

# Corporate Governance in EU Agencies: Balancing Management and Auditing Roles

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**Abstract:** The fulfilment of strategic goals of public organizations is closely related to corporate governance, which assigns responsibilities, power, and controls. The object of this paper is to answer the research question: "Are standard EU audit controls applied to EU Agencies helpful in carrying out the assigned missions?" In the EU, the missions and tasks of Agencies are embedded in the funding acts. The operational performance of an Agency also depends on administrative procedures, such as financial management, compliant with the EU financial framework, and supervised by the European Court of Auditors. A reform agreed by the Council, the Commission, and the European Parliament provided a unified schema for the funding acts, including up-to-date topics such as conflict of interest, fraud prevention, and data protection. In previous work, evidence has been provided that the uniformity of funding acts may have a negative impact on the operational performance of an Agency. On the contrary, specific agency-related goals could be promoted through an ad-hoc normative layer to be added to the standard funding act. Once reaffirmed the need for a trade-off between standardization and customization to improve operational performance, this paper challenges the pros and cons of applying standard EU audit practices to Agencies that operate in an unstable and evolving environment. Standard EU auditing methods have indeed made it easier to control budgetary management, but at the same time, they have often reduced operational performance. The standard budgetary management report of the EU Court of Auditors, which attributes a poor score to implementations not compliant with abstract indicators without a context-related insight, may not only cause unfair budget cuts but also have a negative impact on the ability of an Agency to quickly react to changes in its operational context.

**Keywords:** Agencification, Corporate Governance, Funding act, Principle of annuality, Carry-forwards, Budget transfers

## 1. Introduction

In line with the agencification trend (Verhoest, 2012; McDonald, 2011), the European Union (EU) delegates important tasks to "regulatory" agencies. The assigned tasks cover a wide range of activities, such as providing and reinforcing rules, offering services, controlling and/or advising, with the aim of operating in a framework of coherence, effectiveness, and accountability. In a time of budget cuts, the need to review and standardize the legal framework that defines the activities of Agencies established over several decades became a priority. The Commission, the Council, and the European Parliament established an ad-hoc inter-institutional working group (European Commission, 2005). A common framework was agreed upon, and a joint action plan was launched to improve efficiency, effectiveness, transparency while assuring state-of-the-art governance.

Not all auditing controls developed for the public sector support sound management. The purpose of this paper is to investigate the relationship between the ability of Agencies to fulfill their mission and the impact of the reports of the EU Court of Auditors (ECA) on operational performance. The research method is an experience-driven critical evaluation of institutional and legal aspects.

The ECA's opinions are of primary importance for the correct functioning of EU Agencies because the EU institutions consider the ECA's reports more authoritative than the Agencies' justifications. Recognizing the importance of the different roles of management and auditing, this paper aims to highlight the limitations of some indicators adopted by the ECA in the evaluation of the financial performance of EU Agencies.

## **2. Corporate Governance: Funding Acts**

Corporate governance is about seeing that running the business is done properly<sup>1</sup> and is influenced by many factors, including accounting standards and legal tradition. The EU has the power of establishing Agencies in areas of competence defined by the Treaties (Van Ooik, 2010). The functioning of an Agency is regulated by a funding act adopted by the EU organs - the Council and/or the Commission - taking into account, when required, the opinion of the European Parliament.

The act can be a Decision or a Regulation (Davies, 2007) and defines the mission of an Agency, its tasks and organs<sup>2</sup>. One of the objectives of the reform was taking into account up-to-date issues such as conflict of interest, privacy (enforced by the EU Data Protection Officer), investigation on claims of individuals and companies (ensured by the European Ombudsman), fraud prevention (monitored by Olaf) all topics not relevant in corporate governance at the moment of the establishment of most Agencies. An Agency is also required to operate with efficiency and effectiveness.

Under the generic term of 'regulatory agencies' a wide span of tasks are assigned, regulated, monitored and executed (European Commission, 2005). After the reform, through a common template for the funding act and the institutional reports that each Agency submits to its BoD (hereafter the Management Board, MB), to the Commission (whose representatives sit in most MBs) and to the European Parliament for taking note, evaluation or decision, have been standardized (Orlandi, 2021).

For all Agencies, a cornerstone report is the Multiannual Work Plan completed by the Establishment Plan as far as staff is concerned. Each year an Annual Work Programme details the activities. Quarterly Activity Reports inform on the work in progress, potential delays and/or new business needs. Such a standardization has made easier the work of the controllers, but the impact on the operations has not been taken into account (European Council, 2012).

## **3. Four Levels of Control**

Examining the controls in force before the reform, Ongaro (2012) wrote: "EU agencies represent an extreme case in terms of being (over) controlled and scrutinized." With the reform, the level of control increased, and the staff of the Agencies are forced to devote a significant part of their working time to preparing reports for the controllers and presenting the same reports through four levels of control.

Regarding EU Agencies, the ECA report produced through the process detailed in Figure 1 has a strong impact on the reputation of an Agency and its future budgets. The ECA is not the only

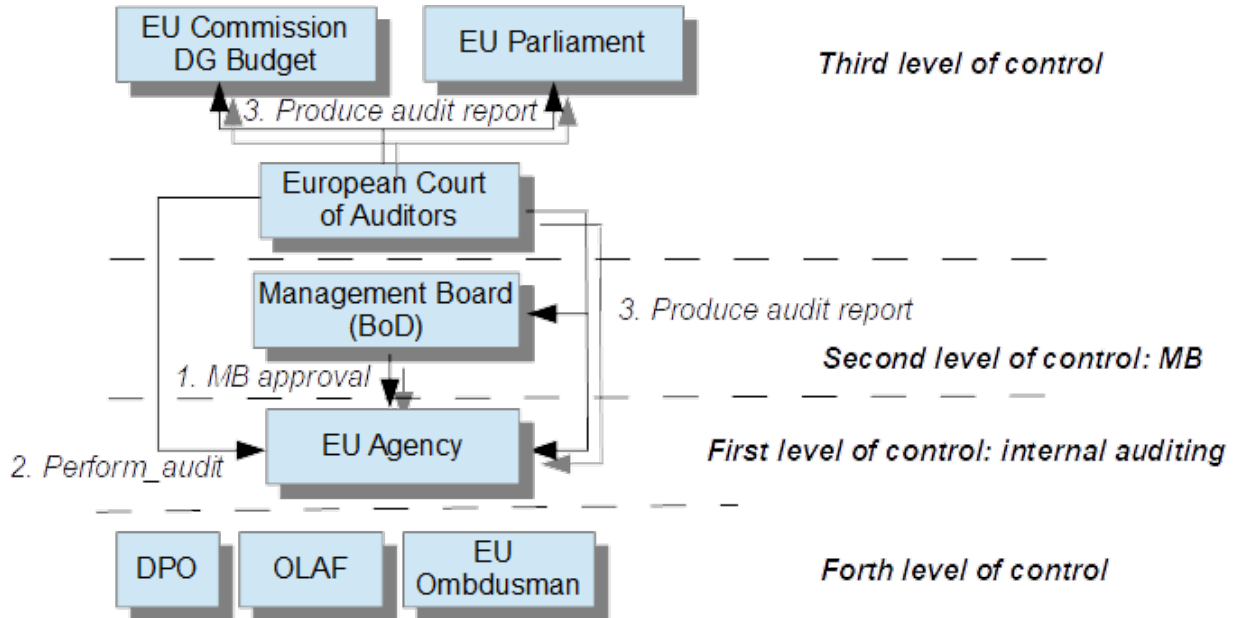
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<sup>1</sup> According to an ISO new standard, 'The ISO 37000:2021 Governance of Organisations Guidance', "Good corporate governance not only fosters an environment of trust, transparency and accountability, it also helps align an organisation's purpose with the interests of society, building strong stakeholder relationships while effectively managing and maintaining its resources. In this way, good governance lays the foundation for the long-term success of organisations. It ensures they contribute to protecting and restoring social, economic and natural environmental systems."

<sup>2</sup> Management Board stands for Board of Directors; Executive Director for CEO.

controller; all acts that are subject to control are first supervised by an "independent" internal audit function (present in most Agencies) reporting to the Director and the MB. Following the advice of the internal auditor and the Financial Committee, the MB discusses, asks for clarifications, requires changes, and finally approves ex-ante the budget proposal and ex-post the budgetary implementation (MB\_approval, Action 1, Figure 1).

**Figure 1:** EU Agencies, the different levels of controls



Independently of the internal auditing, the ECA performs an audit (Perform\_audit, Action 2, Figure 1) and produces an audit report (Produce\_audit\_report, Action 3, Figure 1), which is transmitted to the Agency, the MB, the EU Commission through DG Budget (a further level of control), and the EU Parliament.

In most cases, people sitting in the MBs of EU Agencies representing the Member States are field experts. To make decisions, they need advice on technical areas outside their area of expertise. To cope with this challenge, an MB may establish ad-hoc committees (Orlandi, 2022). For example, the EU Police Office (Europol) established the Head of National Units committee to better focus on Member States' needs, and several committees on technical matters: the Financial Committee, the ICT Working Group, the Security Committee, the Data Privacy Committee, and the Administration Committee.

Within the Administration Committee, the Agency's financial reports are presented and discussed. Financial performance is evaluated against two major sets of controls:

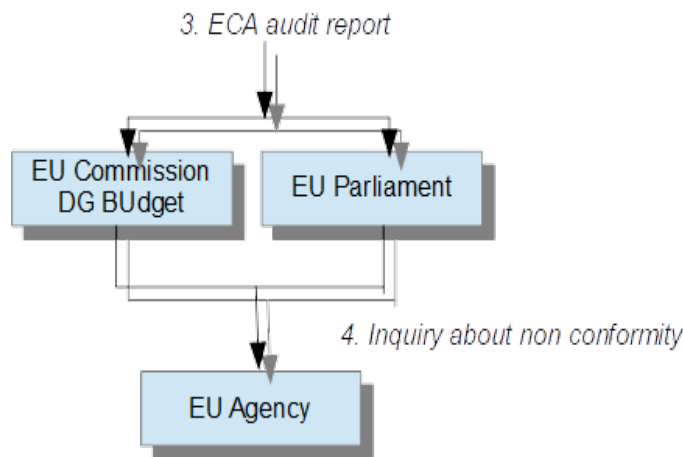
- i. For each business case in line with the Work Programme proposed by the responsible organizational unit and approved by the Agency's TMT, costs must remain within the budgetary limits. Investments or expenditures must be in line with market values, and the quality of goods or services must be checked and ensured, while deadlines are respected.
- ii. Compliance with EU procurement procedures and rules (DG Budget, 2009) must be enforced throughout the entire expenditure lifecycle, including the business case, approval, call for tender, commitment, role of the authorizing officer, and payment deadlines.

Both points are scrutinized ex-ante and ex-post, directly or indirectly through committees by the MB (Figure 1: the second level of control). The budgetary management approved by the MB is scrutinized by the ECA, which controls the correctness of the whole cycle (Figure 1: the third level of control). The picture is completed by benchmarking among Agencies (ECA, 2011), provided by auditors or by the Network of EU Agencies.

One of the most important ECA controls is checking compliance with the principle of annuality. Therefore, the carry-forwards, differences between commitments and cash expenditure, cancellations of carry-forwards, budgetary transfers, and year-end activity are carefully scrutinized. The ECA report is transmitted to the Commission via DG Budget and to the EU Parliament (Figure 2). In this process, the reports of the Agency, prepared by the management and approved by the MB, are less authoritative than the Auditors' report.

An ECA negative opinion is considered a failure (Inquiry\_on\_non\_conformity, Action 4, Figure 2), and the Agency is under scrutiny for lack of compliance.

**Figure 2:** EU Agencies, different levels of controls



## **4. A Rigid Budget in a Changing World**

Year 2015 was a turning point for many EU Home Affairs policies. Due to the civil war in Syria, the number of refugees who crossed the outer border of the EU skyrocketed from 284,000 in 2014 to 1,015,000 according to UNHCR. The number of foreign fighters who joined Daesh since 2011 exceeded 10,000, and some of them with EU passports returned home after receiving military training and committing crimes against humanity. On January 7th and November 13th, a new wave of religiously inspired terrorism perpetrated by EU nationals claimed hundreds of lives in Paris, changing the perception of terrorism in the EU.

Several Member States, including Italy, Greece, and Hungary, invoked EU support to open hotspots for the quick identification of one million people who claimed to be refugees and check them against criminal files. Such an activity required the detachment of staff abroad for a long time, in contrast with the traditional business model of short-term support missions.

While the budget of Europol and the Establishment Plan always had a budget line for combating trafficking of human beings and terrorism, these new dramatic changes - mass arrival of refugees, returning European foreign fighters with their families, and terrorist attacks on the heart of the EU - had not been anticipated in 2013 (year (N-2)) when the 2015 budget exercise began. Therefore, the 2015 and 2016 budgets required adjustments.

## **5. Balancing Operational Needs and Audit Controls**

The ECA focuses on governance costs, cash management, budgetary management, internal administrative procedures, accommodation and overheads costs, host country agreements while the MB's attention is focussed on the effectiveness in addressing what the Member States expect from an EU Agency.

Regarding budgetary management, the ECA carefully scrutinizes the level of budget used, the level of carry-forwards, matching carry-forwards with accruals, cancellation of carry-forwards, budgetary transfers, and year-end activity<sup>3</sup>. A limited carry-forwards is regarded as an indicator of effective and efficient operational planning. A level of carry-forwards or cancellations exceeding the ECA standards (95% implementation of the commitments, Vermeulen, 2009) is normally considered a proof of poor management and could lead the EU Commission to cut (N+1) year budget.

Given the dynamics of the socio-economic processes under the responsibility of operational Agencies and the auditors' limited understanding of the core business of specialised Agencies, controls designed for a relatively static administrative environment where the budget cycle begins two years in advance (N-2) and is subject to few changes (good financial performance, according to the auditors) could turn to have a strong negative impact on the operational performance.

In a panel of 22 Agencies supervised by the ECA between 2008 and 2011, the proportion of operational budget carried forward from one financial year to another was on average in the range 42-45%. The ECA considered such level high and an indication of difficulties Agencies were experiencing in spending the budget. "Reasons for this include inappropriate budget planning and weak implementation capabilities" (ECA, 2011). Even if the level of carry-forwards not used in the following year, a better indicator of poor budget implementation, dropped on average to 13%.

The ECA criticised (ECA, 2011) a high concentration of spending at the year-end (19-21%) but not the rush to spend at the beginning of the year. The latter is a buffer for Agencies against unpredictable delays in the availability of the ordered goods and services. From the Agencies' point of view the opposite should be more appreciated: preparing an operational environment to make the best use of new or additional goods and services requires some time that can hardly be devoted in a few weeks at the beginning of the year. To implement its budget without a negative opinion from the ECA, given the EU financial framework (Commission Européenne, 2008), an Agency is prompted to commit most of the budget as soon as possible to minimise the risk of a delayed payment and the risk of having an "excessive" level of year-end activity, another ECA indicator of poor management.

In the real world there are plenty of acceptable reasons for this kind of "failures" in implementing the budget, most of which are out of an Agency's control, such as the need to cancel or restart a tender due to inadequate or poor offers, possible legal opposition made by the companies that did not win the tender, delay in receiving goods and/or services, non-compliance of goods and/or services with the order, the need to postpone an expenditure due to key staff unplanned unavailability (resignation, pregnancy, sickness, difficulty in recruiting highly specialised professionals with the required security clearance), the opportunity to wait for a new, more performant or less expensive technological product or software release, and delay in the billing process of a vendor or a supplier because the sales department has a different timing from the

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<sup>3</sup> Level of commitments done during the last months of the year.

billing unit, etc In front of the EU institutions, all these explanations have less "credibility" than the ECA's opinion.

**Figure 3:** Balancing the auditor's opinion and the Agency's defence

Carry-forwards, cancellation of carry-forwards, budgetary transfers



Very often, an early commitment violates the just-in-time principle that is universally considered a good indicator of sound management in the private sector. To improve the efficiency and effectiveness of an Agency given such a possible distortion, committing as soon as possible only to be compliant with the ECA standards, even if goods and/or services cannot be used or are no longer necessary, the auditors' report should be balanced by a management "defence" of the budgetary management with the same credibility as far as certain indicators are concerned (Figure 3).

Also, a lower level of expenditures (savings) in purchasing technological goods due to technological evolution should not be considered an indicator of a poor estimation of the value of a good or service done when preparing the draft budget in year (N-2)<sup>3</sup>.

## **6. Conclusion and Recommendations**

The ambition of this paper is to point out the excessive level of control in EU Agencies, which suggests simplification of redundant controls through more trust among the different levels of controllers. On the other hand, the focus of the paper is quite narrow. The point under discussion is not a recent reform, but the privileged position of the ECA in evaluating some aspects of the budgetary management and the excessive importance attributed by the ECA to some parameters, such as carry-forwards, cancellation of carry-forwards, and budgetary transfers, without a peer-to-peer discussion with the management on the validity of the unilaterally imposed interval of "correct" implementation. Also, the apparently aseptic description given by the auditors in their opinion on budgetary management is questioned.

The ambition of this paper is to reach the EU Institutions (the Commission and the EU Parliament) and ask them to rethink the importance attributed to the ECA reports when the Agency can justify the operational convenience in having levels of carry-forwards and budget transfers exceeding the ECA's standards. Auditors should limit their role to highlight that there was a carry-forward, a cancellation of carry-forwards, or a high transfer rate not in line with standard values, avoiding giving a value opinion on the quality of the budget implementation. In front of the Commission and the EU Parliament, the Agency management and the MB should have a level of 'credibility' not lower than the one attributed to the ECA on the interpretation of the motivations behind an 'excessive' carry-forward or a high transfer rate. From the EU Agencies and Member States' point of view, two major aspects should be better investigated to improve the budget process. First, ameliorate the funding act by adding an ad-hoc normative layer that, taking into account the specificity of the tasks of each Agency, could ensure more effective governance (Orlandi, 2021).

Secondly, some auditing indicators work well in a business-as-usual environment. A stable context can be a reasonable working hypothesis for an administrative DG of the Commission, but not for Agencies with an operational mission that have to continuously adapt their strategies and operations based on changes in the business models of criminals and criminal organizations. They also need to take into account new requests and tasks assigned by the parent DG (which may not be aligned with DG Budget) or the Member States through the MB. In the real world, unexpected and unpredictable events may trigger new needs, change the prioritization among business needs, and suggest reallocation of part of the budget. The audit report should not only point out the percentage of carry-forwards (or budget transfer), but also the rationale behind such budgetary management.

Knowing that a negative opinion will have a high stakeholder (the EU Commission, the EU Parliament, and, through the press, the EU public opinion) credibility, the audit report should not punish well-managed, fast event-reacting Agencies. Instead, it should develop mechanisms to consider if and when a budget transfer or a carry-forwards may increase operational performance. Or it should allow the allocation of resources just-in-time, in line with private-style sound management, even if this challenges the Principle of Annuality.

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