in terms of human resources. Any recommendation by the Internal Audit Capability, whether as result of an audit or as a straightforward counsel, needs to be implemented, if accepted, by executive management (and not by the Internal Audit Capability).

4. Internal Audit Capabilities will not provide added value to the DG if used as a substitute for on-the-spot control checks for example in the context of closure of accounts operations, given the incompatibility with the Internal Audit Capabilities' independence. This should happen only in exceptional circumstances, and with the agreement of the Director General, in the form of a special investigation.

ANNEX 2

Audit Needs and Risk Assessment

The work of an Internal Audit Capability needs to be planned and this annex provides some brief guidance on audit needs and risk assessment as main parts of the planning process.

1. Audit needs Assessment

The needs assessment process usually involves:

(a) Identification of all areas of the DG's operations by system and sub-system (through interviews with different levels of management; internal audit's previous knowledge and experience of the DG; organisation chart and *guide de service*; management information giving a breakdown on aims, objectives and targets; review of budgeting and other financial information).

(b) Determination of the way in which systems will be grouped for audit purposes (by Directorate/Unit/Sector, horizontal systems, financial systems, operational systems, monitoring systems, etc.).

The audit needs assessment should be continuously updated to reflect changes in the DG and completely reassessed at least every 5 years.

2. Risk Assessment

Risks are those events or circumstances, which impinge on the ability of the DG to achieve its objectives. Risk assessment should be carried out on all auditable systems and should separately take into account:

- (a) Financial factors (e.g. number and value of transactions; value of expenditure as broken down by categories such as mission/salaries/payments; value of income if appropriate).
- (b) Systems characteristics (e.g. complexity of operations/programmes and skills required; organisational factors such as number of staff, staff turnover, supervisor to staff ratio; effects of changes on systems stability such as likelihood of systems to change; sensitivity of systems such as external pressures, complexity of computer systems and legislation requirements).
- (c) Effect of systems on other systems.
- (d) Management and control (e.g. staff morale such as speed of staff turnover; quality of internal control within the system such as results of the internal control self-assessment exercise and amount of control over the system exerted by other systems).

The resulting assessment can be expressed in numerical terms by using weightings and points rating for each element. However it is usual to group the resulting risks in bands of high, medium and low risks for the purpose of the audit needs.

3. Planning Process

The overall planning process consists of the following stages:

- (1) Identifying of all auditable systems;
- (2) Carrying out a risk assessment on these systems;
- (3) Preparing an overall plan from the audit needs assessment to cover these risks over a given period (say 3 to 5 years);
- (4) Identifying areas/risks to be covered in the first year plan;
- (5) Estimating the audit resources required to meet the audit needs;
- (6) Presenting plans to the Director General for approval and signature;
- (7) Copying of plans to the Commission's Internal Audit Service.

¹ According to the definition used by the Institute of Internal Auditors: “ Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes”. “ Independence allows internal auditors to carry out their work freely and objectively. This concept requires that internal auditors are independent of the activity they audit”. “ Objectivity is an independent mental attitude which requires internal auditors to perform audits in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgement on audit

matters to others” (Sources: IIA).

² Refer to Commission Communication SEC(2000) 560 of 11 April 2000 “The Reform of Financial Management and Control in the Commission”, section 3.2., on the role and mission of the IAS.

³ ‘Assurance’ is to be understood as the Head of the Internal Audit Capability’s professional opinion and should not be confused with the European Court of Auditors’ Statement of Assurance (the DAS).

⁴ President’s letter of the European Court of Auditors of 17 February 2000 on “Audit Activities of the Commission and Others working on its Behalf”.

⁵ Commission Standard for Audit Capabilities, derived from Reform White Paper (Action 81) and Communication on “Reform of Financial Management and Control” of 11 April 2000.

⁶ A draft Internal Audit Charter was produced by the Internal Audit Planning and Co-ordination Group as an annex of its final report which may serve as a point of reference for Heads of Audit Capabilities in preparing their own charters (<http://www.cc.cec/home/admref/en/pcg/ias.pdf>).