

**AUDIT AUTHORITY**

# **ANNUAL CONTROL REPORT**



**IEGULDĪJUMS TAVĀ NĀKOTNĒ**

**ESF, ERDF, CF**

**01.07.2011. – 30.06.2012.**

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All the Annexes of the Annual Control Report are an integral part of this report.

## ABBREVIATIONS

1 OP	Operational Programme “Human Resources and Employment”
2 OP	Operational Programme “Entrepreneurship and Innovations”
3OP	Operational Programme “Infrastructure and Services”
AA	Audit Authority
ACR	Annual Control Report
CA	Certifying Authority
CF	Cohesion Fund
CFCA	Central Finance and Contracting Agency
CHE	Centre for Health Economics
DG EMPL	Directorate General Employment, Social Affairs and Inclusion
DG REGIO	Directorate General Regional and Urban Policy
EC	European Commission
ERDF	European Regional Development Fund
ESF	European Social Fund
EU	European Union
FEI	Financial engineering instruments
IB	Intermediate Body
ISA	International Standards on Auditing
LGA	Latvian Guarantee Agency
LIDA	Latvian Investment and Development Agency
LMLB	Latvian Mortgage and Land Bank
LVL	Latvian lats
MA	Managing Authority
MCS	Management and control system
MEPRD	Ministry of Environmental Protection and Regional Development
MIS	Management Information System
MoC	Ministry of Culture
MoE	Ministry of Economics
MoESc	Ministry of Education and Science
MoF	Ministry of Finance
MoH	Ministry of Health
MoT	Ministry of Transport
MoW	Ministry of Welfare
MUS	Monetary Unit Sample
OP	Operational Programme
PA	Paying Authority
PMB	Procurement Monitoring Bureau
SC	State Chancellery
SEA	State Employment Agency
SEDA	State Education Development Agency
SIF	Society Integration Foundation
SRDA	State Regional Development Agency

## SUMMARY

1. Annual Control Report is prepared by Audit Authority in accordance with Regulation (EC) No 1083/2006 Article 62. (1) (d), (EC) 1828/2006 (Annex VI and VII) and Guidance Note on Annual Control Report and Opinions.

2. In areas where Community budget is managed through shared management arrangements, the ACR and opinions are critical elements that the EC uses in order to assess how the Member States have fulfilled their obligations and responsibilities for using Community budget appropriations.

3. The functions of the Audit Authority under the Operational Programmes: Infrastructure and Services (No 2007LV161PO002), Entrepreneurship and Innovation (No2007LV161PO001) and Human Resources and Employment (No 2007LV051PO001) (hereafter – OPs) are fulfilled by the Ministry of Finance EU Funds Audit Department (*Section 1.1*).

4. Random sample for the audits of operations was selected from the expenditure declared to EC within the period from 1 January to 31 December 2011 (*Section 1.2*).

5. The ACR covers all three Operational Programmes. There is a single Certifying Authority/Payment Authority and single Audit Authority. Functions of the Managing Authority are delegated to 16 Intermediate bodies (*Section 1.3*).

6. The ACR and the Audit Opinion is prepared based on the results of management and control system audits and audits of operations. More detailed steps of preparation of ACR are described in *Section 1.4*.

7. Within the audit period most significant changes in the management and control system are related to Managing Authority – monitoring of delegated functions and the power to interrupt and suspend the payments. Some minor changes within the Certifying Authority were made to improve the certification process. The changes within Audit Authority are related to legal aspects of the separation of functions and communication on deficiencies (*Section 2*).

8. The Single Audit Strategy (dated 8 July 2011) has been updated and communicated to the EC on 26 June 2012 (*Section 3*).

9. As the result of the management and control system audits performed by the Audit Authority, the Managing Authority and Certifying Authority were assessed with category 2. Meaning that the management and control systems of the Managing Authority and the Certifying Authority are determined as working, but some improvements are needed. Deficiencies found have a moderate impact on the functioning of the key requirements/authorities/system. Recommendations have been formulated and most of recommendations were implemented before issuing of audit opinion. Detailed information of the work done regarding management and control system audits is set out in *Section 4*.

10. Error rate identified by the Audit Authority in accordance with the results of the audits of operations is 0,86% that is below the materiality level, thus the expenditure declared to the EC is within the materiality level and are legal and regular. Results of audits of operations and overall opinion are detailed in *Section 5*.

11. The Audit Authority did not relay on the work of other auditors in preparation of the ACR (*Section 6*).

12. In total the recommendations have been implemented in accordance with the management and control system audit plan of implementation of recommendations. There are recommendations that are partially implemented, but do not have an impact on the evaluation of the ACR (*Section 7*).

13. In audit reference period the Audit Authority performed three complementary audits of operations due to risky areas identified within regular audits of operations, follow-up of advance payments and individually significant units (high risk projects). Audit approach and results of complementary audits are described in *Section 8.1*.

14. Taking into account risks identified in implementation of Financial engineering instruments (FEI) and in accordance with Audit Authority's plan for year 2012 Audit Authority from 2 January to 9 November 2012 performed horizontal system audit "Financial engineering" that covered all institutions involved in FEI administration – the Managing Authority, Ministry of Economics and Latvian Investment and Development Agency. Audit approach and results of horizontal system audit are detailed in *Section 8.2*.

15. Recommendations of the EC audits are being implemented in accordance with the action plan and implementation term (*Section 8.3*).

16. The Audit Opinion on effective functioning of the management and control system and the legality and regularity of the underlying transactions of expenditure declared to the EC for the reference period from 1 July 2011 to 30 June 2012 is based on the results of the management and control system audits and audits of operations. The management and control system has been assessed in category 2 and the error rate of the audits of operations is below the materiality level, thus the Audit Authority concludes to have an unqualified Opinion as it is set out in *Table 14 and Section 8.4*.

17. The work of the Audit Authority has been assessed by DG EMPL, DG REGIO and the European Court of Auditors (*Section 8.5*).

18. Based on Audit Authority's audit report the EC concluded that there was a significant risk in the administration of EU funds and made the decision to interrupt Latvia's EU fund financing under all three Operational Programmes. After the implementation of the Managing Authority's and Certifying Authority's action plan the interruption of payments was lifted (with the EC Letters dated 26 June 2012 and 4 July 2012) (*Section 8.6*).

# 1. INTRODUCTION

## 1.1. Indication of the responsible Audit Authority and other bodies that have been involved in preparing the report

In accordance with the Law on Management of European Union Structural Funds and the Cohesion Fund for 2007–2013 and the Cabinet Regulation No 1153<sup>1</sup> “Procedures for Ensuring the Functions of the Audit Authority in the Management of European Union Structural Funds and the Cohesion Fund” the Ministry of Finance fulfils the functions of the Audit Authority.

Based on the Regulation of the Ministry of Finance<sup>2</sup> the European Union Funds Audit Department performs functions of the Audit Authority for the Operational Programmes: “Human Resources and Employment” No 2007LV051PO001 (1 OP), “Entrepreneurship and Innovation” No 2007LV161PO001 (2 OP) and “Infrastructure and Services” No 2007LV161PO002 (3 OP).

Functionally the Head of Audit Authority is subordinated to the Minister of Finance and has the power to report directly to the Cabinet of Ministers via Minister of Finance as it is set by the Law on Management of European Union Structural Funds and the Cohesion Fund for 2007–2013 that is in force since 13 July 2011. According to the Regulation of Ministry of Finance the Audit Authority is administratively subordinated to the State Secretary of the Ministry of Finance.

## 1.2. Indication of the 12 month reference period from which the random sample was drawn

The random sample was drawn for the expenditure declared to the EC for the period from 1 January 2011 to 31 December 2011 and the actual audit work of audits of operations was carried out between 1 July 2011 and 30 June 2012 in accordance with the Single Audit Strategy updated on 8 July 2011.

## 1.3. Identification of the operational programmes covered by the report and of its Managing and Certifying authorities. Where the report covers more than one programme or Fund, the information shall be broken down by programme and by Fund

The ACR refers to the single management and control system that has been developed for the implementation of all three OPs and their relevant funds:

**Table 1: Operational Programmes and respective funds**

Operational Programme		EU Fund
1 OP	<i>Human Resources and Employment</i>	ESF
2 OP	<i>Entrepreneurship and Innovations</i>	ERDF
3 OP	<i>Infrastructure and Services</i>	CF and ERDF

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<sup>1</sup> Since 27 July 2012 replaced by Cabinet Regulation No 501 “Procedures for Ensuring the Functions of the Audit Authority in the Management of European Union Structural Funds and the Cohesion Fund”.

<sup>2</sup> Regulation of the Ministry of Finance No 12-16/7 dated 1 June 2011.

There is a single Managing Authority in Latvia that has delegated its tasks and functions to the 9 Responsible institutions (8 line Ministries and the State Chancellery) and 7 Co-operation institutions (including the Centre of Health Economics which was liquidated on 1 November 2011) corresponding to the three levels EU fund implementation:

- Managing Authority in general is responsible for communication with the EC, evaluation of the implementation of OPs and providing methodological support to Responsible institutions, Co-operation institutions and the beneficiaries, as well as supervision over delegated functions;

- Responsible institutions' main tasks include setting up and determining the national legislation for implementation of the activities/subactivities in accordance with the sectorial competences, preparation of reports and financial planning to the Managing Authority on the implementation of the activity/subactivity and project application evaluation of restricted project application calls;

- At the level of Co-operation institutions – the project implementation monitoring and administrative checks (on-the-spot visits, progress report review, payment claim checks), reporting on irregularities, project selection and contracting with beneficiaries.

The State Treasury is performing the Certifying Authority's and Paying Authority's functions for all three OPs including certifying that the statements of expenditure are accurate and reliable, drawing up certified statements of expenditure and applications for payment and ensuring that adequate information from the Managing Authority on the procedures and verifications carried out in relation to expenditure has been received.

The duties and rights of the institutions involved in the management and control system of EU funds are defined in the Law on Management of European Union Structural Funds and the Cohesion Fund.

The information of the institutions involved in the administration of the OPs and EU funds are broken down in Table 2:

**Table 2: Institutions involved in the management of EU funds**

<b>Operational Programme</b>	<b>Function of</b>	<b>Institution</b>
1 OP	Managing Authority	- Ministry of Finance
2 OP	Paying Authority and Certifying Authority	- State Treasury
3 OP		
1 OP	Responsible institutions	<ul style="list-style-type: none"> <li>- Ministry of Finance</li> <li>- Ministry of Economics</li> <li>- Ministry of Education and Science</li> <li>- Ministry of Welfare</li> <li>- Ministry of Environmental Protection and Regional Development</li> <li>- Ministry of Health</li> <li>- State Chancellery</li> </ul>
	Co-operation institutions	- State Employment Agency



		<ul style="list-style-type: none"> <li>- Central Finance and Contracting Agency<sup>3</sup></li> <li>- State Education Development Agency</li> <li>- Latvian Investment and Development Agency</li> <li>- State Regional Development Agency</li> <li>- Society Integration Foundation</li> </ul>
2 OP	Responsible institutions	<ul style="list-style-type: none"> <li>- Ministry of Finance<sup>4</sup></li> <li>- Ministry of Economics</li> <li>- Ministry of Education and Science</li> </ul>
	Co-operation institutions	<ul style="list-style-type: none"> <li>- Central Finance and Contracting Agency<sup>4</sup></li> <li>- Latvian Investment and Development Agency</li> <li>- State Education Development Agency</li> </ul>
3 OP	Responsible institutions	<ul style="list-style-type: none"> <li>- Ministry of Finance<sup>4</sup></li> <li>- Ministry of Economics</li> <li>- Ministry of Education and Science</li> <li>- Ministry of Transport</li> <li>- Ministry of Welfare</li> <li>- Ministry of Environmental Protection and Regional Development</li> <li>- Ministry of Health</li> <li>- Ministry of Culture</li> </ul>
	Co-operation institutions	<ul style="list-style-type: none"> <li>- Central Finance and Contracting Agency<sup>3</sup></li> <li>- State Education Development Agency</li> <li>- Latvian Investment and Development Agency</li> <li>- State Regional Development Agency</li> </ul>

#### 1.4. Description of the steps taken to prepare the report

The Audit Authority prepares ACR in accordance with Council Regulation No 1083/2006 Article 62 point (1) (d), EC Regulation No 1828/2006 Article 18 point (2) and the Cabinet of Ministers Regulation No 1153<sup>5</sup> “Procedures for Ensuring the Functions of the Audit Authority in the Management of European Union Structural Funds and the Cohesion Fund”. The Audit Authority does not rely on the work of other auditors as its functions are centralized in the Ministry of Finance. The Head of Audit Authority approves the ACR as authorized by the Ministry of Finance Order No 288 “About a circulation of documentation” dated 1 July 2011.

##### 1.4.1. Information used for preparation of the ACR

The following information was used for preparing the ACR:

- 1) the results of the management and control system audits carried out by the Audit Authority over the reference period from 1 July 2011 to 10 December 2012;

<sup>3</sup> From the 1 November 2011 functions of the Co-operation institution are delegated to the Central Finance and Contracting Agency due to the liquidation of the Centre of Health Economics.

<sup>4</sup> Technical Assistance project.

<sup>5</sup> Since 27 July 2012 replaced by Cabinet Regulation No 501 “Procedures for Ensuring the Functions of the Audit Authority in the Management of European Union Structural Funds and the Cohesion Fund”.

- 2) the results of the audits of operations and complimentary sample for the expenditure declared to the EC within the period from 1 January 2011 to 31 December 2011;
- 3) information from follow-up procedures;
- 4) information from reports of other auditors.

#### **1.4.2. Key requirements and assessment criteria**

In accordance with the Single Audit Strategy the Audit Authority performs risk assessment in three levels:

1. Risk assessment per OP;
2. Risk assessment per institution;
3. Risk assessment on the horizontal systems.

The management and control system audits are planned in accordance with the risk assessment by listing the institutions in descending order (from highest risk to the lowest). Audit Authority begins with the system audits in the institutions with the highest level of risk in order to have enough time for implementation of corrective measures and follow-up audits.

The results of the management and control system audits and audits of operations are the base for the annual Audit Opinion that is issued by the Audit Authority.

Within the audit reference period from 1 July 2011 to 10 December 2012 the management and control system audits have been performed in every institution that is involved in the management of EU funds (18 in total) assessing all the key requirements that have been defined by the EC assessment criteria.

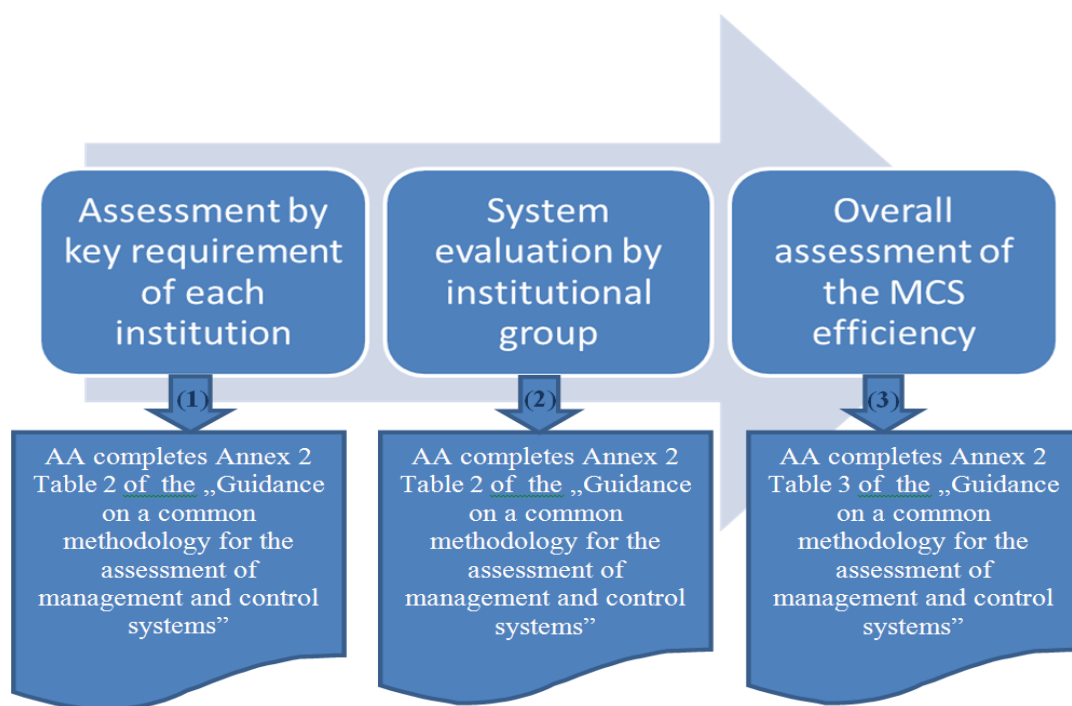
At the planning stage of the management and control system audits the internal control environment of the audited institution is assessed and the main risk factors for each key requirement are determined. In addition, all existing internal controls are identified for the audited institution, whether the controls are in compliance with the EU and national rules and regulations and the controls are sufficient to reduce the risks. The actual controls are tested and results assessed within the course of the audit.

#### **1.4.3. Steps taken to reach overall conclusion and Audit Opinion**

The preparation of the ACR is set out in the Audit Authority's procedure No 8 "Procedure on the preparation of the ACR of the European Union funds in the 2007 – 2013 planning period" that has been prepared taking into account the main elements of the management and control systems key requirements and assessment criteria in accordance with Council Regulation No 1083/2006, EC Regulation No 1828/2006 and EC "Guidance note on annual control reports and opinions".

##### **System Audits:**

Entire process of the ACR to reach the overall assessment of the management and control system can be set in 3 stages:



**Stage 1.** The assessment of the key requirements and assessment criteria are determined in the management and control system audits that are performed by the Audit Authority in each institution - Managing Authority, Certifying Authority/Paying Authority, 9 Responsible Institutions and 6 Co-operation institutions (CHE audited within CFCA audit). The audit results are summarized in the audit report and highlighted in the cumulative management and control assessment table. Detailed assessment of each key requirement and assessment criteria per institution audited are provided in *Annex 3*.

Each assessment criteria and key requirement is assessed in 4 categories as defined in the EC “Guidance on a common methodology for the assessment of management and control systems in the Member States (2007-2013 programming period)”, see *Table 3*.

**Table 3: Category of the assessment criteria and key requirements**

<u>CATEGORY</u>	<u>DESCRIPTION</u>
Category 1.	<b>Works well; only minor improvements needed.</b> There are no deficiencies or only minor deficiencies found. These deficiencies do not have any significant impact on the functioning of the key requirements / authorities / system.
Category 2.	<b>Works, but some improvements are needed.</b> Some deficiencies were found. These deficiencies have a moderate impact on the functioning of the key requirements / authorities / system.
Category 3.	<b>Works partially; substantial improvements are needed.</b> Deficiencies were found that have led or may lead to irregularities. The impact on the effective functioning of the key requirements / authorities / system is significant. Recommendations and/or an action plan have been put in place. The Member State / The European Commission may decide to take corrective action (e.g. interruption or suspension of payments) in order to mitigate the risk of improper use of EU funds.
Category 4.	<b>Essentially does not work.</b> Numerous deficiencies were found which have lead or may lead to irregularities. The impact on the effective functioning of the key requirements / authorities / system is significant – it functions poorly or does not

	function at all. The deficiencies are systemic and wide-ranging. As a consequence, no assurance can be obtained from the assessment of the key requirements / authorities / system. A formal action plan should be prepared and followed up. The Member State / European Commission take corrective action (e.g. suspension of payments) in order to mitigate the risk of improper use of EU funds.
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The assessment of each key requirement can not be classified more favourably than the worst of the assessment criteria.

**Stage 2.** The Audit Authority reaches a conclusion by the institution group and institution audited, based upon the results of the categorisation of each key requirement under Stage 1, subject to the following principles:

- 1) Some key requirements are determined as more essential with regard to the regularity of expenditure and the proper functioning of the relevant authority:
  - Managing Authority: key requirement 4 (management verifications).
  - Certifying Authority: key requirement 3 (soundly based certification).
- 2) A classification in category 1 (Works well, only minor improvements needed) or 2 (works, but some improvements are needed) of the two essential key requirements mentioned above would have a positive influence on the overall conclusion, while deficiencies in other key requirements may downgrade the assessment for the relevant institution.
- 3) If the essential key requirements highlighted at point 1 (or the relevant key requirement for each authority) are classified in categories 3 (Works partially, substantial improvements are needed) or 4 (Essentially does not work), the relevant authority cannot be assessed overall in a higher category. In other words, a higher classification of the other less essential key requirements for the authority in question cannot compensate for this deficiency.

The overall assessment of each institution group cannot be higher than the lowest assessment of relevant key requirement. For example, if one of the institutions is assessed according to category 3, overall assessment of Managing Authority cannot be higher than category 3 (category 2 or 1). The conclusion of assessment of each institution/authority is summarized in *Annex 4*.

**Stage 3.** The Audit Authority concludes on the overall assessment of the management and control system by identifying any mitigating factors/compensating controls that may exist in one authority which effectively reduce the risk in the overall management and control system, in addition the residual risk to regularity is determined as concluded in *Annex 5*.

The overall conclusion by the management and control system provides a basis for determining assurance levels for formulating audit opinions and subsequent action, taking into account the results of audits of operations as provided in detail in *Section 5*.

### **Audits of operations:**

In accordance with the assurance level obtained from system audits, the confidence level is determined for the audits of operations. Before the sample is drawn, the sampling method and parameters of sampling are determined. There is one sample drawn every half

a year including all three OPs. The detailed testing at the level of Intermediate Bodies and final beneficiaries is performed in order to assess whether the expenditure declared to the EC is legal and regular. As a result of the audit of operations regarding any irregular expenditure found, the Audit Authority evaluates the errors, reports to the auditees and calculates the error rate. More details on sampling methodology applied and the results see in *Section 5*.

The overall opinion is based on the results of the management and control system audits and results of audits of operations, detailed evaluation is set out in *Table 14 of Section 8.4*.

## **2. CHANGES IN MANAGEMENT AND CONTROL SYSTEM**

**2.1. Indication of any significant changes in the management and control systems notified to the audit authority as compared with the Management and control description and of the dates from which the changes apply.**

In the period from 1 July 2011 to 30 June 2012 the Managing Authority have made two updates to the Management and control system description - on 31 December 2011 and 30 June 2012. The changes of the Management and control system as compared to the Management and control system description have been assessed by the Audit Authority for the period from 1 June 2008 to 30 June 2012. In addition, any post events that have occurred after the 30 June 2012 also have been taken into account by the Audit Authority establishing its conclusions and providing its opinion.

### **2.1.1. Changes in the period from 1 July 2011 to 31 December 2011**

The most significant changes in the management and control system as compared with the Management and control description (updated by the Managing Authority on 31 December 2011) for the period mentioned above have been reported in the ACR 2011, where the most significant changes were done in regards to the liquidation of the Centre of Health Economics on 1 November 2011, strengthening functional independence of the Audit Authority and implementing public procurement ex-ante controls.

### **2.1.2. Changes in the period from 1 January 2012 to the 30 June 2012, including the events that have occurred after the 1 July 2012.**

Furthermore, the most significant changes in the Management and control system<sup>6</sup> have been made within the Managing Authority, the Certifying Authority, the Audit Authority, as well public procurement issues.

#### Managing Authority

1. To strengthen MA power to interrupt and suspend the payments of EU funds or implementation of activities, if MA identifies the risk that Intermediate Bodies cannot fulfill delegated functions, in 2012:
  - 1.1. Cabinet Regulation No.1041 has been amended on 10 April 2012;
  - 1.2. MA has detailed process of possible interruption of payments in its internal procedures;
  - 1.3. MA has created the register with high risk projects (activities) for the institution monitoring of risks and in urgent cases of interrupted payments.

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<sup>6</sup> Management and control system description updated by the Managing Authority on 31 on 30 June 2012 compared to the Management and control system description updated by the Managing Authority on 31 December 2011.

2. In March 2012 MA has formed a new department and the main responsibilities of this department are:
  - 2.1. improvement of the existing management and control system;
  - 2.2. risk assessment (at the level of IB and horizontal areas);
  - 2.3. evaluation of adequacy of all internal procedures of IB;
  - 2.4. evaluation of the quality of delegated function (verifications at the level of the IB and beneficiaries);
  - 2.5. on-the-spot check performance (the risky projects).
3. To strengthen monitoring of internal procedures of the IB:
  - 3.1. Cabinet Regulation No.524 has been amended in order to stipulate the evaluation of adequacy of all internal procedures of IB once a year;
  - 3.2. MA has developed an internal procedure on evaluation of the internal procedures of IB.
4. To strengthen the monitoring of delegated functions MA has implemented MA verifications of delegated functions at the level of the IB and beneficiaries, including:
  - 4.1. improved the procedure on risk assessment of IB and horizontal areas;
  - 4.2. improved internal procedures on the evaluation of quality of delegated function (verifications at the level of the IB and beneficiaries);
  - 4.3. developed separate data base to store information regarding implementation of MA recommendations (given at verifications of delegated functions);
5. MA re-established internal audit function in the EU funds management and control system. Cabinet Order No 83 has been adopted on 24 January 2012 which determines obligation for Ministry of Finance if necessary to perform EU fund audit verifications as well as to inform Cabinet of Ministers if the recommendations have not been implemented or agreed upon.
6. In order to ensure Certifying Authority with all necessary information on eligibility of the expenditure MA:
  - 6.1. has amended internal procedure and concretized information which will be submitted monthly to CA in order to ensure eligibility of the expenditure;
  - 6.2. once in a half year the head of MA submits CA a report, where the results of checks of the information in Management Information System, follow-up of MA recommendations, status of audit recommendations, statistical and relevant information is described.

Changes in MA have been evaluated by Audit Authority in the follow-up audit of the implementation of recommendations of the Ministry of Finance as the Managing Authority and the State Treasury as the Certifying Authority and the Paying Authority. *See Section 4.4.1.*

#### Certifying Authority

In order to improve certification process of EU funds:

1. CA has requested MA together with the MA confirmation (on MCS) to submit justification (two times a year) with information on the actions taken and controls being performed that allows MA to give assurance to CA.
2. Since January 2012 CA uses the updated checklist for verification of randomly selected payment claims which includes additional checks regarding public procurement and double financing.

Changes in CA have been evaluated by Audit Authority in the follow-up audit of the implementation of recommendations of the Ministry of Finance as the Managing Authority and the State Treasury as the Certifying Authority and the Paying Authority. *See Section 4.4.3.*

#### Audit Authority

In order to emphasize the separation of functions of the Audit Authority from the internal audit function and to specify the role of the Audit Authority Cabinet Regulation No 501 “Procedures for Ensuring the Functions of the Audit Authority in the Management of European Union Structural Funds and the Cohesion Fund” has been adopted on 24 July 2012. The Cabinet Regulation also clearly states communication of Audit Authority in case of finding material deficiencies of the management and control system and disagreed or outstanding recommendations. All draft reports and final reports of Audit Authority are to be sent not only to the institution audited, but also Managing Authority and Certifying Authority.

#### Public procurement

Amendments to Public Procurement Law have been adopted on 21 June 2012 and have come partly into force on 1 August 2012. Another part shall come into force in 2013 and thus it does not affect this ACR and the audit Opinion provided by the Audit Authority. The amendments are aimed to increase effectiveness, competition and transparency in public procurements, as well to decrease administrative burden.

In order to strengthen public procurement controls, the Cabinet Regulation No.419<sup>7</sup> (came into force on 2 January 2012) has been amended by delegating to perform public procurement ex-ante checks to the Intermediate bodies. Procurement Monitoring Bureau continues to perform public procurement ex-ante checks of all major projects and on the sample basis for procurements of construction works above 1 mlj.LVL, also for procurements that have been published in the EU Official Journal. Intermediate bodies on the sample basis perform ex-ante checks for procurements that are beyond Procurement Monitoring Bureau’s checks. Procurement Monitoring Bureau is also responsible for methodological issues regards to procurement ex-ante checks of Intermediate bodies.

During 2012 the Audit Authority carried out a horizontal audit in the area of public procurement in the Managing Authority, Procurement Monitoring Bureau and Intermediate bodies. The scope of the audit included the evaluation of the amendments to public procurement legislation and the ex-ante checks of procurements. *See Section 4.4.4.3.*

### **3. CHANGES TO AUDIT STRATEGY**

The initial Single Audit Strategy was prepared and submitted to the EC on 29 September 2008. The acceptance of the Single Audit Strategy from the EC was received by letter No D(2009)6651 on 7 April 2009.

The latest updated Single Audit Strategy was submitted to the EC on 26 June 2012. The most substantial changes that have been made to the updated Single Audit Strategy are set in points 3.1 – 3.6 below.

3.1. The Audit Authority has determined additional horizontal areas:

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<sup>7</sup> Cabinet Regulation No 419 “Procedures, by which Institutions Involved in the Management of European Union Structural Funds and the Cohesion Fund Ensure the Preparation of Planning Documents and the Implementation of Such Funds”.

- 3.1.1. Publicity requirements;
- 3.1.2. Finance engineering instruments;
- 3.1.3. Irregularities.

3.2. Risk assessment of the management and control system audits is performed at two levels – per OP and per institutions that are involved in the management of the EU funds. In order to establish the risk priority, the Audit Authority determines the risk factors, their share in the overall score and assesses them in 3 or 4 point scoring system according to the detailed scoring system description for each factor. The main change is the reduction of risk factors from 11 to 2 for OPs and from 11 to 4 for institutions (one of them is the assessment of OP). Therefore the intervals for determining the risk priority are also changed.

In order to establish the risk priority of horizontal issues, the Audit Authority determines the risk factors, their share in the overall score and assesses them in 3 point scoring system according to the detailed scoring system description for each factor. Total number of risk factors is reduced to 5 risk factors and therefore the intervals for determining the risk priority are also changed.

Changes to the risk assessment methodology were made in order to introduce more comprehensive and efficient risk assessment process.

3.3. During the reference period following internal procedures have been updated:

- 3.3.1. Internal procedure No ARD-19 “Procedure for the Audit Authority to conduct system audits of the European Union structural funds and Cohesion Fund in 2007–2013 programming period” on 23 May 2012 (detailed in *Section 4*);
- 3.3.2. Internal procedure No ARD-4 “Procedure for the Audit Authority to carry out audits of operations of the European Union structural funds in 2007–2013 programming period” on 25 June 2012 (detailed in *Section 5*);
- 3.3.3. Internal procedure No ESFRD-1 “Procedure to prepare and update Single Audit Strategy of the European Union structural funds in 2007–2013 programming period” on 8 June 2012;

3.4. During the reference period internal procedure No ESFRD-32 „Procedure for the Audit Authority to ensure data input in the Management Information System of the European Union structural funds and Cohesion Fund and internal data bases of Audit Authority, check data quality and use of external information systems” has been developed on 21 June 2012.

3.5. In IT system audits ISO 27002 standards, IT Audit, Assurance and Control standards issued by ISACA and COBIT guidelines are applied. During the reference period 1 Senior expert obtained CISA certificate issued by ISACA.

3.6. The updated management and control system audit plan and the audit approach were presented to the EC in the Bilateral meeting on 24 April 2012.

## **4. SYSTEM AUDITS**

### **4.1. Indication of the responsible audit authority and other bodies that have been involved in preparing the report**

During the reference period all system audits solely have been performed by the Audit Authority that is located within the Ministry of Finance in EU Funds Audit Department (more details see in *Section 1.1*).



#### 4.2. Summary list of the audits carried out (bodies audited)

The summary of the management and control system audits carried out during the reference period and not reported in the ACR 2011, indicating the OP, the audit body, the date of the audit carried out, audit scope, principal findings and conclusions, whether there were systemic deficiencies and the state of follow-up is set out in *Annex 1 and Annex 2*.

The Audit Authority assessed all institutions that are involved in the management of the EU funds performing 16 audits in total (11 management and control system audits, 4 horizontal system audits and 1 follow-up audit) *see Annex 1 and Annex 2*.

In order to assess the management and control system in the most efficient way and to cover all key requirements, some system audits were performed to cover the Responsible institution and its respective Co-operation institution in one single audit:

- Ministry of Education and Science and the State Education and Development Agency;
- Ministry of Welfare and the State Employment Agency;
- State Chancellery and the Social Integration Foundation.

In order to review and assess the implementation of the Managing Authority's and Certification Authority's action plan and implementations of the Audit Authority's recommendation, the audit in the Certification Authority and the Managing Authority was performed as single one.

Management and control system audits, covering 1 institution per 1 audit, were performed in the following institutions:

- Ministry of Economics,
- State Regional Development Agency,
- Latvian Investment and Development Agency,
- Ministry of Transport,
- Ministry of Health,
- Central Finance and Contracting Agency,
- Ministry of Culture,
- Ministry of Environmental Protection and Regional Development.

According to the Single Audit Strategy – during the audit reference period the Audit Authority performed 4 horizontal system audits in the area of:

- Public procurement (the Managing Authority, Procurement Monitoring Bureau, all Co-operation institutions (6) and two Responsible institutions Ministry of Transport and Ministry of Environmental Protection and Regional Development);
- IT systems (the Managing Authority, The Certifying Authority, Procurement Monitoring Bureau, and all (15) Intermediate bodies);
- State aid (the Managing Authority and all (14) Intermediate bodies);
- Financial engineering (the Managing Authority, Ministry of Economics, Latvian Investment and Development Agency).

#### 4.3. Description of the basis for selection of the audits in the context of the audit strategy

In accordance with the latest updated Single Audit Strategy, that was submitted to the EC on 26 June 2012 via SFC2007, the risk assessment methodology has been updated. More detailed information is set out in *Section 3 point 3.2*.

As a result of the risk assessment, in total 11 institutions were assessed at high risk and 8 institutions – at low risk. The summary of the risk assessment per OP and per institution for the period from 2011 to 2015 is provided in *Table 4*, also the detailed calculations and table of institutions is provided in the updated Single Audit Strategy's Annex 5.

**Table 4: Summary of the Risk assessment per institution**

OP	Institution	Amount of EU funding	Total score of risk assessment	Priority
1 OP	MoESc	-	35	Low
	SEDA	236,9 m	43	High
	MoW	-	35	Low
	SEA	241,7 m	38	High
	MoEcon	-	35	Low
	LIDA	50,9 m	38	High
	MEPRD	-	35	Low
	SRDA	7,2 m	35	Low
	MoF	-	35	Low
	MoH	-	35	Low
	CFCA	34,6 m	35	Low
	SC	-	35	Low
	SIF	11,8 m	35	Low
2 OP	MoESc	-	33	Low
	SEDA	219,1 m	41	High
	MoEcon	187,1 m	36	High
	LIDA	307,5 m	36	High
	MoF	-	33	Low
	CFCA	23 m	33	Low
3 OP	MoESc	-	35	Low
	SEDA	267,8 m	43	High
	MoEcon	-	35	Low
	LIDA	201,2 m	38	High
	MEPRD	567,9 m	41	High
	SRDA	310,7 m	38	High
	MoT	1,162 b	41	High
	CFCA	700,5 m	41	High
	MoW	-	35	Low
	MoH	-	35	Low
	MoC	-	35	Low
	MoF	-	35	Low
Managing Authority			46	High
PMB			37	High
Certifying Authority			37	High
Paying Authority			28	Low

In general, the Responsible Institutions are line ministries that are competent in setting up the policy for certain area (i.e. Ministry of Health is responsible for the management of health policy in the state). Their functions, amongst other, would include monitoring the implementation at the activity/sub-activity level, set up the project

application assessment criteria and the planning documentation, manage the financial flow of the state budget and EU funds.

Functions of the Co-operation institutions are generally delegated to the state agencies, whose functions would include project application selection process, contracting with beneficiaries, EU fund monitoring at the level of projects, on-the-spot checks, payment request approval, reporting on irregularities, evaluation of the procurement and publicity requirements.

The Audit Authority's general approach according to the Single Audit Strategy in system audits is:

- To assess all institutions that are involved in the management of the EU funds;
- To assess key requirements and criteria with highest risks;
- Assess basic horizontal priorities.

During the audit reference period the Audit Authority performed 4 horizontal system audits in such areas:

- Public procurement;
- IT systems;
- State aid;
- Financial engineering.

**4.4. Principal findings and conclusions drawn from the audit work for the management and control systems and their functioning, including the sufficiency of management checks, certification procedures and the audit trail, adequate separation of functions and compliance with Community requirements and policies.**



#### **4.4.1. Conclusion reached on the Managing Authority**

The Managing Authority of the EU funds for the 2007-2013 programming period is located in the Ministry of Finance and it is responsible for administrating the following functions in accordance with Council Regulation No 1083/2006 Article 60:

- ensuring establishment and implementation of computerised information system – Management Information System (MIS);
- evaluations of implementation of the OPs;
- organization of the monitoring committee;
- preparation and submitting of the annual and final reports on implementation to the EC;
- Communication to EC regarding information of the major projects.

The rest of the Managing Authority's functions (in regards of implementation, monitoring and control at the Priority/Activity/Project level) are delegated to the Intermediate bodies:

- project application selection process and setting up the assessment criteria for approval of the monitoring committee;
- verifications of the expenditure declared by the beneficiaries and on-the-spot checks;
- ensuring separate accounting system or an adequate accounting code for all transactions relating to the operation;
- setting up procedures to ensure that all documents regarding expenditure to ensure an adequate audit trail;
- assurance provided to the Certifying Authority (partially);
- compliance with the information and publicity requirements.

Based on the information provided in the Audit Authority's audit report<sup>8</sup>, the EC made the decision to interrupt Latvia's EU fund financing under all three Operational Programmes, notifying its decision in EC's Letter No Ares (2012)94198 dated 27 January 2012 and EC's Letter No.Ares (2012)113559 dated 1 February 2012. The EC concluded that there was a significant risk in the administration of EU funds, based on the following deficiencies in the performance of the Managing Authority's functions:

- The Managing Authority should have enough power to require strengthening the control system in case it is not satisfied with the work of any Intermediate body;
- The Managing Authority does not carry out sufficient supervision of delegated functions and inspection of payment applications prepared by Intermediate bodies before these are submitted to the Certifying Authority.

In order to renew EU fund financing for Latvia, the Managing Authority developed and on 17 February 2012 approved *the Managing Authority's action plan for the improvement of the EU fund management and control system* (hereinafter – the Managing Authority's action plan), which provided the implementation of 27 measures to eliminate the deficiencies specified by the EC.

During the reference period the Audit Authority conducted the audit with the objective of obtaining reasonable assurance that the measures stipulated in the Managing Authority's action plan are being implemented. The opinion of Audit Authority is that the planned measures have essentially been implemented and will strengthen the Managing Authority's control over the fulfilment of delegated functions:

1. The Managing Authority has strengthened its influence on bodies involved in the administration of EU funds, in situations when the Managing Authority is dissatisfied with their work in regard to the fulfilment of their delegated functions.
2. The Managing Authority has improved the control mechanism for supervising delegated functions, ensuring systematic analysis of the information in the possession of the Managing Authority, and verification of the fulfilment of delegated functions at

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<sup>8</sup> Audit Authority's Audit Report No.1DP/2DP/3DP-VI-11/38 dated 24 October 2011 *On the Operational Effectiveness of the Management and Control System Devised by the European Union's Structural Funds and Cohesion Fund for the 2007-2013 Programming Period in the Ministry of Finance as the Managing Authority and Responsible Body*

the level of Responsible/Co-operation Institutions and project implementers for risky areas.

In order to conclude on the assessment of the Managing Authority, the Audit Authority audited all key requirements of all Intermediate bodies that are implementing the functions delegated by the Managing Authority. The approach of Audit Authority is that the overall assessment of the Managing Authority cannot be higher than the lowest assessment of the institution of its delegated functions.

As it is summarized in *Annex 3* and *Annex 4* after determining the overall assessment per key requirement for each institution involved in the management and control system, the Managing Authority is assessed in **the category 2** – the management and control system within the Managing Authority is working, but some improvements are needed in regards to build up efficiency of supervising of delegated functions. As the improvements were made during the ACR reference period and assurance of the effectiveness of improvements made, the Audit Authority can get from further audits.

Results of the horizontal system audits are described in detail in *Section 4.4.4*.

#### **4.4.2. Conclusion reached on the Intermediate bodies**

As a result of the management and control system audits (see *Annex 3* and *Annex 4*) it is concluded that the management and control system established within the Intermediate bodies is assessed in **the category 2** – is working, but some improvements are needed in regards to quality and scope of management verifications especially:

- public procurement controls;
- project on-the-spot controls;
- payment claim controls.

More detailed information on the analysis of the errors and findings in order to identify their systemic nature are provided in *Section 4.5*.

##### **4.4.2.1. The Investment and Development Agency of Latvia**

In the first half of 2012 the Audit Authority carried out a management and control system audit in the LIDA. As the result of the audit the overall effectiveness of the management and control system of the LIDA was assessed as 2 - „works, but some improvements needed” except for the Programme Cooperation Institution, which administrates measures where LIDA fulfils functions of a final beneficiary as well as an Intermediate body, due to the assessment of the following key requirements / assessment criteria:

- Key requirement 4 / Criteria 10, 12, 13, 15 – deficiencies were found in the first level controls carried out by the Programme Cooperation Institution, as there is lack of audit trail within the verifications of payment claims and on-the-spot checks.

The Audit Authority prepared report that was approved on 5 July 2012. Already in June 2012 based on the preliminary findings of the Audit Authority, the Managing Authority interrupted declaration to EC of expenditure within measure 2.3.2.1.0 “Business incubators” that is administrated by Programme Cooperation Institution. In order to lift the interruption of the payments, LIDA must implement all recommendations and actions set by the Audit Authority according to the action plan.

The Audit Authority performed additional follow-up checks during system audit fot ACR 2013 (full system audit results on LIDA will be reported in the year 2013) to get assurance whether deficiencies found within the Programme Cooperation Institution are eliminated and all recommendations of the Audit Authority are implemented properly.

Interim report of system audit was prepared on 19 December 2012. Conclusion of the Audit Authority is following: LIDA has implemented all high priority recommendations of the Audit Authority and actions according to the action plan at the procedural level. The Audit Authority followed-up the implementation of recommendations; however the Audit Authority got the assurance of implementation of 12 recommendations based on the evaluation of LIDA procedures. The practical appliance of the procedures will take place in January 2013. Management and control system of measure 2.3.2.1.0 “Business incubators” is improved. However the effectiveness of improved controls will be possible to assess in the future during next system audits.

Nevertheless, as the Managing Authority had interrupted declaration of expenditure to EC, the Audit Authority is of the opinion that the Managing Authority has taken appropriate actions to eliminate deficiencies found. Final assessment of LIDA is **category 2** – “works, but some improvements are needed”, because of the changes made in the management and control system.

#### 4.4.2.2. The State Education Development Agency

In the first half of 2011 the Audit Authority carried out a management and control system audit in the SEDA. As the result of the audit the overall effectiveness of the management and control system of the SEDA was assessed as „works partially”, due to the assessment of the following key requirements / assessment criteria:

- Key requirement 4 / Criteria 13, 14 – deficiencies were found in the first level controls carried out by the SEDA, as there is lack of audit trail within the on-the-spot checks, public procurement controls and controls of advance payments and inappropriate quality of on-the-spot checks.

The Audit Authority prepared a report that was approved on 11 May 2012. In July 2012 based on the findings of the Audit Authority, the Managing Authority interrupted declaration to EC of expenditure within all measures administrated by SEDA. In order to lift the interruption of the payments, SEDA had to implement all recommendations and actions set by the Audit Authority’s according action plan.

Based on the EC request the Audit Authority performed additional assessment whether deficiencies identified in the Audit Authority’s audit report concerning SEDA could have caused financial discrepancies to the expenditure already declared to the EC. The assessment results were reported to the EC and the Managing Authority on 23 July 2012. The Audit Authority’s conclusion was - deficiency regarding advance payments did not have a financial impact on already declared expenditure and SEDA had already started to implement recommendations made by the Audit Authority and had envisaged activities to increase the quality of on-the-spot visits. Based on the SEDA’s actions taken to improve management and control system and information provided by the Audit Authority, the Managing Authority lifted the interruption of the payments on September 2012.

To get assurance whether deficiencies found within the SEDA are eliminated and all recommendations of the Audit Authority are implemented properly, the Audit Authority performed follow-up checks during system audit (full system audit results on SEDA will be reported in the ACR 2013). Draft report of the system audit was prepared on 13 December 2012. The conclusion of the Audit Authority is: SEDA has implemented all recommendations of the Audit Authority and actions according to the action plan. Management and control system of the SEDA has been improved. However there is still space for improvements regarding documentation of results of on-the-spot checks.

Taking into account preliminary results of the Audit Authority and all actions taken by the SEDA and the Managing Authority, the Audit Authority is of the opinion



that final assessment of SEDA is **category 2** – “works, but some improvements are needed”, because of the changes made in the management and control system.

#### 4.4.3. Conclusion reached on the Certifying Authority

The management and control system established in the State Treasury as the Certifying Authority and the Paying Authority is working effectively, but based on the information provided in the Audit Authority’s audit report<sup>9</sup>, the EC made the decision to interrupt Latvia’s EU fund financing under all three Operational Programmes, notifying its decision in EC’s Letter No Ares (2012)94198 dated 27 January 2012 and EC’s Letter No Ares (2012)113559 dated 1 February 2012. The EC concluded that there was a significant risk in the administration of EU funds, based on the following deficiencies in the performance of the Certifying Authority’s functions – the Certifying Authority does not carry out sufficient controls in such areas as public procurement procedures, state aid, project selection and financial engineering instruments.

In order to renew EU fund financing for Latvia the Certifying Authority developed and on 17 February 2012 approved an Action Plan *“For Elimination of the Deficiencies Referred to in the Audit Authority’s Report No 1DP/2DP/3DP-SEI-11/43 On the Operational Effectiveness of the Management and Control System Devised by the European Union Structural Funds and Cohesion Fund for the 2007-2013 Planning Period in the Treasury as the Paying and Certifying Agency and for Implementation of the Measures Specified in the European Commission’s Letters regarding the Suspension of Payments”* (hereinafter – the Certifying Authority’s action plan), which provided for the implementation of 11 measures to eliminate the deficiencies specified by the EC.

During the reference period the Audit Authority conducted the audit with the objective of obtaining reasonable assurance that the measures stipulated in the Certifying Authority’s action plan are being implemented. The Audit Authority’s opinion is that the Certifying Authority has implemented the most significant measures mentioned in the action plan, has improved the certification process introducing an additional control mechanism for such areas as public procurement procedures, state aid and project selection and the certification process is being carried out. As the improvements were made during the ACR reference period and assurance of the effectiveness of improvements made the Audit Authority can get from further audits, the management and control system established within the Certifying Authority is assessed in **the category 2** – works, but some improvements are needed.

#### 4.4.4. Conclusion reached on the Horizontal priorities

##### 4.4.4.1. IT systems

During the reference period the Audit Authority performed horizontal system audit on efficiency and security of EU funds’ management information system. It was concluded, that EU funds’ management information system correspond to the EC’s regulations and national regulations and system’s data corresponds to general requirements of confidentiality, integrity and availability, although some minor and moderate improvements should be made in the fields of:

- Data quality;
- Definition of value and availability level of data;
- IT risk evaluation;
- Disaster recovery plan – completeness and testing;

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<sup>9</sup> Audit Authority’s Audit Report No.1DP/2DP/3DP-VI-11/38 dated 24 October 2011 *On the Operational Effectiveness of the Management and Control System Devised by the European Union’s Structural Funds and Cohesion Fund for the 2007-2013 Programming Period in the Ministry of Finance as the Managing Authority and Responsible Body*

- Update testing;
- Segregation of user/administrator roles;
- Storage of backups;
- Log file analysis and regular system monitoring;
- Security of server room.

#### 4.4.4.2. State aid

During the reference period the Audit Authority performed state aid horizontal system audit. As a result of the horizontal state aid system audit it is concluded that:

- state aid is identified at the EU funds planning stage and state aid is controlled during EU funds project implementation stage, but the “grey area” is the state aid controls outside EU funds;
- management and control system established within the Intermediate bodies regarding state aid controls works, however, there are some improvements needed.

#### 4.4.4.3. Public procurement

The Managing Authority has delegated the public procurement control checks to the Intermediate bodies, including the ex-ante public procurement checks and methodological issues to the Procurement Monitoring Bureau.

The functions of the Procurement Monitoring Bureau are to:

- perform public procurement ex-ante checks;
- supervise ex-ante public procurement checks that are carried out by Intermediate bodies;
- ensure methodological issues regards to procurement ex-ante checks of Intermediate bodies (elaboration procedure and check-lists for ex-ante public procurement checks, regular meetings with Intermediate bodies, consultations).

This function of ex-ante public procurement checks is determined to be as an additional control. Thus, in accordance to the audit scope of the Audit Authority’s horizontal public procurement system audit in the Procurement Monitoring Bureau Key requirement 4 was audited, however, the overall assessment of the Bureau was not determined. The overall assessment of the Procurement Monitoring Bureau can be provided in the unity with results of the procurement controls in Responsible and Co-operation institutions.

During the horizontal public procurement system audit the Audit Authority found out that:

- In order to strengthen public procurement controls, ex-ante checks have been implemented in 2012.
- Ex-ante checks of procurements have positive impact as they:
  - are preventive – legality of procurement is checked before the public procurement agreement is signed;
  - reduce mistakes in public procurements: aproximetly 67% of public procurements contain deficiencies and mistakes, that have been detected and corrected at the stage of ex-ante check.

As a result of the horizontal public procurement system audit it is concluded that the management and control system established within the Intermediate bodies, regarding public procurement controls, is working, however, there are some improvements needed:

- improve the methodology and supervision of ex-ante checks;
- increase the amount of ex-ante checks;



- facilitate the quality of public procurement documents and process (e.g. standardized procurement documentation forms, training of the beneficiaries).

#### 4.4.4.4. Financial engineering

See more detailed information on *Section 8.2*.

#### 4.5. Indication of whether any problems identified were considered to be of a systemic character, and of the measures taken, including a quantification of the irregular expenditure and any related financial corrections.

In total as a result of system audits the Audit Authority issued 121 recommendations:

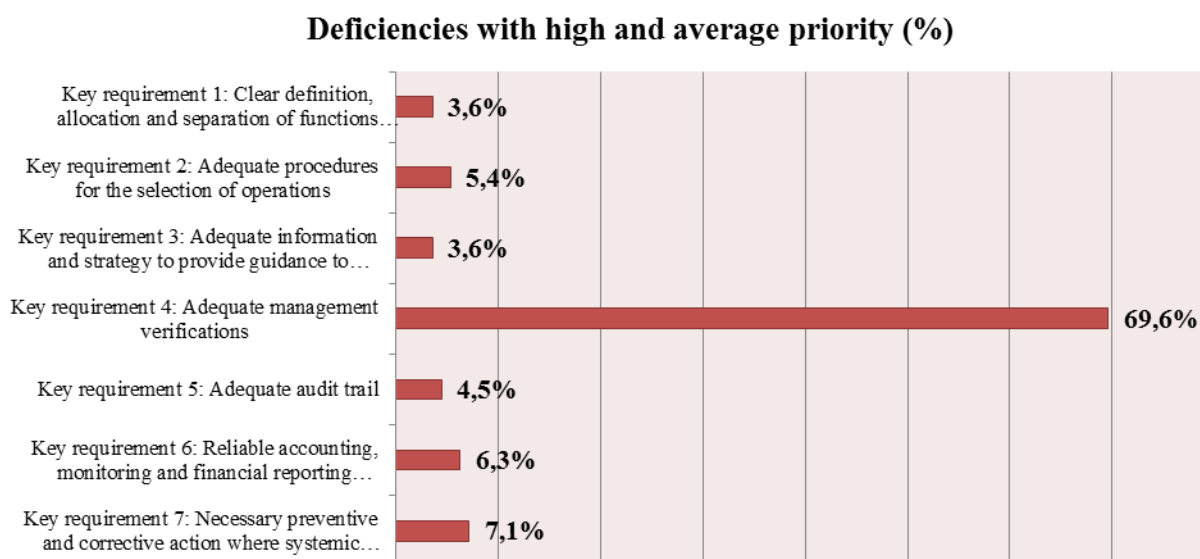
- 31 high priority recommendations;
- 69 average priority recommendations;
- 21 low priority recommendations.

Implementation status of issued recommendations in the time of issuing Opinion and ACR:

	Recommendations priority			TOTAL
	High	Average	Low	
Recommendations implemented	25	44	4	<b>73</b>
Recommendations partly implemented	1	2	1	<b>4</b>
The deadline of implementation of recommendations not in force	4	20	16	<b>40</b>
Recommendations are not implemented	1	3	-	<b>4</b>
<b>TOTAL</b>	<b>31</b>	<b>69</b>	<b>21</b>	<b>121</b>

The Audit Authority performed the analysis of the errors and findings in order to identify their systemic nature. As it is shown in *Chart 1* almost 70% of all deficiencies identified by the Audit Authority during the system audits are identified within Key requirement 4 - Adequate management verifications.

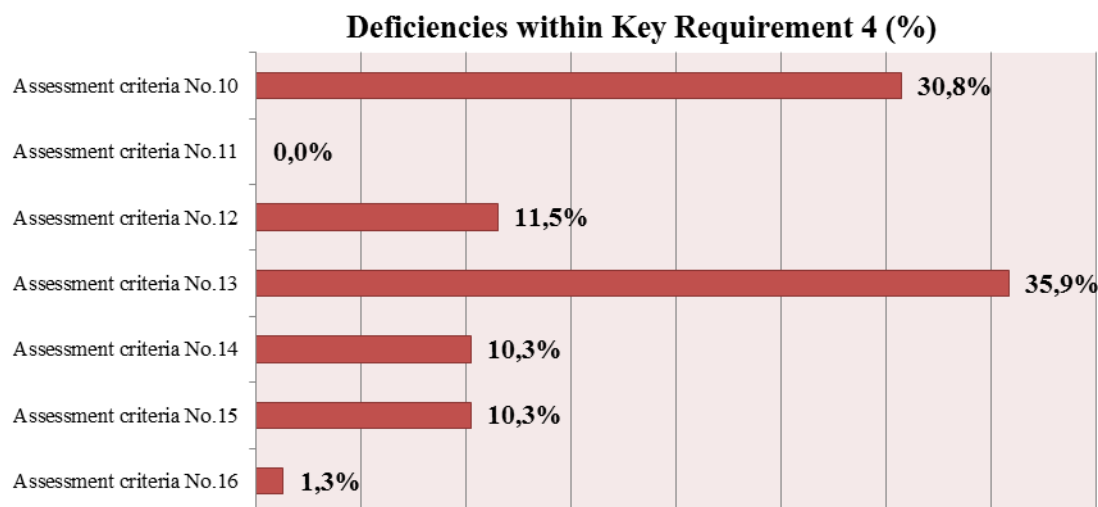
**Chart 1**



Almost 36% of all deficiencies identified within Key requirement 4 are related to assessment criteria No 13, this means that the deficiencies regarding quality and scope of on-the-spot verifications could be treated with systemic character. As it is described in

Section 4.3 the approach of Audit Authority is to assess key requirements and criteria with highest risks, and Audit Authority's system audit results approved that improvements are still possible in such high risk areas as management verifications.

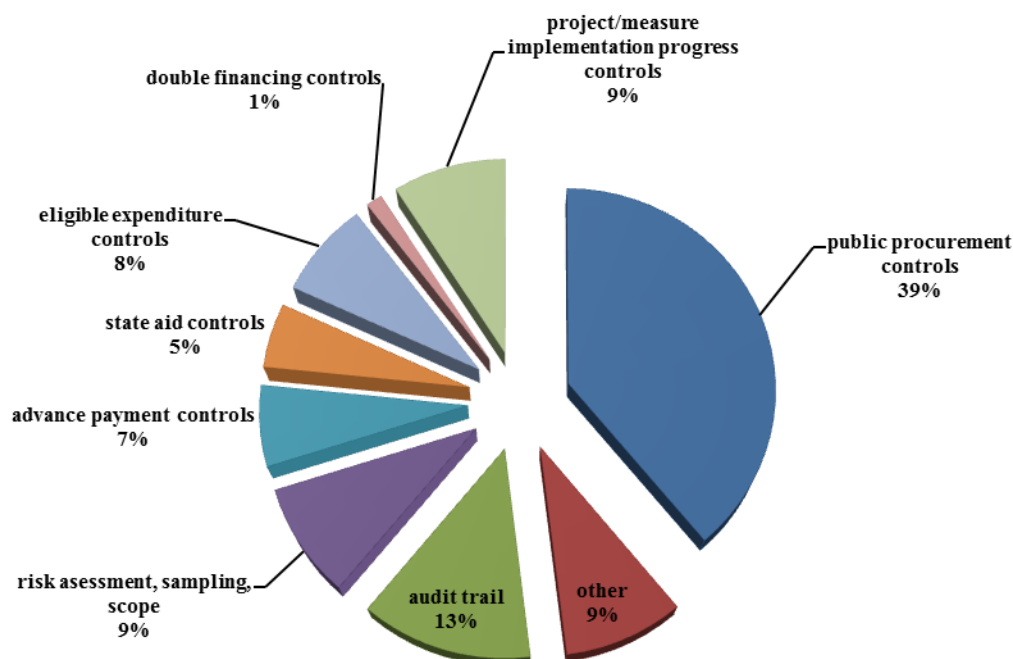
**Chart 2**



The Audit Authority performed qualitative evaluation of deficiencies identified and considered that (*see Chart 3*):

- 39% of all deficiencies regarding the management verifications are related to the public procurement controls (6 irregularities with financial impact which the Audit Authority found during system audits were related to the shortcomings of the public procurement). Taking into account system audit results the Audit Authority performed horizontal management and control system audit in public procurement area, more detailed information see *Section 4.4.4.3*.
- 13% of deficiencies are related to insufficient documentation of controls/control results (audit trail);
- 9% of deficiencies are related to insufficient/not well described sampling methods of operations selected as well as risk assessment of projects;
- 9% of deficiencies are related to insufficient controls of projects/measures physical and financial progress.
- All other deficiencies are minor and related to such areas as insufficient administrative verifications regarding the expenditure, advance payments, state aid rules, double financing and other.

Areas of Deficiencies within Key Requirement 4 (%)



## 5. AUDITS OF OPERATIONS

### 5.1. Indication of the bodies that carried out the audits of operations, including the audit authority

Audits of operations regarding certified expenditure in calendar year 2011 were carried out solely by the Audit Authority (*See section 1.1*).

### 5.2. Description of the basis for selection of the sample(s). Indication of the materiality level and, in the case of statistical sampling, the confidence level applied.

Audit Authority carried out audits of operations in accordance with Audit Strategy updated on 8 July 2011.

Audits of operations are performed for expenditure declared to the EC during the period – from 1 January to 31 December 2011 within all three Operational Programmes:

- 1) Operational programme „Human Resources and Employment” (ESF) – 2007LV051PO001;
- 2) Operational programme „Entrepreneurship and Innovations” (ERDF) – 2007LV161PO001;
- 3) Operational programme „Infrastructure and Services” (CF and ERDF) – 2007LV161PO002.

Audits of operations are carried out within the reference period from 1 July 2011 to 30 June 2012. During the reference period two regular audits were conducted (broken down by expenditure certified within 6 months period):

- 1) for the expenditure declared to EC from 1 January to 30 June 2011 (audit No AI/SAI-ESF-11/41);
- 2) for the expenditure declared to EC from 1 July to 31 December 2011 (audit No AI/SAI-ESF/ERAF/KF-12/5<sup>10</sup>).

For each regular audit one population was formed and one selection done. Population included certified expenditure in the first half of 2011 only for first Operational Programme<sup>11</sup> and the second half of 2011 for all three Operational Programmes.

Sampling unit is a payment claim covering eligible expenditure approved by Certifying Authority and included in statements of expenditure submitted to the EC.

Sampling method was determined according to EC's Guidance note on sampling methods for Audit Authorities (COCOF 08/0021/01-EN) for each regular audit. General criteria taken into account for determination of sampling method were number of sampling units in population. For expenditure certified in:

- 1) the first half of 2011 population consist of less than 800 sampling units and the sampling method used was the non-statistical sampling method;
- 2) the second half of 2011 population consists of more than 800 sampling units and the sampling method used was the statistical sampling – Monetary Unit Sampling (MUS).

For sampling 10 basic (no changes in standard values) selection parameters were used<sup>12</sup>, see *Table 5*.

**Table 5: Parameters used for sampling**

Parameters	Value	
	I half of 2011	II half of 2011
Assurance from the system (SP)	Average	Average
Confidence level	70%	80% <sup>13</sup>
Book value of expenditure declared for selected half a year (BV)	LVL 47 703 259,41	LVL 467 548 800,25
Materiality level	2%	2%
Tolerable misstatement (TM)	LVL 954 065,19	LVL 9 350 976,01
Reliability factor (RF)	1,21	1,61
Anticipated misstatement (AM)	10%	10%
Expansion factor (EF)	1,2	1,3
Interval	LVL 788 483,63	LVL 5 000 739,85
Sample size	601 units	4 178 units

<sup>10</sup> Including audit No DR-TP-12/22 on payment claim of the Project No VSID/TP/CFLA/08/10/013 of Technical Assistance, which was performed separately due to avoid possible conflict of interest as the Audit Authority is beneficiary of the particular project.

<sup>11</sup> during the period from 1 January to 30 June 2011 expenditure declared only within first Operational Programme because of interruption of payments of 2 OP and 3 OP.

<sup>12</sup> All parameters determined according to European Commission Guidance note on sampling methods for Audit authorities (COCOF 08/0021/01-EN)

<sup>13</sup> In accordance with the Annual Control Report approved on 23 December 2011 where the opinion of management and control system is provided and evaluated with category 2 „works, but some improvements are needed“, assurance from the system was Average, so that the confidence level can be set 70%. However, due to the fact that within the system audits performed by AA few areas for major improvement were found and tacking into account concern expressed by European Commission as well as to gain higher assurance level, confidence level was set 80%

From total 4 779 payment claims regarding expenditure declared to EC in year 2011, 141 payment claims were selected (46 – first half of 2011, 95 – second half of 2011). See *Table 6* for payment claims broken down per audit.

**Table 6: Expenditure declared during year 2011 and selected units**

Population size (Expenditure declared during 2011)		Selected sample			Exact verified expenditure		
units	LVL	units	LVL	%	units	LVL	%
<b>Expenditure declared from 01.01.2011. to 30.06.2011</b>							
601	47 703 259,41	46	30 757 931,40	64,48	46	19 230 868,42	40,31
<b>Expenditure declared from 01.07.2011. to 31.12.2011</b>							
4 178	467 548 800,25	95	103 858 044,29	22,21	95	96 026 576,13	20,54
<b>Total:</b>							
<b>4 779</b>	<b>515 252 059,66</b>	<b>141</b>	<b>134 615 975,69</b>	<b>26,13</b>	<b>141</b>	<b>115 257 444,55</b>	<b>22,37</b>

### 5.3. Description of the principal results of the audits of operations

Results of audits of operations broken down by operational programs are included in *Table 7*.

**Table 7: Results of audits of operations**

	Certified expenditure (LVL)	Sample (units)	Audited expenditure (LVL)	Irregular expenditure found within sample	Error within sample
<b>Expenditure declared from 1 January to 30 June 2011</b>	<b>47 703 259,41</b>	<b>46</b>	<b>19 230 868,42</b>	<b>17 909,70</b>	<b>0,09%</b>
1 OP (ESF)	47 703 259,41	46	19 230 868,42	17 909,70	0,09%
<b>Expenditure declared from 1 July to 31 December 2011</b>	<b>467 548 800,25</b>	<b>95</b>	<b>96 026 576,13</b>	<b>1 436 082,70</b>	<b>1,50%</b>
1 OP (ESF)	60 012 523,30	13	10 068 352,34	10 176,63	0,10%
2 OP (ERDF)	58 284 863,70	10	12 623 700,59	1 054 206,00	8,35%
3 OP (CF and ERDF)	349 251 413,25	67	73 334 523,20	371 700,07	0,51%
1 OP, 2 OP, 3 OP (technical assistance projects) <sup>14</sup>	-	5	-	-	-
<b>TOTAL:</b>	<b>515 252 059,66</b>	<b>141</b>	<b>115 257 444,55</b>	<b>1 453 992,40</b>	<b>1,26%</b>

According to the second subparagraph of Article 17(4) of EC Regulation No 1828/2006 projected error rate was calculated and compared with the set materiality level – 2%, in order to reach conclusions for the total population.

For the population of the first half of 2011 non-statistical sampling was used and for the population of the second half of 2011 MUS was used according to the EC's guidelines<sup>15</sup>. Conclusions were reached in several steps according to internal procedures of Audit Authority.

<sup>14</sup> the amounts divided between operational programmes

<sup>15</sup> European Commission Guidance on treatment of errors disclosed in the Annual Control Reports (COCOF\_11-0041-01-EN) and the Guidance note on sampling Methods for Audit Authorities (COCOF 08/0021/01-EN).

Most likely error for:

- the first half of 2011 – 0,10%;
- the second half of 2011 – 0,86%.

The audit opinion is delivered on the basis of highest most likely error and the results of the audit that was conducted for the expenditure certified in second half of 2011 (audit No AI/SAI-ESF/ERAF/KF-12/5) as the sample is representative (see *Table 7*) comparing to sample of the first half of 2011. Therefore most likely the error for the expenditure declared within 2011 is set as 0,86%, which does not exceed materiality level – 2%.

Conclusions reached after the qualitative analysis performed are described in *Section 5.4*. All errors found were classified as systemic and random errors and all were included in calculation of most likely error. All errors were projected to the population<sup>16</sup>. Upper error limit was calculated and set as 2,82%. The Audit Authority performed re-calculation of the upper error limit with confidence level 70% as initially according to the ACR 2011 assurance on the system was average and confidence level was set as 70%. As a result the upper error limit is 2,31%. Further actions taken by the Audit Authority regarding results of regular audits of operations are described in *Section 8.1.1*.

#### 5.4. Conclusions drawn from the results of the audits of operations with regard to the effectiveness of management and control system

For the reporting period according to Article 16(2) of EC Regulation No 1828/2006 results of regular audits of operations provide reasonable assurance that statements of expenditure submitted to the EC for all 3 Operational Programmes are correct and underlying transactions are legal and regular, except in individual cases when deficiencies were identified in fields highlighted in *Table 8*. Total most likely error for expenditure declared to the EC in year 2011 is 0,86%, and does not exceed materiality level of 2%.

**Table 8: Errors found broken down by operational programs and fields**

Field of error	Number of errors			Total
	1 OP	2 OP	3 OP	
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<b>Systemic errors</b>				
Procurement	10	1	5	<b>16</b>
Publicity	6	-	-	<b>6</b>
Project selection process	-	-	2	<b>2</b>
Storage of supporting documents	2	-	-	<b>2</b>
<b>Random errors</b>				
Procurement	7	-	6	<b>13</b>
Project selection process	-	-	1	<b>1</b>
Eligibility of expenditure	8	-	2	<b>10</b>
Supervision of project implementation	-	-	8	<b>8</b>
Not achieved the objective of the project	1	-	-	<b>1</b>
Storage of supporting documents	-	-	1	<b>1</b>
<b>Total</b>	<b>34</b>	<b>1</b>	<b>25</b>	<b>60</b>

<sup>16</sup> Section 2.6 of the European Commission Guidance on treatment of errors disclosed in the Annual Control Reports (COCOF\_11-0041-01-EN)

Detailed qualitative analysis performed on the errors found and their significance is indicated in *Annex 6*.

Further analysis on the systemic errors, their significance and actions taken by Audit Authority and other institutions is described in the *Section 5.5 and 5.6*.

### **5.5. Information on the follow-up of irregularities, including revision of previously reported error rates.**

Recommendations regarding findings and errors detected in the regular audits of operations regarding year 2011 and implementation status of those recommendations are summarized in *Annex 7*.

In total as a result of regular audits of operations Audit Authority issued 38 recommendations. Implementation status of issued recommendations at the time of issuing opinions and ACR is:

- 19 – recommendations implemented;
- 1 – recommendation partly implemented;
- 18 – the deadline of implementation of recommendations not in force yet.

Within the reference period there were no cases of fraud or suspected fraud identified. However in one case red flags have been identified and information has been communicated to the Corruption Prevention and Combating Bureau for the deeper investigation.

There were no changes in determined and reported error rates regarding ACR 2011.

### **5.6. Problems which are considered systemic in nature and the measures taken.**

The Audit Authority performed qualitative evaluation of the identified problems and considered that several of them are with systemic nature in fields of:

1. Procurement – legal requirements are not met or partially met. Non-compliances identified regarding:
  - inadequate application of negotiation procedure in case of additional works,
  - significant amendments to the signed procurement agreement,
  - discriminatory and/or inadequate requirements for applicants.16 non-compliances detected within all 3 OP, 15 of them are with financial impact;
2. Publicity – final beneficiaries didn't comply or partly comply with the minimum requirements of publicity and visual identity. 6 non-compliances detected within 1 OP and 5 of them with financial impact;
3. Project selection process – poorly designed project applications. 2 non-compliances without financial impact detected in one particular 3 OP measure 3.1.5.3 “Hospital Health Care Development”. Performance indicators that has to be achieved during project implementation are not defined clearly;
4. Storage of supporting documents – 2 non-compliances without financial impact detected within two particular 1 OP measures 1.4.1.1 “Complex support measures for integration of population into society and the labour market” and 1.2.2.1.2 “Supporting for lifelong learning policy Guidelines” that are administrated by State Employment Agency.

Breakdown of systemic errors and their financial impact is presented in *Table 9*.

Table 9: Systemic errors

Field of error	1 OP		2 OP		3 OP		Total ineligible expenditure (LVL)	Total ineligible expenditure outside the sample (LVL)
	Number of errors	Ineligible expenditure (LVL)	Number of errors	Ineligible expenditure (LVL)	Number of errors	Ineligible expenditure (LVL)		
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>	<i>8</i>	<i>9</i>
Procurement	10	14 019,50	1	1 054 206,00	5	356 743,86	<b>1 424 969,36</b>	<b>3 674 112,84</b>
Publicity	6	94,53	-	-	-	-	<b>94,53</b>	<b>895,69</b>
Project selection process	-	-	-	-	2	-	-	-
Storage of supporting documents	2	-	-	-	-	-	-	-
<b>Total</b>	<b>18</b>	<b>14 114,03</b>	<b>1</b>	<b>1 054 206,00</b>	<b>7</b>	<b>356 743,86</b>	<b>1 425 063,89</b>	<b>3 675 008,53</b>

As a result of detected deficiencies with systemic character that were found during the audits of operations, there are several actions taken by Audit Authority and other institutions:

1. Procurement: to eliminate deficiencies in procurement procedures found on the project level, recommendations were given on the project level (*see Annex 7*). Amendments to Public Procurement Law (came into force on 1 August 2012) now clearly are stating: what are significant amendments to contract and prohibition of significant contract amendments. As well additional controls are in place since 2 January 2012 – ex-ante checks of procurement documentation, which according to preliminary evaluations eliminates deficiencies in 67% of procurements. In addition Audit Authority performed management and control system audits within every institution where one of main points of audit scope was procurement issue as well as horizontal procurement system audit was performed to verify and assess system improvements (*see Section 2.1.2. Public procurement and Section 4.4.4.3*). As well as Audit Authority plans to keep paying attention to this particular deficiency during the next reference period. As improvements within the system are implemented during 2012 Audit Authority will be able to assess the efficiency of them during the next auditing period;
2. Information and publicity: As the deficiency was found only in 1 OP, the recommendations were given to eliminate particular deficiencies within the projects and recommendations to the Intermediate bodies were given to strengthen the first level controls, by paying additional attention to compliance with the information and publicity requirements within projects. Although the deficiency was classified as systemic, as a result of quantitative analysis of deficiencies, the financial impact estimated as not material.
3. Project selection process (poorly designed project applications): Taking into account that the deficiency was detected in one particular 3 OP measure 3.1.5.3 “Hospital Health Care Development”, where the Central Finance and Contracting Agency fulfils the functions of Cooperation Institution since 1 November 2011 (previous functions of Cooperation Institution were fulfilled by the Centre for Health Economics), the recommendation was given for elimination of the deficiency. Also the Audit Authority plans to pay more attention to deficiency mentioned above during management and control system audit in the next reference period.



4. Storage of supporting documents: As it is stated above only two systemic errors without financial impact were detected within 1 OP two measures that are administrated by State Employment Agency the recommendation was given for elimination of the deficiency which at the moment of preparation of the ACR is implemented.

As it is stated above only two systemic errors with financial impact – public procurement and publicity were detected and, in addition to system improvements, Audit Authority evaluated also necessity for additional selection of items for audit in those fields. After evaluation Audit Authority concluded that problems in publicity are with minor financial impact and further evaluation is not necessary. However, horizontal system audit in the area of publicity is planned in 2013.

In the field of procurement Audit Authority evaluated overall situation in solving problems in procurement and concluded that improvements are already in process (please see *Section 2.1.2* where further changes in management and control system regarding procurement are highlighted and *Section 4.4.4.3* where results of horizontal audit is described). Regarding additional selection, public procurement was one of the main points of the audit scope of management and control system audits as well as complementary sample was made and extra payment claims were selected within Intermediate bodies where most of deficiencies were found within regular audits of operations (see *Section 8.1.1*).

## **6. COORDINATION BETWEEN AUDIT BODIES AND SUPERVISORY WORK OF THE AUDIT AUTHORITY**

### **6.1. Description of the procedure for co-ordination between different national audit bodies and the audit authority itself**

For the ACR purposes and the Opinion of the Audit Authority 2012 as the functions of the Audit Authority are centralized in the Ministry of Finance, the Audit Authority did not rely on the work of internal audit bodies or any other body.

### **6.2. Description of the procedure for supervision applied by the audit authority to other audit bodies**

Not applicable.

## **7. FOLLOW UP OF PREVIOUS YEARS' AUDIT ACTIVITY**

Regarding implementation of recommendations of previous years' system audits it is concluded that institutions that are involved in the management of the EU funds implement the system audit recommendations in accordance with the action plan, however, there are 5 recommendations regarding improvements of the existing system that are partly implemented and are still in the process of implementation.

Regarding implementation of recommendations of audits of operations – there were 32 open recommendations reported in previous ACR (see *Annex 8*). At the moment of preparation of current ACR, there is still 1 recommendation partly implemented and 2 recommendations that are not due until 31 December 2012.

Recommendations that are not entirely implemented do not have an impact on the evaluation of the ACR.

## 8. OTHER INFORMATION

### 8.1. Complementary audits of operations

In addition to the regular audits of operations, the Audit Authority performed three complementary audits of operations within current reference period (*See Section 8.1.1 – 8.1.3*).

#### 8.1.1. Complementary Audit of Operations (due to risky areas identified within regular audits of operations)

Audit No PDR-12/19 has been performed from 16 July to 5 October 2012 to reach reasonable assurance whether results of regular audits of operations and opinion of certain internal control systems remains constant.

Results of the regular audits of operations were evaluated regarding all 9 institutions that administrated expenditure in the year 2011. Taking into account the results of regular audits of operations (*see Table 10*) as well as deficiencies found within management and control system audits, it was concluded, that errors and deficiencies were found within projects administrated by certain institutions.

**Table 10: Complementary sample divided by institutions and errors previously found**

Institutions administrating expenditure declared in 2011	Number of payment claims selected within regular audit of operations (I half of 2011)	Number of payment claims selected within regular audit of operations (II half of 2011)	Total number of selected items	Number of payment claims with financial errors <sup>17</sup>		Number of payment claims selected in addition
				items	%	
MoT	0	16	16	2	13	-
MEPRD	0	14	14	2	14	-
CFCA	1	19	20	8	40	5
CFCA (CHE)	2	8	10	8	80	5
LIDA	2	15	17	2	12	2
SEA	17	6	23	4	17	5
SIF	2	0	2	0	0	-
SEDA	21	9	30	12	40	5
SRDA	1	8	9	1	11	-
<b>Total:</b>	<b>46</b>	<b>95</b>	<b>141</b>	<b>39</b>	<b>28</b>	<b>22</b>

As a result complementary sample was drawn, 22 units selected and audit performed.

Five populations were determined from the expenditure certified and declared to the EC during the period from 1 January to 31 December 2011<sup>18</sup>. Four populations consisted of payment claims declared by institutions with more than 15% of faulty payment claims (according to *Table 10*) and one population consisted of payment claims declared within certain measures where deficiencies were found within management and control system audits. The selection was done using the random sampling method (ACL program):

- 1) First population was made out of payment claims declared by Central Financing and Contract Agency (except payment claims of Technical Assistance projects). It was decided to select five payment claims due to high number of material errors found (40% of total payment claims selected);
- 2) Second population was made out of payment claims declared by Central Financing and Contract Agency (payment claims declared by Centre for Health

<sup>17</sup> Data on June 2012 (preliminary results)

<sup>18</sup> Payment claims already verified during regular audits of operations were excluded.

Economics till November 2011). It was decided to select five payment claims due to high number of material errors found (80% of total payment claims selected);

- 3) Third population was made out of payment claims declared by State Education Development Agency within 2OP and 3OP. 1OP was not included because of analysis of errors found. It was decided to select five payment claims due to high number of material errors found (40% of total payment claims selected);
- 4) Fourth population was made out of payment claims declared by State Employment Agency (excluding projects where final beneficiary is SEA, as deficiencies were found within the measures where the final beneficiary is not the SEA). It was decided to select five payment claims from measures where the final beneficiary is not the SEA;
- 5) Fifth population was made out of payment claims declared by Investment and Development Agency of Latvia in particular under measure 2.3.2.1.0 "Business incubators" and measure 2.1.2.1.1 "Centres of Competences". It was decided to select one payment claim from each measures due to significant deficiencies found within management and control system audits No 1DP/2DP/3DP-LIAA-12/3 and No 2DP-EM/LIAA-11/53.

As result of complementary sample 23<sup>19</sup> payment claims were verified and errors in the fields of public procurement, publicity, project selection, eligibility of expenditure and supervision of project implementation as well as deficiencies regarding design of supporting documents were identified.

Breakdown of errors identified in complementary audit of operations and their financial impact is presented in *Table 11*.

**Table 11: Results of complementary audit**

Field of error	1 OP		2 OP		3 OP		Total ineligible expenditure (LVL)	Total ineligible expenditure outside the sample (LVL)
	Number of errors	Ineligible expenditure (LVL)	Number of errors	Ineligible expenditure (LVL)	Number of errors	Ineligible expenditure (LVL)		
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>	<i>8</i>	<i>9</i>
Procurement	1	-	-	-	4	34 822,85	<b>34 822,85</b>	<b>64 398,99</b>
Publicity	1	-	-	-	1	-	-	<b>32,47</b>
Project selection	-	-	1	-	-	-	-	-
Eligibility of expenditure	-	-	1	2,98	1	601,90	<b>604,88</b>	-
Supervision of project implementation	-	-	1	-	-	-	-	-
Design of supporting documents	-	-	1	-	-	-	-	-
<b>Total:</b>	<b>2</b>	<b>-</b>	<b>4</b>	<b>2,98</b>	<b>6</b>	<b>35 424,75</b>	<b>35 427,73</b>	<b>64 431,46</b>

Accordingly, as a result of the complementary audit of operations 8 recommendations were issued (detailed summary in *Annex 9*). 2 recommendations are implemented, for others deadline of implementation is not in force at the moment of issuing ACR.

<sup>19</sup> one payment claim verified in addition as one payment to the final beneficiary selected consisted of two payment claims

### 8.1.2. Complementary Audit – follow-up of advance payments

Audit No PDR-ERAF/KF-12/20 was performed from 16 July to 17 October 2012 to reach reasonable assurance whether the expenditure declared to the EC as advance payments are eligible as well as timely reporting is done on the actual use of advance.

The scope of complementary audit was six advance payments declared by Latvian Investment and Development Agency to the EC during years 2010 and 2011 and selected by Audit Authority during regular audits of operations. However, only three payment claims (declared to the EC during 2010) were audited as advance payments declared to the EC 2011 were not acquired at the time of complementary audit.

It was concluded, that advance payments declared to the EC during 2010 are eligible as well as reported. Regarding advance payments declared to the EC during 2011, several errors were identified that are presented in *Table 12*

**Table 12: Results of complementary audit**

Field of error	3 OP		Total ineligible expenditure (LVL)	Total ineligible expenditure outside the sample (LVL)
	Number of errors	Ineligible expenditure (LVL)		
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Eligibility of expenditure	2	-	-	9 565,47
Supervision of project implementation	3	-	-	-
<b>Total:</b>	<b>5</b>	<b>-</b>	<b>-</b>	<b>9 565,47</b>

Ineligible expenditure listed in the *Table 12* were project revenues from the deposits.

Accordingly, as a result of the complementary audit of operations 5 recommendations were issued (detailed summary in *Annex 9*). Deadline of implementation of recommendations are not in force at the moment of issuing ACR.

### 8.1.3. Complementary Audit – individually significant units/projects

Audit No PDR-12/21 was performed from 16 July to 31 October 2012 to reach reasonable assurance whether opinion of certain internal control system remains constant.

During the programming period 2007-2013 Audit Authority receives information about a variety of possible deficiencies within implementation of the EU funded projects (correspondence between the project administrating institutions and other interested parties, including individual complaints) as to why the projects were considered as high risk projects.

10 projects (36 payment claims) were selected for which complaints have been received and the deficiencies were not remedied (no appropriate financial corrections and/or payments recovered). Expenditure within the projects was declared EC from 2009 till the end of 2011.

Contrary to complains received, referring to which audit was launched, material errors were found within procurement procedures. Breakdown of errors identified in complementary audit of operations and their financial impact is presented in *Table 13*.

**Table 13: Results of complementary audit**

Field of error Systemic/ non-systemic (S/N)	3 OP		Total ineligible expenditure (LVL) (within 2009-2011)	Total ineligible expenditure outside the sample (LVL)
	Number of errors	Ineligible expenditure (LVL)		
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Procurement	6	103 455,60	103 455,60	7 860,47
Supervision of project implementation	1	-	-	-
<b>Total:</b>	<b>7</b>	<b>103 455,60</b>	<b>103 455,60</b>	<b>7 860,47</b>

Accordingly, as a result of the complementary audit of operations 5 recommendations were issued (detailed summary in *Annex 9*). Deadline of implementation of recommendations are not in force at the moment of issuing ACR.

## **8.2. Financial engineering instruments audit**

In order to implement one of the EC's recommendations formulated in the EC fact-finding mission (No 2007LV161PO001) that took place in Latvia from 18 to 19 January 2010, the Audit Authority performed 2 audits in June and July 2011. The audits were performed in SIA „Latvian Guarantee Agency” (No 2DP/EM/LGA-11/33) and State joined stock company “Latvian Mortgage and Land Bank” (No 2DP/EM/LGA-11/35), where during the fact-finding mission EC auditors found a non-compliance of issued guarantees and loans with Article 45 of EC Regulation No 1828/2006 (guarantees and loans issued within the framework of ERDF financed OP “Entrepreneurship and Innovations” activity 2.2.1.3 “Guarantees for development of enterprise competitiveness” and activity 2.2.1.4 “Loans for development of enterprise competitiveness”).

Work done by Audit Authority was re-performed by the DG REGIO auditors in mission (No 2011/LV/REGIO/J2/976/1) held in Latvia in October 2011. Draft report was received on 8 June 2012 with 3 recommendations issued for Audit Authority and Managing Authority (2 recommendations with high priorities). The Audit Authority took immediate actions and reported necessary information to DG REGIO, in total 4 letters were sent to DG REGIO (sent on 3 August, 28 August, 29 October and 5 November 2012). At the moment of issuing ACR 2012 no official information about EC's final position is available.

The Managing Authority prepared an action plan for implementation of DG REGIO recommendations (see *Annex 10*). Last updated version was sent to DG REGIO on 5 November 2012.

DG EMPL mission regarding FEI (No Ares(2012)813285) in the Managing Authority was held from 5 to 8 December 2011. Draft report was received on 4 July 2012. Contradictory procedure is not yet started as Latvian version is not yet received.

Taking into account the problems identified in implementation of FEI and in accordance with the Audit Authority's plan for year 2012, the Audit Authority from 2 January to 9 November 2012 performed horizontal system audit “Financial engineering” (No 1DP/2DP-EM/LIAA-11/54) that covered all institutions involved in FEI administration – Managing Authority, MoE and LIDA.

The Audit Authority performed assessment of efficiency of management and control system implemented to administer FEI covering all institutions and financial intermediaries acting in implementation of FEI till 31 December 2011.

Audit Authority covered all 7 key requirements and took into account Common audit framework for financial engineering instruments in the context of structural funds (DG REGIO 31 July 2011) and integrated 3-phased approach into a standard approach.

Audit results – audit report for the EC was uploaded to SFC2007 on 11 December 2012. For elimination of deficiencies the Audit Authority issued 19 recommendations and 5 of them with high priority:

1. MoE should change funding agreement between the MoE and a Financial Intermediary (LMLB) within activity 2.2.1.4.1 in order to prevent that funding agreement includes provisions which allow usage of interest and other gains attributable to Structural funds' contribution (ERDF) to cover the cost of borrowing money from the Financial Intermediary (LMLB).
2. MoE should decrease the amount of certified expenditure within activity 2.2.1.4.1 relating ineligible amount raised from a cost of borrowing money from the Financial Intermediary (LMLB).

3. The Managing Authority should continue to develop supervision over the delegated functions and supervision over the use of FEI (determination of clear objectives and analysis of actual information), to ensure optimal use of FEI funding.
4. The MoE should make correction to ensure that the guarantees that were issued for inadequate purpose (6 guarantees) in activity 2.2.1.3 for a total amount of LVL 1 912 967,52 is not included in expenditure declaration.
5. The MoE should make correction to ensure that the guarantees that were issued to firms in difficulty (2 guarantees) in activity 2.2.1.3 for a total amount of LVL 143 391,90 is not included in expenditure declaration.

Recommendations No 4 and 5 with financial impact were not agreed due to fact that there are no final position received from EC regarding previous recommendations with financial impact.

Audit Authority does not provide a common assessment of management and control system of FEI due to fact that there are significant uncertainties that are discussed with the EC and final position is not formed. Findings regarding this audit do not impact Opinion issued regarding ACR 2012, because no expenditure was declared in 2011.

### **8.3. Audits of the European Commission and the European Court of Auditors**

The Audit Authority has collected the information on the recommendations of the EC audits that are due as on 30 November 2012 and concluded that the institutions involved in the management of the EU funds implement recommendations in accordance with the action plan:

1. All recommendations of the DG EMPL audit mission “*Review and re-performance of the work of the Audit Authority pursuant to Articles 62, 72 and 73 of Council regulation (EC) No 1083/2006 – OP Human resources and employment CCI 2007LV051P0001, Annual Control Report and Audit Opinion submitted 31/12/2010*” (28 February to 11 March 2011, final report received on 17 February 2012, No 1311) are implemented and ineligible expenditure was recovered and deducted from the statement of expenditure submitted to the EC on 12 July 2012.

The DG EMPL audit mission (27 to 30 September 2011, final report on 25 October 2012, No 1384) was carried out in order to assess the management and control system in the area of public procurement. Before issuing the final report, MA had already elaborated and implemented the action plan to improve the management and control system in area of public procurement. The final report addressed 1 recommendation to MA, which is not implemented yet as the deadline is 25 January 2013.

Report of the European Court of Auditors’ mission (14 to 25 November 2011, PF-4541) within Statement of Assurance 2011 to assess regularity and legality of ERDF (“Infrastructure and Services” No 2007LV161PO002 (3 OP)) expenditure, as well the management and control system was received on 5 March 2012. No deficiencies were found.

### **8.4. The overall level of assurance from the combination of the results of the system audits and audits of operations**

The Audit Opinion of the Audit Authority is prepared in accordance to the EC Regulation No 1828/2006 Annex VII and ISA 800 “Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks”.



The Audit Opinion results from the management and control system audits and audits of operations. The relationship between the management and control system audits and audits of operations that is determined by the Audit Authority is set out in *Table 14*.

**Table 14: Preparation of the Audit Opinion**

MCS audit results	Materiality level		Systemic error where financial correction can not be prevented	
	Below materiality level < 2%	Above materiality level > 2%	Significant, but not comprehensive	Significant and comprehensive
<b>1</b>	Unqualified opinion	Qualified opinion	-	-
<b>2</b>	<b>Unqualified opinion</b>	Qualified opinion	Qualified opinion	-
<b>3</b>	Qualified opinion	Qualified opinion / Adverse opinion	Qualified opinion / Adverse opinion	Adverse opinion
<b>4</b>	Adverse opinion	Adverse opinion	Adverse opinion	Adverse opinion
<b>Information missing</b>	Disclaimer	Disclaimer	Disclaimer	Disclaimer

The management and control system is assessed in category 2 (*see Section 4 and Annex 5*) and the error rate of the audits of operations is below the materiality level (*see Section 5*), as well based on other information (*see Section 8*) the Audit Authority conclude to issue an Unqualified Opinion.

### **8.5. Assessment of the Audit Authority**

In the period from 1 January to 30 November 2012 the Audit Authority's work has been assessed by the EC:

1. From 30 January to 1 February 2012 DG REGIO performed audit mission No. 2012/LV/REGIO/J2/1093/1 „*Review the audit work carried out by the Audit Authority for the preparation of the Annual Control Report*”. Report is not received yet.
2. Final report (English version) of the three DG REGIO missions (No 2011/LV/REGIO/J2/958/1 (6 to 10 June 2011) No 2011/LV/REGIO/J2/975/1 (27 June to 1 July 2011) and No 2011/LV/REGIO/J2/976/1 (3 to 7 October 2011)) regarding assessment of the Audit Authority work in order to assess modules 1 – 4 was received on 17 July 2012.

The overall work of the Audit Authority was assessed by the DG REGIO in category 2 – works, but some improvements are needed:

- to strengthen the independence of the Audit Authority and improve of the financial corrective mechanism. The recommendations are implemented and the independence of the Audit Authority and implementation of recommendations of Audit Authority are ensured by the amendments made to various legal acts (*see also Section 2*);
- in the Audit Authority's assessments within system audits and audits of operations. The Audit Authority has improved the methodology of system audits and audits of operations, as well increased the effectiveness in auditing public procurement – the Audit Authority has improved the checklists for public procurement verifications within audits of operations.

3. Final report of the DG EMPL mission “*Review and re-performance of the work of the Audit Authority pursuant to Articles 62, 72 and 73 of Council Regulation (EC) No 1083/2006 – OP Human resources and employment CCI 2007LV051P0001, Annual Control Report and Audit Opinion submitted on 31 December 2010*” (28 February to 11 March 2011) regarding assessment of the Audit Authority work was received on 17 February 2012.

The overall work of the Audit Authority was assessed by the DG EMPL in category 2 – works, but some improvements are needed in areas of public procurement verifications of the Audit Authority. The Audit Authority has improved the checklists for public procurement verifications within system audits and audits of operations.

The assessment of Audit Authority done by DG REGIO and DG EMPL is provided in *Annex 3*.

4. Report of the European Court of Auditors mission (14 to 25 November 2011, PF-4541) within Statement of Assurance 2011 to assess regularity and legality of ERDF (“Infrastructure and Services” No 2007LV161PO002 (3 OP)) expenditure, as well the management and control system was received on 5 March 2012. No deficiencies were found in the work of the Audit Authority.

#### **8.6. Interruption of the interim payments (Article 92 of Regulation No 1083/2006) under Operational Programmes “Entrepreneurship and Innovation”, “Human Resources and Employment” and “Infrastructure and Services”**

Based on the information provided in the Audit Authority’s audit report<sup>20</sup>, the EC made the decision to interrupt Latvia’s EU fund financing under all three Operational Programmes, notifying it’s decision in EC’s Letter No Ares(2012)94198 dated 27 January 2012 and EC’s Letter No Ares(2012)113559 dated 1 February 2012. The EC concluded that there was a significant risk in the administration of EU funds, based on the following deficiencies in the performance of the Managing Authority’s and the Certifying Authority’s functions:

- The Managing Authority should have enough power to require strengthening the control system in case it is not satisfied with the work of any Intermediate body;
- The Managing Authority does not carry out sufficient supervision of delegated functions and inspection of payment applications prepared by Intermediate bodies before these are submitted to the Certifying Authority.
- The Certifying Authority does not carry out sufficient controls in such areas as public procurement procedures, state aid, project selection and financial engineering instruments.

In order to renew EU fund financing for Latvia:

- The Managing Authority developed and on 17 February 2012 approved *the Managing Authority’s action plan for the improvement of the EU fund*

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<sup>20</sup> Audit Authority’s Audit Report No.1DP/2DP/3DP-VI-11/38 dated 24 October 2011 *On the Operational Effectiveness of the Management and Control System Devised by the European Union’s Structural Funds and Cohesion Fund for the 2007-2013 Programming Period in the Ministry of Finance as the Managing Authority and Responsible Body*



*management and control system* (hereinafter – the Managing Authority’s action plan), which provided for the implementation of 27 measures to eliminate the deficiencies specified by the EC.

- The Certifying Authority developed and on 17 February 2012 approved an Action Plan *“For Elimination of the Deficiencies Referred to in the Audit Authority’s Report No 1DP/2DP/3DP-SEI-11/43 On the Operational Effectiveness of the Management and Control System Devised by the European Union Structural Funds and Cohesion Fund for the 2007-2013 Planning Period in the Treasury as the Paying and Certifying Agency and for Implementation of the Measures Specified in the European Commission’s Letters regarding the Suspension of Payments”* (hereinafter – the Certifying Authority’s action plan), which provided for the implementation 11 measures to eliminate the deficiencies specified by the EC.

The Audit Authority from 16 March to 13 April 2012 reviewed and assessed the implementation of the Managing Authority’s action plan and the Certifying Authority’s action plan and implementation of the Audit Authority’s recommendations.

On 26 April 2012 the Audit Authority prepared and submitted to the EC report on assessment of implementation of the Managing Authority’s action plan and the Certifying Authority’s action plan and implementation of the Audit Authority’s recommendations.

On 26 April 2012 the Audit Authority submitted to the EC opinion on the improvements made together with an audit opinion on:

- the quality of the management verifications at the level of the Managing Authority as well as its supervision over the Intermediate bodies;
- the certification process.

Taking into account the actions performed and planned by the Audit Authority, the EC considered that conditions mentioned in EC’s interruption letters in order to lift the interruption of the payment deadline are fulfilled. Interruption of payments was lifted with EC’s Letter No.Ares (2012)827166 dated 26 June 2012 and EC’s Letter No.Ares (2012)811344 dated 4 July 2012.

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