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SUBJECT: Audit Committee 2010 Annual report

SUBMITTED BY: Chairman of the Audit Committee

ADDRESSEES:

1. Administrative Council (for information)
2. Budget and Finance Committee (for information)

SUMMARY

This document contains the 2010 Annual report of the Audit Committee of the Administrative Council of the European Patent Organisation.

Audit Committee

Annual report 2010

W. Schellekens - Chairman
V. Cypris
G. Drage
P. Ernst

Munich 20 January 2011

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I. INTRODUCTION

The Audit Committee (the Committee) of the European Patent Organisation was established by the decision CA/D 9/09 dated 23 June 2009 of the Administrative Council (the Council). The members of the Committee were appointed during the December 2009 meeting of the Council for a period of three years starting on 1 January 2010. In 2010 the Committee held three meetings in resp. April, July and November. At its first meeting the Committee selected its Chairman.

The Committee is composed of:

- Wim Schellekens - Chairman
- Viktor Cypris
- Geoffrey Drage
- Paul Ernst

With regard to Article 4 (1) and (2) of CA/D 9/09 which states that the Audit Committee shall:

- submit its opinions and proposals, as defined in articles 5 and 6, to the President, and if the Committee deems it to be necessary, to the Administrative Council as well as to the Budget and Finance Committee,
- submit a report on its activities at least annually to the Administrative Council and the Budget and Finance Committee, including an assessment of the Office's approach to risk and mentioning any specific issues which have not been resolved,

the Audit Committee presents its report 2010 to the Administrative Council as well as to the Budget and Finance Committee. In practice, the Committee can only operate effectively, efficiently and economically with the cooperation of the Office. The Committee would like to acknowledge the cooperative support it received from the President and from the staff of the Office throughout the year.

With regard to the nature and the meaning of the above mentioned opinions, proposals and the annual report and activities, the Committee wishes to emphasise that it is an advisory body and as such:

- shall not conduct any audits or perform audit activities. Neither the Committee intends to provide assurance based upon its activities. Therefore the Committee's opinions, proposals and the annual report are not audit opinions or audit reports as mentioned in the International Standards on Auditing (ISA's) issued by the International Auditing and Assurance Standards Board.
- If the Committee considers that an audit should be performed on a specific issue, it will propose to the President to have such an audit performed by Internal Audit, or request the Administrative Council to ask the Board of Auditors to carry out a specific investigation or review with regard to article 76 (3) of the Financial Regulations of the EPO.

The Committee had a discussion on its role and its area of competence as defined in CA/D 9/09. It was agreed that the content of CA/D 9/09 should be regularly reviewed and that the Committee's Annual report to the Administrative Council could contain recommendations for changes which might be considered as necessary.

II. REPORT

A. RISK MANAGEMENT

1. The Committee was informed about the Risk management policy currently under development by the Office with a presentation at its first meeting (April) and a draft policy document at its third meeting (November). meeting. It noted that an Organisational risk management policy had not yet been established and implemented. Until now, only a methodology had been developed and not decided upon.
2. The Committee stressed the importance of establishing and implementing such a general Organisational risk management policy as an instrument for the President who, under the EPC, is accountable to the Administrative Council. This also would strengthen risk awareness within the Office. The Committee emphasised that the risk management policy under development would concern a general Organisational risk management *system*. The responsibility of the actual management of risks remains one of the main responsibilities of management which cannot be delegated to a risk management officer.
3. In parallel, organisational units should elaborate their own risk management policy, adapted to their specific situation, but compliant with the general organisational risk management policy decided at top-management level. Communication, both

horizontally and vertically, is crucial, since risk management should first of all be a collective exercise. In this respect, it was suggested that illustration with concrete risk examples (concerning buildings, for instance) could help to focus attention on the need for a risk management policy. The Committee also suggested that managers report regularly on specific risks in their area and on measures taken to mitigate these risks.

4. With regard to the draft policy, the Committee took a positive view of the envisaged methodology, combining top-down and bottom-up approaches, but did not discuss concrete proposals in detail. Nor did it wish to give an opinion yet on the question of standard. Major development work still had to be performed in this area such as the assessment of major strategic risks for the Organisation, definition of a general policy of how much risk is acceptable to the Office and of ways to address those risks. The Committee welcomed assigning further work on Organisational Risk Management to the Controlling Office, as intended by the President, as a sensible solution, provided that the Controlling Office had the resources and skills needed for that work.
5. The Committee also welcomed the idea of setting up a risk register, but pointed out that it was impossible to identify and plan for all potential risks. The Committee suggested creating a register of events likely to generate the risks against which the Organisation wishes to safeguard itself. Thereby it suggested to provide for a risk aggregation feature, i.e. a mechanism to appreciate the consequences of the simultaneous occurrence of several identified risks which, isolated, would create limited problems.
6. In conclusion the Committee stressed that, in order to carry out its mission including an assessment of the Office approach to risk, it must be provided with regular progress reports on the development and implementation of the organisational risk policy, the actual assessments of risk by management contained in risk management reports showing gross risk, potential impact, risk appetite, management's mitigating actions, net risk, responsibilities and timelines.

B. CHANGES IN THE REGULATORY FRAMEWORK OF THE ORGANISATION

a) Amendment of Article 24(2) of the Service Regulations

7. Amendment of Article 24(2) of the Service Regulations was one of the measures proposed by the Office's anti-fraud working party following a recommendation from Internal Audit. The objective of this amendment was to strengthen the position of permanent employees receiving orders they consider irregular or contrary to the interests of the Organisation, and to ensure that the Office is better informed about

the risks associated with such situations. The new version of Article 24 aims at protecting sufficiently employees receiving orders which they consider to be irregular, and will ensure an adequate information of the President via the filter of Internal Audit.

8. The Committee expressed full support to the amendment of Article 24(2) of the Service Regulations as proposed by the Office.

b) Changes in the FinRegs and Tender Guidelines relating to Procurement (as of 2011)

9. The changes in the FinRegs and the Tender Guidelines relating to procurement create a separation of duties between the responsibility of the budget holder for the purpose of the expenditure and the procurement officer who is responsible for the actual acquisition in accordance with the procurement policies. This segregation of both responsibilities is in accordance with generally accepted principles of internal control and is following recommendations of the Board of Auditors.
10. The Committee noted that the reorganisation had not yet led to staff savings, but suggested that this could happen if e-tendering and e-invoicing were introduced. The Committee also noted the expected timeframe for this project was two to three years. The Committee considered it important that the Central Procurement department reports on the realised staff savings. The Committee noted that an audit by Internal Audit of the results obtained by this new unit was planned for 2012.

C. INTERNAL AUDIT

a) The Internal Audit Charter

11. The Committee endorsed the Internal Audit Charter as revised and improved following comments it had formulated concerning the initial text. Support of the executive to Internal Audit was now clearly enhanced in its view. The Committee fully appreciated the difficulty of balancing the necessary independence of Internal Audit against the administrative need to anchor it with the executive. Yet the Committee took the view that the independence of Internal Audit should be properly embedded in the formal legislative structure of the Office, the Financial Regulations, in line with the practice of other organisations.
12. Major assets and liabilities of the Office are contained in the Reserve Funds for Pension and Social Security (RFPSS). The Board of Auditors made remarks on

the risks and the management of the Funds. Management of the RFPSS requires a proper internal control structure within the Office. Given these risks and the relative importance of the assets and liabilities for the Office, its annual accounts and the Contracting states, the Board of Auditors drew the attention of the Committee to the fact that transactions and procedures regarding the operations of the RFPSS are excluded from the area of competence of Internal Audit.

13. The resources (in both quantitative and qualitative terms) to be assigned to Internal Audit (directly or indirectly by means of expert studies and temporary skill-based additions) were obviously crucial to its performance, as measured against established benchmarks. The Committee noted in particular that the major projects recently launched by the Office regarding SPP, IT and buildings, clearly call for Internal Audit activities receiving appropriate resources.
14. The Committee proposed:
 - that the independent Internal Audit function be formally recognised in the Financial Regulations, so as to strengthen the position of Internal Audit within the Office;
 - To include the procedures concerning management and operations of the RFPSS in the area of competence of Internal Audit and to adjust the Internal Audit Charter accordingly.

b) Internal Audit medium term plan

15. The Committee noted the mid term Audit plan prepared by Internal Audit without giving an opinion as to its content when it was presented at its inaugural meeting. It nevertheless expressed the view that policies regarding Risk management and Anti-fraud are subject to review by Internal Audit.

c) Internal Audit plan for 2010

16. The Committee took note of the changes to the Internal Audit work programme as compared to the medium-term plan which had been submitted at its inaugural meeting. It noted that proposed changes concerned activities initially planned for 2011. In particular, the Committee shared the President's view that, in view of the importance to be attached to Human Resources policy, the audit on "reporting/promotion" should start earlier than initially planned. The Committee also understood the need to launch an audit on internal and external communication, but pointed out that this audit may require specific skills which were not necessarily available within Internal Audit.

17. The Committee commented that an Internal Audit plan is generally based on a risk analysis and assessment. The Head of Internal Audit explained that launching audits on specific risk areas would be difficult at this stage, since the risk management policy still had to be defined; nor were there a list of risks. The Committee agreed to look again at the planned audit activities for 2011 at its next meeting.
18. At its November meeting, the Committee noted that the work programme of the Board of Auditors for 2011 was being established, taking full account of the work programme of Internal Audit.

d) Internal Audit Reports

19. The Committee considered that, in order to follow the progress accomplished in the implementation of the recommendations, it should be presented with a regularly updated register of recommendations from Internal Audit, the Board of Auditors and of its own recommendations, showing which recommendations have been implemented and which recommendations have not been taken up, with an indication, in the latter case, of the reasons for non-implementation.
20. The Committee took note of the work done by Internal Audit, specifically:

- Accompanying audit of the Isar building renovation project

The Committee understood that Internal Audit had taken such a time consuming accompanying audit approach in the expectation that the Office would then be able to implement recommendations during the project. In view of this intention, the Committee expressed surprise at the low rate of implementation of Internal Audit recommendations and considered that if the Office did not take advantage from this audit approach, another less intensive approach might be preferred. The Committee noted that the Board of Auditors also had concerns about this approach and its implications regarding the independence of Internal Audit. The Committee considered that these concerns were understandable and should be kept in mind when evaluating the audit approach. The Committee was informed of the decision of the President to stop the accompanying audit and to replace it by an ex-post audit after completion of the project, and expressed the wish to be further updated on this matter.

- Audit on the cost of school education

The Committee noted that this audit covered a sensitive area in terms of staff entitlements and would need further consideration in the context of the general approach by management to human resource issues.

- Accompanying audit on SPP programme

The Committee's attention was drawn to the Single Patent Process programme, representing a budget of Eur 240 million for the period 2009-2014, and to the problems of ascertaining the intended efficiency benefits. The Committee noted that the SPP programme had been put on hold, pending the outcome of the external IT audit commissioned by the President, but that activities initiated before the launch of this study were continuing. Considering the risk involved, the importance of the project and the size of the investment, the Committee welcomed this external study. It wished to receive a copy of that study and to be informed on the executive's opinion on the findings.

- Quality Audits

The Committee noted that the quality index for search and examination lied outside the range set by the Office. Nevertheless the quality of Search had been improving in the last 3 years. The purpose of the audit was to provide recommendations for improvements. After implementation of recommended measures a new audit to assess their impact would be useful. The Committee questioned the rationale of the ongoing annual audits when the quality of the processes showed no signs of improvements. The Committee considered that the resources of Internal Audit might be used more effectively.

The Office representatives explained that there was a continuous change in the legal framework, partly triggered by audits' results. The results, thus, had an impact on quality. Quality monitoring furthermore required the performance of such annual audits. Regarding the more effecting use of Internal Audit's resources, the involvement of quality auditors was in the opinion of Internal Audit in line with the recommendations of the Audit Committee.

D. HUMAN RESOURCE MANAGEMENT

21. The Committee indicated that, in view of the importance of the Human Resources question to the Office, it would like to consider the management approach to the relevant issues and the risk factors involved (*inter alia* cultural change, motivation, sick leave, productivity measurement, ethics, and procedures for internal dispute resolution). In general the Committee observed that although different policies may be implemented, the overall approach should be consistent and coherent.
22. The Committee intends to meet the Head of the Human Resource department in 2011 to get an overview of the approach and controls implemented concerning HR-management. It was noted that the Office had made progress in 2010 on the long pending issue of Antifraud policy and had presented a draft Code of Conduct.

a) Antifraud policy

23. The Committee stressed that anti-fraud policy is an essential element of good governance. It noted that anti-fraud had been a long-pending issue at the EPO, for which some rules and regulations had already been put in place. The Committee further noted that before deciding upon and implementing such a policy the President had instructed Internal Audit to make an inventory of existing rules and regulations, which could then be incorporated into a coherent anti-fraud policy. This would mean an additional and significant burden for Internal Audit, which could jeopardise other important chapters of its work programme. The Committee was of the opinion that such a situation must be avoided. The Committee took the view that making an inventory of existing regulations normally should be part of the regular work of the HR department. It furthermore considered that it could be desirable for Internal Audit to audit the acceptance, awareness and proper execution within the Office of the anti-fraud policy once it was implemented. The Committee suggested that the Internal Audit plan on this subject should be adjusted accordingly.

b) Code of conduct

24. While welcoming the draft Code of conduct presented by the Office as an important step, the Committee considered that further reflection was needed, in particular in the light of criticisms from the Staff Representation, which the Committee considered to be partly understandable. Therefore the Committee was of the opinion that Staff Representation should be involved into this further reflection. The Committee also recommended that the Office takes following comments into account when continuing elaborating its Code of conduct;

- a Code of conduct should not have a threatening character but rather provide positive guidance and promote trust and ethical behaviour. It should raise awareness of the fact that some kinds of behaviour which are not necessarily categorised as "fraud", since they do not involve personal gain, may nevertheless be harmful in a broad sense to the entire Organisation. The draft code seemed to have particularly been designed as an anti fraud code;
- a Code of conduct should not be too legalistic, detailed or repeating existing rules/and regulations, but rather refer to the general principles and policies of the Office concerning the preferred behaviour and conduct as well as the rights and duties of permanent employees of the Organisation. These principles are formalised and set out in the Staff Regulations. To this extent, the Code of conduct should be part of the Staff obligations;
- thought should be given to the creation of an instance to which staff could refer in case of uncertainty about the conformity of specific behaviours to the proposed Code of conduct. Installation of a kind of ombudsman can be mentioned in this connection;
- the Committee considers that a "whistle-blowing" mechanism is needed.
- After establishing such a code a proper introduction throughout the Office is necessary to create and to maintain the desired culture and behaviour in the Organisation.

E. FINANCIAL ISSUES

a) Annual accounts and audit opinion by the Board of Auditors

25. The Committee noted that the annual accounts of the Office are prepared under the international accepted accounting standards IFRS. When an entity states that its accounts comply with IFRS, the International Accounting Standard (IAS) requires full compliance with all IFRS standards. This requirements is not fulfilled concerning the plan assets of the RFPSS. As clearly indicated indicated in the 2009 Board of Auditors report, this non-compliance could jeopardize the BoAs' unqualified audit opinion in future years. The Committee noted that the problem of compliance with IFRS 19.7 (concerning plan assets) had not yet been solved, and that thought was being given to using IFRS 9 (concerning financial instruments) instead.

26. The Committee considered that it would be helpful if the Office could submit relevant proposals to the Committee at an early stage, so that it could make a constructive contribution on this -admittedly very complex - matter.

b) Financial position

27. The Committee expressed concern about the financial position of the Office and especially about the negative equity of 1.860.000 EUR at the end of 2009.
28. After a presentation given by the Principal Director Finance the Committee noted, first, that procedural costs were not covered by procedural fees; second, that there are uncertainties concerning future revenues from annual fees on granted patents, which are a cornerstone of the EPO's financing scheme; third, that the member States' guarantee is limited to pensions, and could not be treated as an asset. The Committee therefore pleaded for strict controls on expenditure and even for savings wherever possible. It was nevertheless pleased to hear that unit costs had significantly improved in recent years.
29. The Committee welcomed the study, initiated by the President, of the budgetary and financial position of the Office by Deloitte and looked forward to being advised further on this matter once the report had been completed.

F. PENSION FUND

30. The Committee noted explanations given by the Funds Administrator and the Principal Director Legal Services on the RFPSS and their operation.
31. The Committee noted that the findings of the recently finalised Hewitt study on RFPSS governance would be distributed after they had been discussed by the Office management and the Supervisory Board of the RFPSS.
32. The Committee was particularly pleased to hear that the concerns it had expressed at its inaugural meeting, in April 2010, about the exclusion of the internal control measures applying to the RFPSS from the area of competence of Internal Audit were echoed in the recommendations emerging from the Hewitt study.
33. The Committee agreed to come back to this matter at one of its next meetings. It would then examine the consequences which, in the view of the Office and the RFPSS Supervisory Board, should follow from the Hewitt study.