

"Tolerable risk: making the implicit explicit"

The concept of 'tolerable risk' in the Court of Auditor's opinion 2/2004

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Introduction

I thank you for your invitation to speak here today. I feel both honoured and privileged to be taking part in this event, the second seminar organised by this Committee within a year on topics linked to EU budget financial management and control. In my opinion this is indicative of the serious attention now being paid by all European Institutions to improving control over EU funds. I like to think that the Court has made a major contribution to this process with its opinion on 'single audit'. I look forward to today's discussions resulting in further substantive progress and bringing us nearer to meeting the expectations of the European Union stakeholders and citizens.

In 2004 the Court issued its opinion on the single audit model in which it suggested the creation of a 'Community Internal Control Framework'. Through the definition and application of common standards and procedures, this would serve as a basis for improving the internal control of European Union funds at all levels from the Commission to Member and beneficiary States.

As part of this framework the Court stressed the need for an appropriate balance between, on the one hand, the cost of controlling, and on the other, the benefit such controls bring in terms of managing risk. It is this aspect – in particular the meaning and consequence of 'tolerable risk' – I would like to develop today.

My presentation will involve:

- a brief overview of the relevant aspects of the Court's opinion;
- a discussion of costs and risks;
- the meaning and consequence – in terms of defining systems - of tolerable risk; and
- how the concept could be applied in practice.

I will finish by touching upon the impact and consequences of the concept for the Court and its work.

The Court's opinion

The Court's opinion was prepared within the context and framework of the Court as the external auditor of the European Union. The Court is not, and should not be, part of the internal control system. But we were able to use our knowledge and experience – and indeed independence - to identify the overall strengths and weaknesses in the conception and implementation of internal control, and to make suggestions on how the situation could be improved.

The Court is particularly gratified that its opinion has been given due consideration by the European Parliament and Council - namely in the context of the last two discharge procedures - and by the Commission in preparing its analysis of the current situation, and as an element of inspiration for the resulting action plan towards an 'Integrated Internal Control Framework'.

The risk of errors in the transactions underlying the Community budget is a combination of two factors: the risk that an error will occur in the first place – the so-called 'inherent' risk – and the risk that errors are not prevented or detected and corrected by the internal control systems – 'control' risk.

Improving control based on a rational and efficient framework requires explicit recognition of a simple, but important, concept: control systems cannot, and indeed should not, aim for zero risk.

Not only is the pursuit of zero error extremely expensive, but is unlikely ever to be achieved. Once it is recognised that a certain risk of error can, and should, be tolerated, then the next step is to define or set the tolerable risk, taking into account the cost of the control procedures needed to achieve that risk – the cost/benefit balance.

The relevant aspects of the opinion can be summarised as follows:

- any control system is a trade-off between the cost of operating the defined intensity of checks on the one hand, and the benefits these procedures bring on the other;
- the benefit involves reducing the risk that funds are wasted and contain error to a tolerable level;
- it is likely that the level of tolerable error or irregularity would vary between different budgetary areas, depending on both the cost of controls and the inherent risk that the transactions contain errors or irregularities;
- in practical terms, each budgetary area would require the definition of a tolerable risk of error, together with the type and intensity of checking at the final beneficiary level considered necessary to achieve this result:
- the trade-off or balance between the costs of controls against the benefits they bring would be a critical aspect of the control strategy. It should be set openly and transparently and approved by the political authorities of the Union, based on detailed proposals of the Commission.

I would like to introduce a further important aspect: tolerable risk is not just a concept used when defining the focus and intensity of control systems, but should also be given specific consideration when designing expenditure (and revenue) schemes or programmes. The way that expenditure is calculated, claimed for and distributed has an enormous impact on both its cost of administration and its inherent risk profile. As the Court's opinion underlines, effective and efficient internal control systems require the legislation underlying the policy

and processes to be clear and unambiguous, and of sufficient detail to secure the proper use of funds. Unnecessary complexity – such as requirements which do not contribute to the scheme’s main objectives – should be avoided.

Costs and risks

Control systems are designed to mitigate or manage the risk of error either by preventing errors occurring (directly through pre-payment checks, indirectly by dissuasion) or by detecting and correcting errors that have occurred (essentially through post payments checks, ideally on-the-spot at the beneficiaries).

The cost of controlling a given population of transactions is easy to understand, but difficult to measure, particularly in areas of shared management where a significant control burden – together with the associated costs - is carried by Member States. In the Court’s view, all costs associated with administering and controlling Community expenditure are of importance, whether they are borne by Community or national budgets.

I would like to underline three important issues:

- Firstly, the cost referred to is the overall cost of controlling a specific budgetary area, not the individual cost of controlling individual transactions;
- Secondly, given the nature of the risks, the most effective controls are generally on-the-spot inspections of beneficiaries, which are generally expensive to undertake; and
- Thirdly, the vast majority of Community expenditure is fragmented into millions of - mostly relatively small - payments to millions of beneficiaries.

At present, the Commission does not know how much either the administration or control of the 80% of the Community budget under shared management costs. Obtaining reliable information on this subject is an essential step in both assessing the current situation and providing a basis for a rational control framework. The Commission’s action plan seeks to

obtain such information on a pilot basis. In my view this exercise should be given the highest priority.

I now turn to the benefits of control procedures: the reduction in, or containment of, the risk of error or irregularity. I will be talking primarily about the risk of error of legality and regularity in underlying transactions, but similar considerations apply to other factors such as risks to sound financial management and risks to the reliability of accounting data and the financial statements.

Errors are of course damaging because they reflect funds being wasted, beneficiaries wrongly benefiting from taxpayers' money and their existence results in a poor public perception of the quality of EU management. It is in all our interests that systems are effective in managing and containing risks in a rational way, with due regard to the costs involved.

Risk of error arises from both deliberate and accidental acts by beneficiaries, and varies between different budgetary areas and transaction types. For example, beneficiaries within the Union making regular claims based on rules with which they are familiar – agriculture, say - are likely to be of lower risk than more geographically remote beneficiaries undertaking one-off projects following rules and procedures with which they are not familiar – the case for much development aid.

I would also like to mention at this point that the process by which many claims are made – self declaration by beneficiaries in order to receive funds to their benefit – is inherently more risky (but less expensive to administer) than one in which the manager, or an independent third party, raises a claim for the beneficiary based on a detailed inspection. By choosing to administer much of its expenditure in this way, the Union has taken a deliberate decision to accept a relatively high level of risk without openly acknowledging the fact or setting out its consequences. In my view, these risk factors should be specifically taken into account when designing or revising income and expenditure schemes.

Tolerable risk: meaning and consequences

This brings me to the concept of tolerable risk of error: the risk of error in a population that can be tolerated, taking into account the costs of control to arrive at that level. I would like to stress that this concerns risk within a population of transactions as a whole - a budgetary area, for instance - and not an acceptable level of risk within individual claims. It should not be viewed as a margin of error for each beneficiary to aim for, nor should it impact on the recovery and sanction processes when an error is detected.

As we have seen, the risk of error will depend on the type of transactions, the clarity and complexity of the rules to be respected, the familiarity of the beneficiaries with the scheme and its rules, the routine or non-routine nature of the claims, the existence and severity of sanctions, the physical location of beneficiaries etc.. Similarly, the cost of control depends on a number of factors, some of them the same as for risk: the type of transactions, the clarity and complexity of the rules, the physical location of beneficiaries etc..

It is entirely rational that tolerated risk could vary between budgetary areas, depending on the inherent risk of error, the cost of control and even public interest and perception.

Indeed, the current control arrangements contain an implicit understanding that a certain level of risk can be tolerated. By requiring only a limited level of on-the-spot checks - mostly 5 or 10% of transactions - 90 to 95% of transactions remain unchecked at the level of the beneficiary, and therefore open to risk. Neither the resulting risk or cost criteria are openly acknowledged or measured, making it very difficult to judge the extent to which the systems are effective and meeting their objectives.

Within agriculture, the regulations require 5% of area aid claims to be checked on-the-spot, whereas for animal payment claims it is 10%. Presumably this reflects a higher risk for animal payments. However, the Court's testing finds a greater incidence of (residual) error in the animals area, indicating that the higher level of regulatory checking is insufficient to mitigate the additional risks. While this may indeed be intended, the Court has no clear basis or criteria against which to judge the outcome.

The Court last year published a special report (No 3/2005) on the control of environmental expenditure in agriculture. The Court found that not only is this expenditure risky by its nature - payments made to farmers for self-declared activities which ultimately reduce their output and profitability - but is extremely expensive to check. Despite the high risk, the level of checking remains at 5%. Is this due to the higher costs involved, or an explicit decision to accept more risk? There is no clear answer.

Application in practice

Application of an effective cost-benefit balance will require, as a basis, extensive information on the fixed and variable costs of controlling expenditure, an analysis of the inherent risk of errors within transactions and the setting of a realistic but acceptable target - perhaps expressed as a range - for the risk that can be tolerated or accepted (tolerable risk).

As I mentioned earlier, the Court considers that the target for tolerable risk and the related cost implications are of such importance that they should be done in consultation with, and with the approval of, the political authorities: Council and Parliament.

Once the tolerable risk and cost criteria are set, then the control systems - based on the key attributes identified by the Court in its opinion - should establish the type and, in particular, density of the controls needed to result in that risk (in terms of residual error).

An integral part of the system would be the estimation of the outcome in terms of the amount of residual error. One approach - possibly the most efficient and effective - is through the use of statistical sampling to estimate the level of residual risk in the population - the level of error remaining after the controls have been undertaken.

This information, together with the cost of controls, would be compared against the approved tolerable risk target, and used to refine the control approach and intensity for the following exercise. Checking would be increased when the estimated residual risk exceeded

the accepted tolerable risk range, and reduced when estimated risk was significantly lower than tolerable risk.

The Court's opinion recognises that – following this model - the appropriate cost and benefit balance is unlikely to be achieved in the first year of operation but would require fine-tuning over a number of years. Alternative approaches could be foreseen, such as basing each control visit on marginal cost and benefit information. While such an approach may be theoretically responsive, its planning and practical application is likely to be extremely complex and cumbersome.

Tolerable risk and the Court of Auditors

Before concluding, I would like to set out the relationship between the Court and some of the issues being discussed today.

The primary purpose of improving the Communities internal control system is not to provide assurance to the Court, but to allow Commission management to obtain assurance that the public funds under their responsibility are being used legally and regularly.

The Court is the EU's external auditor and, like any other external auditor, is not part of internal control. This separation is essential if the Court is to achieve effective and objective oversight of both management and its results. The role of the external auditor is not to simply take assurance from internal controls, but to obtain and present its own objective evidence on their proper and effective functioning.

Of course, there is an interest for the Court in improved systems. When control systems are tested by the auditor and found to be effective and reliable, they may be relied upon to reduce the amount of testing on transactions, thus increasing efficiency. However, setting tolerable risk criteria is likely to have an even greater impact on the Court's work, by providing objective criteria against which the Court could judge the effectiveness of systems

and their result on the legality and regularity of transactions. As such, it would increase both the efficiency of the Court's work, and the clarity and added value of its findings.

Summing up

In conclusion, tolerable risk applies twofold: firstly, when conceiving and designing expenditure programmes, and secondly, when considering the costs and benefits of control systems.

In this sense, the Court recommends moving from the current situation where systems are essentially designed around inputs, with implicit and non-transparent consideration of costs and benefits, to a situation of greater transparency where systems are explicitly designed in terms of cost, and what they are required to achieve - their output in the context of the risks involved.

This has the advantages that:

- all stakeholders - from management through to external auditors - are aware of the aims of the control systems;
- the criteria can be adapted to meet the different risk and cost of control profiles for the various areas,
- it will lead resources to be used in a more rational, open and hopefully better way.

It is encouraging that the Commission has recognised the importance of the consideration of costs and benefits in its current plans for an integrated internal control framework. I hope the Commission will take further inspiration from the Court's opinion in terms of the development and application of 'tolerable risk'.

Thank you for your attention.