National Audit Office

Financial management in the European Union

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 999 Session 2005-2006 | 29 March 2006

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Comptroller and Auditor General
National Audit Office

22 March 2006

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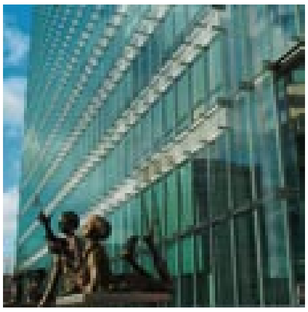

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EXECUTIVE SUMMARY

1 In 2004, expenditure by the European Union amounted to €100.1 billion (£67.9 billion[1]). The United Kingdom's net contribution to Community funds was €4.8 billion (£3.3 billion), comprising gross payments to the European Union of €11.7 billion (£7.9 billion), after taking account of the United Kingdom's abatement of €5.3 billion (£3.6 billion) and receipts of €6.9 billion (£4.7 billion).

2 In recent years, the institutions of the European Union and Member States have focused attention on improving the state of financial management within the European Union. This is partly because the European Court of Auditors (the Court) has not issued a positive Statement of Assurance in each of the last 11 years. To address this issue, the Barosso Commission has made it a strategic objective during its mandate to strive for a positive Statement of Assurance from the Court.

3 The United Kingdom Parliament has taken a great interest in European Union matters, including seeking better management and oversight of European funds. In April 2005, the Committee of Public Accounts published a report focused on these issues and made a number of recommendations for improvement[2]. The Government responded positively to the Committee's recommendations[3], and committed itself to taking forward the initiatives to improve the financial management of European funds during its Presidency of the Council of the European Union in the latter half of 2005. Appendix 1 sets out the Committee's conclusions and recommendations and the Government's response to them.

4 This report continues our practice of recent years of informing Parliament of the results of the examination of the European Union's accounts by the Court and progress on the various initiatives to improve financial management and control. In line with previous years, we summarise:

- the key findings from the Court's report on the 2004 financial year, in particular in relation to the Common Agricultural Policy and Structural Measures;
- the information available on irregularities, including possible fraud; and
- the progress made in improving financial management.

The key findings

On the Court's Statement of Assurance for 2004

5 The Court has not issued a positive Statement of Assurance on European Union expenditure for the eleventh year in succession, although its report noted improvements on the previous year. The Court concluded:

- **the reliability of the accounts**: that, in general, the Community accounts faithfully reflected revenue and expenditure for the year and the financial position at the year end. The Court could not however be certain that all the transactions relating to sundry debtors had been correctly and completely recorded.

1 This, and all other figures for 2004, has been converted at the 2004 annual exchange rate of £1=€1.4742.
2 *Financial Management of the European Union*, Committee of Public Accounts, Eighteenth Report, Session 2004-05, HC 498.
3 Treasury Minutes on the Twelfth, Fourteenth and Sixteenth to Eighteenth Reports from the Committee of Public Accounts 2004-2005.

- **legality and regularity of the transactions underlying the accounts**: that they were, taken as a whole, legal and regular with respect to revenue, commitments, administrative expenditure, expenditure on the pre-accession strategy, and areas of expenditure under the Common Agricultural Policy covered by the Integrated Administration and Control System (IACS)[4]. But it was unable to do so for four (of the six) main areas of expenditure, including expenditure under the Common Agricultural Policy not covered by IACS and Structural Measures.

6 The Court agreed with the Commission's view that while significant progress had been made to improve internal controls more work was required to increase their effectiveness.

On budget management

7 The Court reported an increase in the percentage of the European Community budget actually spent to 95 per cent from 92 per cent in 2003 and 86 per cent in 2002. The Court concluded that this increase and the reduction in the surplus were due to improved management by the Commission. The Court noted, however, that commitments for future years on the Structural Funds (2000-2006 programme period) had reached €136 billion (£92 billion), equivalent to nearly five years expenditure at the 2004 rate. This reflected delays in earlier years in setting up and starting the operation of these programmes. The Commission responded that the total level of commitments should be seen in the light of the time remaining for the execution of the remaining payments. The Commission considered that existing controls placed limits on the extent to which payments could be pushed back. It did not share the Court's concern that the accumulated commitments would hamper the start of new programmes.

On the Common Agricultural Policy, Structural Measures, and irregularities (including possible fraud)

8 For expenditure under the Common Agricultural Policy, the Court concluded that, where properly applied, the Integrated Administration and Control System, which covers area aid and animal premium payments, was effective and limited the risk of irregular expenditure. IACS covers 59 per cent of expenditure on the Common Agricultural Policy, or 26 per cent of the European Union's budget. As in previous years, the Court concluded that for expenditure not covered by IACS, for example on export refunds and cotton, olive oil and tobacco production, controls were weaker, resulting in a greater risk to the legality and regularity of the transactions.

9 In relation to Structural Measures, the Court reported that the Commission had continued its efforts to improve the internal control environment. But the Court found weaknesses in the management and control systems across all the programmes, demonstrating the need for further improvements. It also reported numerous errors of legality and regularity and identified a number of risks inherent to the legality and regularity of transactions. The two programmes examined by the Court in the United Kingdom exhibited some of these weaknesses, such as a failure to carry out day-to-day management checks and to provide a sufficient audit trail.

10 The Court continued to report delays in closing the 1994-1999 Structural Fund programmes. By the end of March 2005, for example, only 661 of the 994 programmes within the European Regional Development Fund had been closed. Delays increase the time required by the Commission to make financial corrections and divert administrative resources in both the Commission and Member States away from managing the current programmes.

4 Integrated Administration and Control System – a computerised database of holdings and aid applications for identifying and registering parcels of agricultural land and animals; plus a set of associated administrative checks and on-farm inspections.

11 During 2004, the 25 Member States reported to the Commission's anti fraud body (known as OLAF) 9,475 irregularities, including possible fraud, with a value of €983 million (£667 million). Excluding those reported by the ten new Member States (75 cases with a value of €5 million, or £3 million) to enable comparisons with 2003, the number of cases increased by 12 per cent and the value by five per cent.

On the introduction of a new accruals accounting system

12 In January 2005, the Commission introduced a new accounting system designed to produce accounts on an accruals, rather than a cash, basis. The first set of accounts produced on the new basis will therefore be for the 2005 financial year. During 2004, the Court carried out an audit of the different phases of the project's implementation. The Court reported that the Commission had made considerable progress towards introducing the system, but was concerned over whether the opening balances for 2005 would be established in time to produce a draft account. The Commission considered that the project had largely met the objectives set for the first eight months of 2005, and expected to have established the opening balances by the end of March 2006 in line with the project's timetable.

On the development of an action plan to improve financial management

13 In June 2005, the Commission published its 'roadmap', intended to move the European Union towards a positive Statement of Assurance. In November 2005, the Council of Ministers (Economic and Financial Affairs), known as ECOFIN, published its conclusions on the 'roadmap'. Taking into account the Council's comments, the Commission published its Action Plan in January 2006, designed to address important gaps between the current system of controls and those proposed as part of an integrated internal control framework. The Action Plan proposes to address four key themes: simplification of the management of European Community funds; strengthening management declarations and audit assurance; developing the approach to audit and determining the costs and benefits of controls; and addressing known weaknesses in specific programmes. The Plan sets a timetable for delivering the different action points.

CONCLUSION AND RECOMMENDATIONS

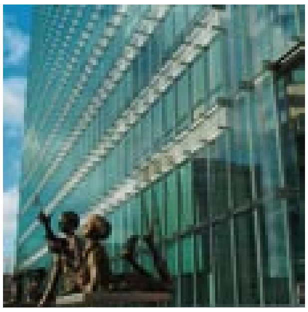
14 As mentioned in the Comptroller and Auditor General's last report, there is a need for further improvements in the management and control systems used in the Commission and Member States, particularly with regard to the closure of old programmes under Structural Measures. The delays in closing the 1994-1999 Structural Measures programmes continue to divert resources that could otherwise help with managing current programmes. The United Kingdom Government, working with other Member States, should share lessons learnt from the closure of the 1994-1999 programmes and ensure that there are robust plans to apply these lessons to the closure of the 2000-2006 programme. The United Kingdom authorities should use their influence to encourage the Commission and Member States to establish efficient and effective procedures for the 2007-2013 period.

15 The United Kingdom authorities have acknowledged some weaknesses in their management and control systems for Structural Measures and, despite making some progress, have accepted that further improvements are needed. The Office of the Deputy Prime Minister and the Department for Work and Pensions should ensure that the guidance they issue to the nine regional Government Offices and other organisations administering projects makes schemes' requirements clear and that day-to-day management checks are given sufficient priority.

16 The report of the Committee of Public Accounts and the Commission's Action Plan highlight 'contracts of confidence', relevant to Structural Measures, as a way of improving accountability. And the Government said that it was hopeful that the relevant authorities in the United Kingdom would be able to sign up to this initiative. To date, no 'contracts of confidence' have been signed. The Government should therefore renew its efforts to implement this initiative by continuing to encourage the development of the 'contracts of confidence' in the European Union and by identifying opportunities for the United Kingdom to enter into them.

17 OLAF (the Commission's anti-fraud body) has taken welcome steps to estimate the level of fraud in individual sectors of the budget, drawing on information provided by Member States. The United Kingdom authorities should support OLAF's work and continue their efforts to encourage Member States to agree on ways of measuring irregularity and fraud that can provide a complete and reliable picture of the stewardship of European funds.

18 We welcome the continuing improvements to the Court's Statement of Assurance and Annual Report, which contains more information on the Commission's progress in improving financial management, for example its assessment of expenditure on the Common Agricultural Policy. The Committee of Public Accounts was keen to see the Court develop its report in this way, and thereby assist the Commission and Member States in making the progress needed to achieve a positive Statement of Assurance.

19 The Court is currently completing a self assessment exercise to identify its strengths and weaknesses and is arranging a peer review of its approach and work. This is an important step towards addressing a recommendation made by the Committee of Public Accounts in its 2005 report. However, the Court has no plans at present to develop its value for money work as suggested by the Committee.

20 The Committee of Public Accounts considered that the size of the European Union's budget and the United Kingdom's contribution to it emphasised the need for strong financial management and frameworks of accountability and that the European Union's audit and accountability arrangements had been characterised by inertia. There have been valuable developments during the United Kingdom's Presidency including work on the Commission's roadmap which are intended to move the European Union towards a positive Statement of Assurance. There is still a long way to go. The successful implementation of the Commission's proposals will need the co-operation and support of other European Institutions and the State Audit Institutions and control agencies of Member States to obtain clear agreement on the approach to be taken. The United Kingdom authorities, working with their Austrian and Finnish counterparts, should give a high priority to helping to bring the current initiatives to a successful conclusion during the Barroso Commission's mandate.

PART ONE

The European Union budget and the European Court of Auditors' findings for 2004

1.1 This Part outlines the responsibilities of the various institutions of the European Union and Member States for securing the sound financial management of European Union funds. It deals, in particular, with:

- the European Union's budgeting process;
- the European Union's budget for 2004;
- the role played by the European Court of Auditors; and
- the Court's Statement of Assurance on the 2004 Accounts.

i) The European Union's budgetary process

1.2 The structure of the European Union is shown in **Figure 1 overleaf**. The Council of Ministers (the Council) and the European Parliament act jointly as the budgetary authority to approve the budget proposed by the European Commission (the Commission). The annual budgets are within a framework known as the Financial Perspective, which sets out the budgetary priorities for a seven year period, which the Parliament, the Council and the Commission have agreed. The current Perspective covers the period 2000 to 2006[5]. Once adopted, the annual budget is implemented by the Commission which distributes funds to other European Institutions and Member States. Over 80 per cent of Community funds are administered through arrangements where management responsibility is shared between the Commission and national, regional and local authorities within the Member States.

ii) The European Union's budget for 2004

1.3 For 2004, budgeted expenditure was €105.0 billion (£71.2 billion), seven per cent more than in 2003, and the budget for income was €101.8 billion (£69.1 billion). The 2004 financial year was the first to reflect the expansion of the European Union from 15 Member States to 25 from 1 May 2004, and the budget was increased by 7.8 per cent to take account of the expansion. The sources of income and main expenditure programmes are explained in **Figure 2 overleaf**.

1.4 In 2004, actual expenditure totalled €100.1 billion (£67.9 billion) and revenue was €103.5 billion (£70.2 billion). An analysis of revenue and expenditure is shown in **Figure 3 and Figure 4 (on page 9)**.

1.5 The Court reported an increase in actual expenditure as a percentage of budgeted expenditure to 95 per cent (from 92 per cent in 2003 and 86 per cent in 2002). This increase led to a reduction in the budget surplus (the difference between budgeted expenditure of €105.0 billion and actual expenditure of €100.1 billion) to €4.9 billion (£3.3 billion). Of this, €2.8 billion (£1.9 million) was carried over to 2005, leaving a budget surplus of €2.1 billion (£1.4 billion). The Court reported that the increased spending rate and the reduction in the surplus reflected, in part, improved management by the Commission.

5 In December 2005, the 25 Member States reached agreement on the 2007-2013 Perspective, setting a maximum expenditure level at €862 billion (1.045 per cent of Gross National Income). The 2000-2006 Financial Perspective represented 1.10 per cent of Gross National Income.

1 The five institutions of the European Union

The European Parliament

- 732 elected members
- Scrutinises the European Union's decision making process
- An arm of the Community's budgetary authority
- Administrative spend: €1.2 billion (£0.8 billion)

The Council of the European Union

- One Minister for each Member State
- Senior legislative body of the Community
- An arm of the Community's budgetary authority
- Administrative spend: €507 million (£344 million)

The European Court of Auditors

- One member from each Member State
- External auditor of the accounts of all revenue and expenditure of the Community
- Administrative spend: €84 million (£57 million)

The European Commission

- One Commissioner for each Member State
- Proposes and executes Community policies and ensures each Member State meets their Treaty obligations
- Implements the budget
- Administrative spend: €3.7 billion (£2.5 billion)

The European Court of Justice

- One judge from each Member State
- Rules on the questions of Community law and whether actions taken by Community institutions, Member Governments and other bodies are compatible with the Treaties
- Administrative spend: €216 million (£147 million)

NOTE

Total expenditure on European Institutions was €5.9 billion (£4.0 billion). The five institutions listed above accounts for €5.7 billion (£3.9 billion). The European Economic and Social Committee; the Committee of the Regions; the European Ombudsman; and the European Data Protection Supervisor accounted for the remaining €0.2 billion (£0.1 billion).

Source: National Audit Office

2 The source of income and expenditure streams explained

Source of income

- **Traditional own resources** – consisting of customs duties, including those on agricultural products, on a range of commodities imported from non-Member States and sugar levies charged on the production of sugar to recover part of the cost of subsidising the export of surplus Community sugar into the world market.
- **Value added tax (VAT) – based contributions** – based on a uniform rate (calculated by the Commission) applied to the VAT base in each Member State, subject to a cap.
- **Gross National Income (GNI) – based contributions** – calculated according to the Member States' Gross National Income.
- Other revenue and the surplus brought forward from 2003.

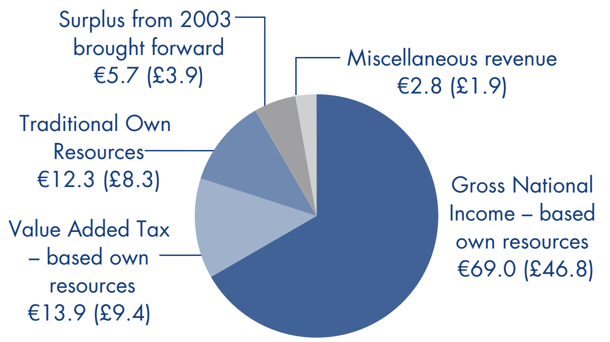
Expenditure programmes

- **Common Agricultural Policy**, schemes to support farmers and agricultural markets.
- **Structural Measures**, programmes to promote structural adjustment in under-developed regions, supporting economic and social conversion in areas facing structural difficulties, and to support the adaptation and modernisation of policies and systems of education, training and development.
- **Internal policies**, a range of measures including research and development.
- **External actions**, including food aid, humanitarian and development aid.
- **Administrative expenditure**, for the five Community Institutions and other bodies.
- **Pre-accession aid**, supporting candidate countries joining the European Union.

Source: National Audit Office

3 Source of receipts in 2004 (all figures in billions)

Total revenue for 2004 was €103.5 billion (£70.2 billion)



Source: Data from the European Court of Auditors' annual report for the 2004 financial year

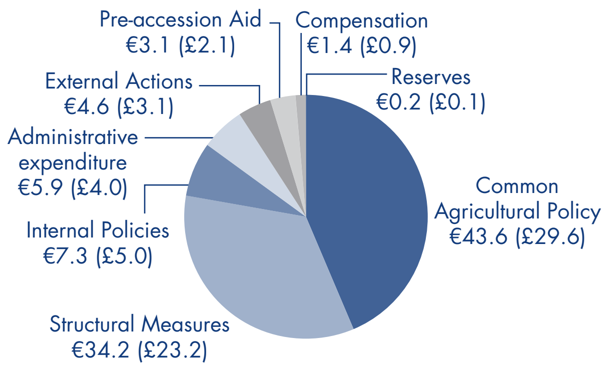
NOTES

1 Figure 3 explains each item of revenue.

2 Not all figures cast due to rounding.

4 Sources of expenditure for 2004 (all figures in billions)

Total expenditure for 2004 was €101.1 billion (£67.9 million)



Source: Data from the European Court of Auditors' annual report for the 2004 financial year

NOTES

1 Figure 3 explains each item of expenditure.

2 Compensation is paid to new Member States as part of a political agreement that they should not become net contributors to the budget as this stage of their membership of the European Union.

3 Not all figures cast due to rounding.

1.6 The budget of the European Union is set within the multi annual framework of the Financial Perspective. The Commission has, in addition to an annual payments budget, a budget for commitments entered into over each cycle. The Court reported that outstanding budgetary commitments had increased by 4.5 per cent to €110.1 billion (£74.7 billion) by the end of 2004, due to the additional budgetary commitments for the new Member States. The Court noted, however, that due to the nature of the budgetary process, the balance of outstanding budgetary commitments does not reflect the full extent of legal commitments. Total outstanding legal commitments for the Structural Funds 2000-2006 programme period at the end of 2004 were €136 billion (£92.3 billion) and represented nearly five years' payments at the 2004 spending rate. This reflected delays in earlier years in setting up and starting the operation of these programmes. The Court noted that to liquidate these commitments would require a much higher spending rate at the end of the programme period.

The United Kingdom's net contribution

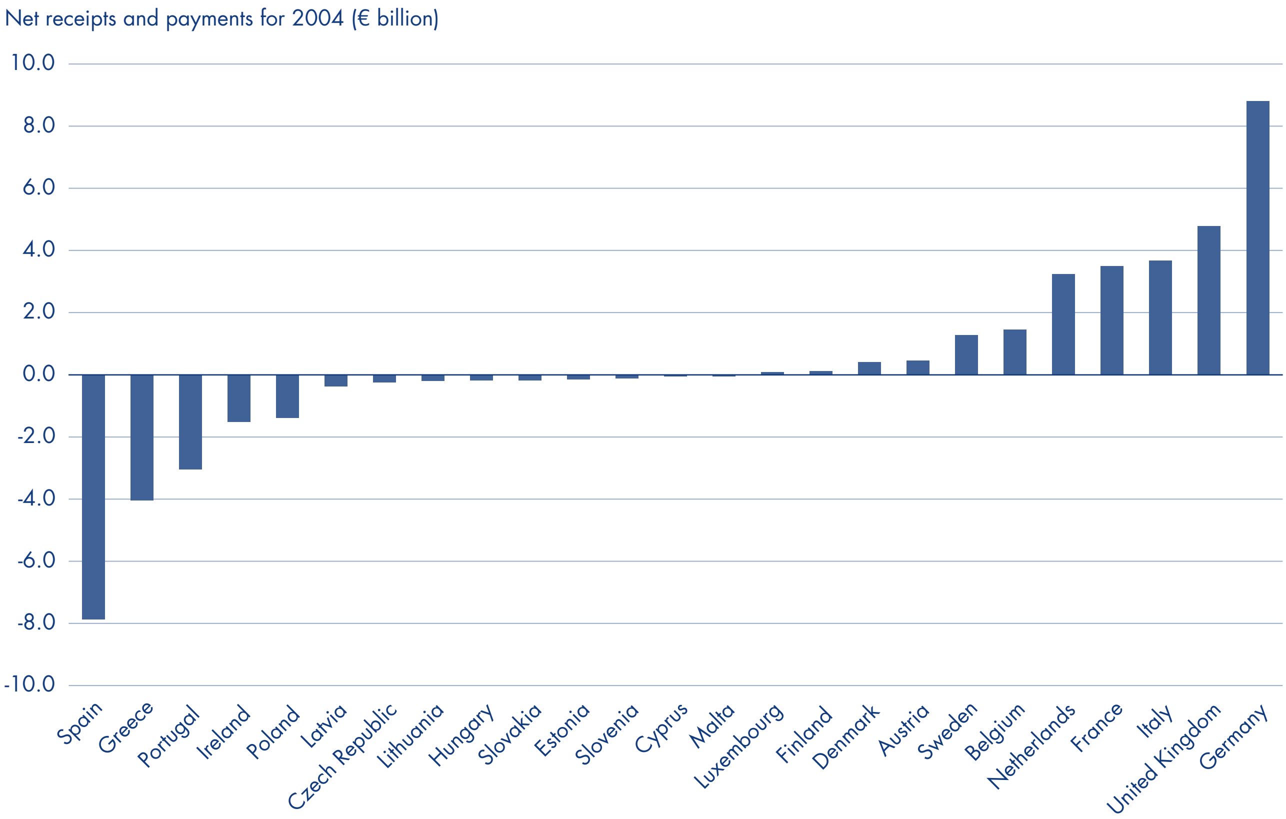
1.7 The United Kingdom made a net contribution of €4.8 billion (£3.3 billion) to the budget of the European Community in 2004 **(Figure 5 overleaf)**, the second highest net contributor, and compares with €4.0 billion (£2.7 billion[6]) in 2003. The United Kingdom's gross contribution to the budget of the European Union was €11.7 billion (£7.9 billion), after taking into account of the United Kingdom's abatement of €5.3 billion (£3.6 billion) and receipts of €6.9 billion (£4.7 billion). This was the fifth largest level of receipts, behind Spain, France, Germany and Italy.

1.8 As part of the settlement on the 2007-2013 Financial Perspective, the United Kingdom has agreed to a change to the expenditure to which its annual abatement is applied. The United Kingdom was originally granted the abatement as part of the negotiations leading to the agreement on the European Union's budget in 1984. Under the current formula the abatement would have increased from £3.6 billion in 2003 to an annual average of £4.8 billion over the 2007-2013 period[7]. In December 2005, the United Kingdom agreed an amendment to its abatement. As a result, the United Kingdom's annual average abatement will reduce by around £0.8 billion to £4.0 billion over the seven years of the next Financial Perspective.

6 This, and all other 2003 figures, has been converted at the 2003 annual average exchange rate: £1=€1.4320.

7 The abatement was calculated as 66 per cent of the United Kingdom's net contribution. The final calculation for any given year is made four years later, allowing time for the final figures to be known with some certainty. The new formula gradually disapplies expenditure on economic development by the ten new Member States.

5 Member States' net receipts and payments for 2004



Source: Data from the European Court of Auditors' report for the 2004 financial year

iii) The role of the European Court of Auditors

1.9 The European Court of Auditors is the European Union's external auditor. The Treaty establishing the Community requires the Court to examine all revenue and expenditure of the Community and of bodies established by the Community, and whether financial management has been sound. It also requires the Court to provide the Parliament and the Council with a Statement of Assurance[8]. The Court publishes an annual report after the close of each financial year. The Court can carry out investigations into specific topics and publishes its findings in Special Reports. For 2004, it published five such reports which are listed in Appendix 2.

1.10 After the accession of ten new Member States on 1 May 2004, the Court comprised 25 members, one from each Member State. The Members are nominated by their Member State and the nominations are scrutinised by the European Parliament. Appointment to the Court is formally made by the Council of Ministers after consultation with the European Parliament. In 2004, the Court had around 750 staff.

1.11 The Committee of Public Accounts, in its report last year on financial management in the European Union, recommended that that the Court should consider a peer review of its approach and work. In February 2006, the Court's President told the European Parliament's Committee on Budgetary Control that it had begun a self-assessment exercise to establish its strengths and weaknesses, which will lead to an action plan of remedial measures. This will be followed by a peer review intended to assess the quality of the Court's management and outputs and to identify corrective action.

8 In French, Déclaration d'assurance (DAS).

1.12 The Committee also concluded that there was scope for more value for money work and reporting by the Court. The Court currently has no plans to expand its work in this area.

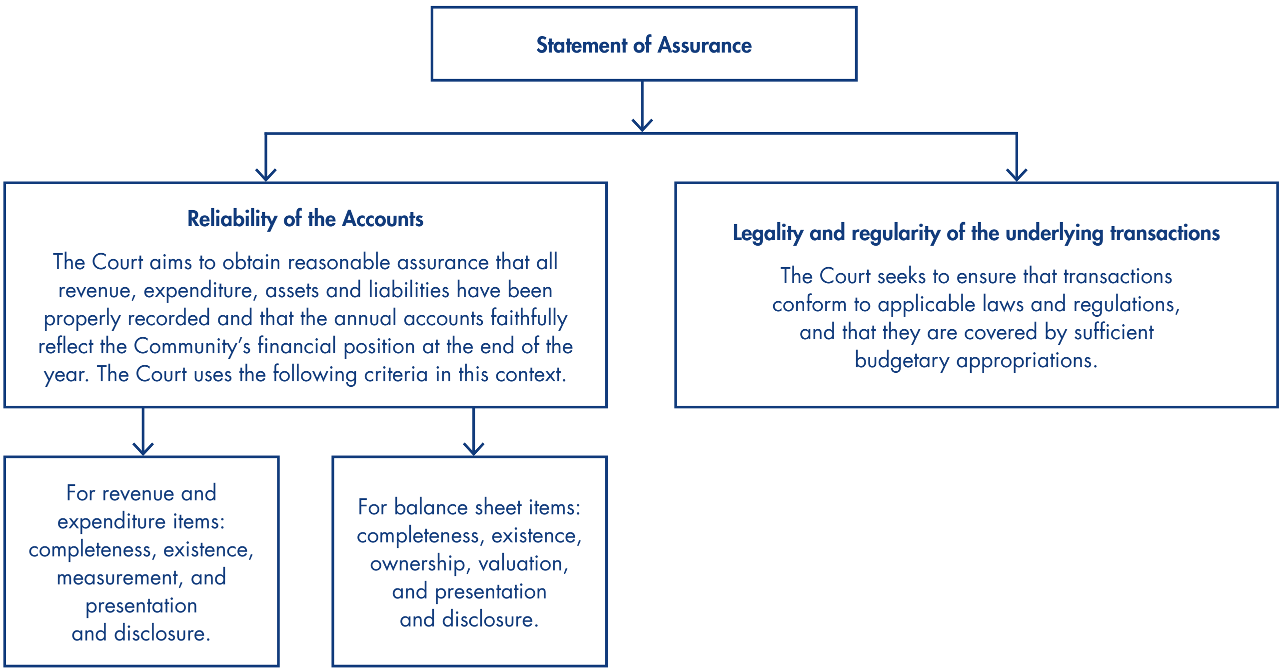
The Court's Statement of Assurance and audit methodology

1.13 The Court's examination of the Community's annual accounts is based on international audit standards[9], adapted to reflect the Court's duties and responsibilities and take account of the Community context. The Statement of Assurance covers the **reliability of the accounts** and the **legality and regularity of the underlying transactions (Figure 6)**. The Court's methodology for its audit of the 2004 financial year was based, as it had been for the previous three years, on four sources of evidence.

- An examination of the operation of the supervisory systems and controls applying to expenditure of European funds by Community Institutions, Member States and other countries; these systems are designed to confirm the legality and regularity of revenue and expenditure.
- Sample checks of transactions for revenue, and for each major area of expenditure down to the level of the final beneficiary.
- An analysis of the Annual Activity Reports[10] and the declarations of the Commission's Directors-General and the procedures applied in drawing them up.
- An examination of the work of other auditors who are independent of the Community's management procedures.

1.14 The Court has supplemented its Statement of Assurance with specific assessments of the Community's major areas of activity[11]. It has also sought to rely increasingly on the Commission's management and supervisory controls in these areas. The Court also examined the Commission's efforts to re-organise its internal control system.

6 The Statement of Assurance covers the reliability of the accounts and the legality and regularity of the underlying transactions



Source: National Audit Office

9 Such as the International Organisations of State Audit Institutions (INTOSAI) and the International Standards on Auditing.
10 An annual report, from each Director General to the Commission, on the Directorate-General's performance in relation to its management of the budget.
11 Common Agricultural Policy, Structural Measures, Internal Policies, External Actions, Pre-Accession Strategy and Administrative Expenditure.

iv) The Court's Statement of Assurance on the 2004 accounts

1.15 In November 2005, the European Court of Auditors did not issue a positive Statement of Assurance on the European Union's Accounts for the eleventh year in succession. The Auditors' Report concluded that, compared to previous years, the European Commission had made progress in strengthening its financial systems in a number of areas. The Court's overall conclusions are set out below.

- On the **reliability of the accounts** the Court concluded, generally, that the Community accounts faithfully reflected the Communities' revenue and expenditure for the year and the financial position at the year end, except for the value of miscellaneous revenue and debtors as it could not be certain that all the transactions relating to sundry debtors had been correctly and completely recorded.
- On **the legality and regularity of the transactions underlying the accounts** the Court concluded that they were, taken as a whole, legal and regular with respect to revenue, commitments, administrative expenditure, expenditure on the pre-accession strategy, and CAP expenditure covered by the Integrated and Administration Control System (IACS). However, the Court identified four (of the six) areas of expenditure - those parts of the Common Agricultural Policy not covered by IACS, Structural Measures, Internal Policies and External Actions – which were materially affected by errors **(Figure 7)**. In 2003, the Court had qualified its opinion on five areas, the four noted in 2004 plus pre-accession aid. Part 2 of this Report provides further details of the Court's opinion on CAP expenditure and Structural Measures.

Assurance provided by the Directors-General

1.16 Since 2001, each Director-General within the Commission has been required to prepare an Annual Activity Report. This document is a management report to the Commission on the Directorate-General's performance in relation to the management of its budget. Annual Activity Reports must also include reservations, where the Director-General has identified material internal control weaknesses. Action plans are required to remedy weaknesses.

7 The Court's findings for items of expenditure which were materially affected by errors

- **Common Agricultural Policy**: the Court found continuing evidence that expenditure not subject to the Integrated Administration and Control System (IACS) posed greater risks because systems governing non-IACS expenditure were not as effective. The Court concluded that expenditure under the Common Agricultural Policy, taken as a whole, was still materially affected by errors. These findings are considered in greater detail in Part 2 of this report.
- **Structural Measures**: the Court again found weaknesses in the management and control systems which showed the need for improvements to comply fully with regulatory requirements. These findings are considered in greater detail in Part 2 of this report.
- **Internal policies**: the Court noted progress in certain areas but was unable to gain sufficient assurance as to the legality and regularity of payments due to problems with supervisory and control systems.
- **External actions**: the Court noted that improvements to the Commission's supervisory and control systems had yet to lead to a comprehensive approach to the supervision, control and audit of organisations receiving funding.

Source: National Audit Office summary of the European Court of Auditors' annual report for the 2004 financial year

1.17 For 2004, all the Directors-General had stated that they had obtained reasonable assurance that the resources allocated to them had been used for the specified purposes. They concluded that internal controls had ensured that the underlying transactions were legal and regular. The Court reported a reduction in the overall number of reservations made by the Directors-General, from 49 in 2003 to 32 in 2004. The Court highlighted the improved reporting of reservations, with Directors-General concentrating on weaknesses that presented important risks for the legality and regularity of the underlying transactions. In the Court's view, however, the extent of the reservations expressed by some Directors-General was not always compatible with the overall conclusion provided.

1.18 The Court concluded that the Commission's 2004 Synthesis of the Annual Activity Reports continued its efforts to improve transparency. However, while the Court agreed with the Commission's assessment of its internal control system, the Court concluded that further steps were required to reach the Synthesis report's conclusion that the situation was 'globally satisfactory'.

1.19 The Court identified guidance on Annual Activity Reports issued by the Commission and peer review as a key factor contributing to the improvements that had been made. Despite these improvements, the Court reported that the remaining weaknesses were such that it could only place limited reliance on Annual Activity Reports as a source of assurance. The Court noted, for example, that there was no agreed threshold for what constituted a material system weakness.

1.20 For the second year, the Director-General for the budget reported on the quality of the internal control systems of the Directorates-General. The report recorded significant progress in implementing internal controls since the establishment of the Commission's White Paper on Reform in 2000[12]. The Director-General's report recognised that further efforts were required to improve the effectiveness of controls, focusing on enhancing supervision procedures for financial management; strengthening risk management; review and simplification of low value contracts and grants; and the creation of an integrated internal control framework. The Court agreed with the Commission's overview.

The European Parliament and the European Commission have emphasised the need to move towards a clear audit certificate

1.21 The Council and the Parliament examine the accounts of the European Community together with the Court's report. The Council, by 31 March of the year following publication, makes a recommendation to the Parliament on whether to grant 'discharge' for the Budget (to signify that the Parliament considers the stewardship of Community funds has been sound and according to instruction, and that expenditure is in line with the objectives set in the Budget). The Parliament's Budgetary Control Committee examines the report and the Council's recommendations and produces a draft discharge decision and motion for a resolution. By 30 April, the Parliament votes on the decision and motion, having received recommendations from the Council.

1.22 The European Commission, the European Parliament and the Council of Ministers have stressed the importance of moving towards a positive Statement of Assurance. In April 2005, the European Parliament granted discharge to the European Commission for responsibility for the Union's 2003 budget. The accompanying report contained 78 recommendations focused on the need to move towards a positive Statement of Assurance and introduce a Community Internal Control Framework. The development of these recommendations is outlined in Part 3 of this report.

Scope of the National Audit Office report

1.23 For each of the last eleven years, the Comptroller and Auditor General, the head of the National Audit Office, has reported to the United Kingdom Parliament on financial management in the European Union[13]. These reports draw extensively from the Annual Reports of the European Court of Auditors.

1.24 In March 2005, the Committee of Public Accounts visited a number of European Institutions to examine Financial Management in the European Union and follow up the issues raised in the Comptroller and Auditor General's report. The Committee concluded that a major factor contributing to the qualified audit opinion was the level of errors identified by the Court. This was partly due to the complexity of schemes and programmes, particularly for payments under the Common Agricultural policy and Structural Measures. It welcomed the commitment by all parties to achieving a positive Statement of Assurance but concluded that the scale of the task was formidable. It urged the United Kingdom Government to use the occasion of its Presidency to improve accountability in the European Union[14]. The Committee's recommendations along with the United Kingdom Government's response are summarised at Appendix 1.

1.25 Our work for this report is based primarily on a review of the Court's annual report on the 2004 financial year. This was supplemented by interviews with officials at relevant organisations, details of which are set out in **Figure 8 overleaf**.

12 White Paper on Reforming the Commission – COM (2000) 200, 1 March 2000.
13 The Comptroller and Auditor General's last report on this issue, *Financial Management of the European Union* was published in March 2005. HC 289, Session 2004-2005.
14 *Financial Management of the European Union* (Eighteenth Report of Session 2004-05, HC 498).

8 Organisations where we conducted interviews

In the United Kingdom

- HM Treasury
- Department for Work and Pensions
- Office of the Deputy Prime Minister
- Department of Trade and Industry
- Rural Payments Agency

At European Institutions

- European Court of Auditors
- European Commission
  - DG REGIO – the Directorate-General for Regional Policy
  - DG EMPL – the Directorate-General for Employment and Social Affairs
  - DG AGRI – the Directorate-General for Agriculture and Rural Development
  - DG BUDGET – the Directorate-General for Budget
  - OLAF – the European Union's Anti-Fraud Office

Source: National Audit Office

1.26 This report examines:

- Part 2: the European Court of Auditors' findings with respect to the Common Agricultural Policy and Structural Measures, and irregularities, including possible fraud.
- Part 3: efforts to improve financial management and accountability in the longer term, including progress made during the United Kingdom's Presidency of the European Union.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PART TWO
The Court's findings on the main areas of expenditure

2.1 This Part considers the Court's findings in respect of:

i) the Common Agricultural Policy;

ii) Structural Measures; and

iii) irregularities, including possible fraud.

i) The Common Agricultural Policy

2.2 In 2004, expenditure on the Common Agricultural Policy (CAP) was €43.6 billion (£29.6 billion) and represented 44 per cent of the budget. There are two main activities:

- support for the agricultural sector through direct aid and intervention measures; and
- rural development (such as investment in farm holdings and agri-environmental schemes).

2.3 Paying agencies located in Member States are responsible for CAP expenditure. In 2004 there were 91 such agencies across the 25 Member States. They are required to provide the Commission with assurance on the admissibility of claims and compliance with rules. The process for making payments to farmers and the controls over these payments are shown in **Figure 9 overleaf**. Each Member State is also required to appoint a certifying body to examine the procedures of and statements of expenditure from local paying agencies.

2.4 The United Kingdom has six Paying Agencies[15], each of which produces an account for expenditure on the Common Agricultural Policy. These accounts are be audited by the Comptroller and Auditor General, the United Kingdom's certifying body[16], under a service level agreement with the United Kingdom Co-ordinating Body, which reports to the Ministers in the United Kingdom with responsibility for agriculture. The Co-ordinating Body has responsibility for advising on European Union regulations and liaising, on behalf of the Paying Agencies, with the relevant Directorate-General. It is also responsible for encouraging effective financial control, facilitating efficient and effective interactions between Paying Agencies and European institutions, and encouraging the adoption of measures designed to lead to improvements in Paying Agencies' processes and performance.

15 Rural Payments Agency for England; Scottish Environment and Rural Affairs Department; National Assembly for Wales; Department for Agriculture and Rural Development Northern Ireland; Forestry Commission; and the Countryside Council for Wales.

16 The certifying body examines the paying agency procedures and statements, amongst other things.

9 The role of paying agencies

1. Farmers present claims to **Paying Agencies** in the year before payment is due, based on, for example, areas cultivated and the number of eligible animals.
2. The **Paying Agency** completes administrative checks on all claims and a sample of claims are subject to on the spot checks.
3. Each **Paying Agency** pays claimants and is then reimbursed by the Commission.
4. The **Paying Agency's** accounts and payments are examined by an independent auditor (the certifying body), which reports to the Commission. The Commission also audits Paying Agencies on a sector by sector basis.
5. The Commission must decide whether to accept the accounts and audit reports (a process known as clearance of the accounts).
6. The Commission may examine the payments made by a Paying Agency. Where weaknesses are identified it may improve financial corrections.

Source: National Audit Office

The Court's overall findings on Common Agricultural Policy expenditure

2.5 As in previous years, the Court's examination of control systems, and the legality and regularity of the underlying transactions, included:

- assessing how well the financial control systems were working in Member States, as well as the post-payment and physical checks carried out by the Commission on subsidised agricultural exports;
- examining the Commission's financial clearance decision for expenditure in 2004;
- testing a sample of transactions directly; and
- examining the Director-General's Annual Activity Report.

2.6 Overall, the Court concluded that in 2004, where properly applied, the Integrated Administration and Control System (IACS) was effective in limiting the risk of irregular expenditure. The IACS is the key management and control tool for area payment and animal premium schemes, covering almost €27 billion (£18 billion) in 2004, or 59 per cent of CAP expenditure. IACS comprises a computerised database of holdings and aid applications, systems for identifying parcels of agricultural land, and for identifying and registering animals. It also includes a co-ordinated set of administrative checks and on-farm inspections.

2.7 The Court found that IACS was operating in all of the 14 of the 15 Member States (which formed the European Union prior to May 2004), apart from Greece[17]. In Greece, the Court reported serious deficiencies in the way in which the system functioned with the result that the system was not reliable. Greece accounted for €3 billion (£2 billion), or seven per cent of CAP expenditure in 2004. The Commission has implemented an action plan to address the weaknesses identified by the Court in Greece. It will also make recoveries each year to compensate for the increased risk of irregularity.

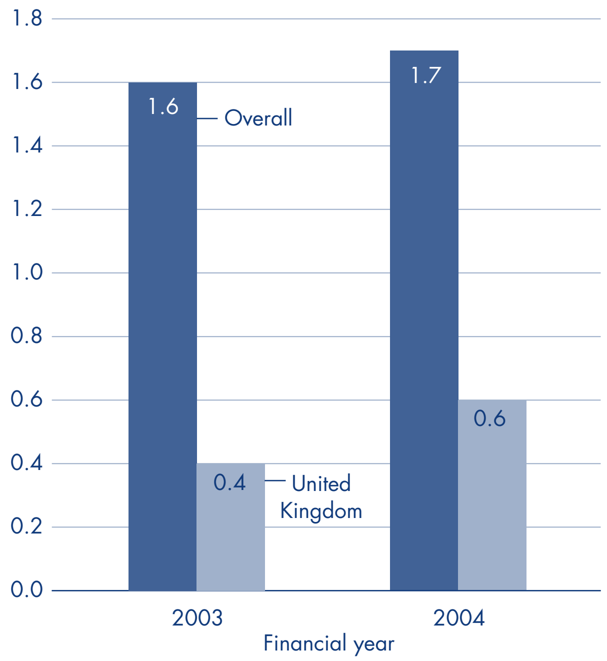
2.8 For area aid schemes, Member States had informed the Commission that they had completed risk-based and random on-the-spot checks for 8.1 per cent of claims (representing 11.4 per cent of the total land area claimed for). Of this, 1.6 per cent was found not to be eligible agricultural land. While the figure reported by the United Kingdom to the Commission increased slightly between 2003 and 2004, it was much lower than average for Member States **(Figure 10)**. The Court concluded that the reported results of the random error checks provided a reasonable estimate of the likely error in claims in the 14 of the 15 Member States in which IACS operated satisfactorily. Overall, the Court:

- concluded that the majority of payments were error free (the same as in the previous year);

17 Payments subject to IACS in the ten new Member States were not material.

10 Error rates for the Area Aid schemes, forage areas and other crops across the European Union and for the United Kingdom in 2003 and 2004

Error rates reported by Member States to the European Commission (percentage)



Source: European Court of Auditors' report on the 2004 accounts

NOTE

Results are based on random on-the-spot and risk-based checks.

- noted that where errors were identified, they were relatively small and had no marked impact on overall expenditure; and
- highlighted a small number of cases which were affected by larger errors, but the impact of such was lower than in previous years.

2.9 On animal premium schemes, the Court noted that the error rate for the largest scheme, the suckler cow premium, reported to the Commission by Member States, identified by inspection of cattle showed small variations between Member States (between 0.1 per cent and 1.9 per cent), apart from Italy where an error rate of 10.2 per cent was reported. The overall error rate declined from 2.0 per cent reported in 2003 to 1.4 per cent in 2004. The figure for the United Kingdom also showed a decline from 0.8 per cent to 0.7 per cent.

2.10 The Court concluded that expenditure not covered by IACS[18], some €18 billion (£12 billion), posed a greater risk as the systems controlling this expenditure were not as effective.

The Court's conclusion on the clearance procedure

2.11 The Commission is required to ensure that Member States have made proper use of the funds they have received under the Common Agricultural Policy, a procedure known as the *clearance of accounts*. There are two parts to this process.

- **Accounting clearance.** Accreditation and certification of accounts.
- **Compliance clearance.** The management and supervisory systems intended to ensure the legality and regularity of underlying transactions.

2.12 The Court, for its report on the 2004 accounts, examined the Commission's financial clearance decision. The Court noted that

- 71 of the 91 Paying Agencies (78 per cent), representing €32 billion (£22 billion), or 73 per cent of CAP expenditure, had received unqualified opinions from their certifying bodies; the remaining 20 Paying Agencies (representing some €12 billion, or £8 billion), all from outside the United Kingdom, received a qualified or negative opinion due to overpayments, illegible expenditure, missing supporting documents, weaknesses in delegating functions, or incomplete or misleading information about debtors;
- the Commission had approved the accounts of 86 of the 91 Paying Agencies (compared with 21 out of 85 in 2003). The accounts of the five remaining Paying Agencies[19], all from outside the United Kingdom, represented nine per cent (compared to 43 per cent for the 2003 financial year) were 'disjoined' from (that is, not included in) the Commission's financial decision because, for example, of a failure by the certifying body to quantify the financial impact of errors and a failure to carry out on the spot checks. The Commission will carry out a more detailed examination of these accounts in subsequent months. The amount involved was €4 billion (£3 billion), some nine per cent of CAP expenditure for 2004.

18 Intervention, export refunds, rural development, and other expenditure.
19 In Italy (AGEA), Spain (Madrid), Luxembourg (Ministère de l'Agriculture), Germany (Bayern, Umwelt) and France (ACCT/SDE).

2.13 The Court concluded that, in general, the Commission's financial clearance work for 2004 was based soundly on the work of Member States' certifying bodies. The Court, however, noted that the certifying bodies work was not intended to provide the Commission with assurance that transactions were legal and regular. The Court therefore reiterated its view that certification, or another part of the control chain, should cover the legality and regularity of transactions expenditure at the level of the beneficiary. In response to the Court, the Commission said that the new regulation on financing of CAP expenditure included a requirement that heads of Paying Agencies should sign an ex post declaration of assurance on the legality and regularity of expenditure.

2.14 The Court also examined the Commission's conformity decisions – financial corrections for the incorrect application of control over claims in past years. The Court reported that, in 2004, the Commission, took three decisions in respect of expenditure from 1998 to 2003, leading to financial corrections valued at €406 million (£275 million) – meaning that the relevant Member States will repay this expenditure. The Court also reported that, for the period 1999 to 2004, the Commission's conformity decisions had led to corrections valued at €2.7 billion (£1.8 billion), of which €150 million (£102 million) related to the United Kingdom. The Commission's conformity decisions were not complete for any year later than 1998.

ii) Structural Measures

2.15 In 2004, expenditure on Structural Measures totalled €34 billion (£23 billion) and accounted for just over 34 per cent of the European Union budget, the second largest component. Structural Measures mainly comprise payments from four Structural Funds **(Figure 11)**. Ninety-four per cent of expenditure, from all four funds, is targeted at three priority objectives. Expenditure in 2004 consisted of ongoing payments for the current programme period (2000-2006) and final payments for the previous programme period, 1994-1999.

- **Objective 1 (territorial)**: promoting the development and structural adjustment of regions whose development is lagging behind;
- **Objective 2 (territorial)**: supporting economic and social conversion in industrial, rural, urban or fisheries-dependent areas facing structural difficulties; and
- **Objective 3 (thematic)**: supporting the adaptation and modernisation of policies and systems of education, training and employment.

2.16 Responsibility for the sound management of the Structural Measures programmes is shared between the Commission and Member States. For each programme, a Member State designates a Managing Authority (responsible for the management of the programme such as selection of projects, monitoring of implementation, and verification and conformity with rules and regulations) and a Paying Authority (responsible for drawing up and submitting applications for payments and receiving them from the Commission). The Paying Authority also certifies the expenditure by the Managing Authority. Member States may also designate Intermediate Bodies to act on behalf of the Managing or Paying Authority in dealing with the financial beneficiaries of the funding. Finally, Member States are responsible in the first instance for the audit of systems and a sample of projects. The main responsibilities governing the management and control of expenditure on the Structural Funds are set out in three European Community regulations[20]. These are set out in **Figure 12 on page 22**. **Figure 13 on page 23** shows the management and control systems for the structural funds administered in the United Kingdom.

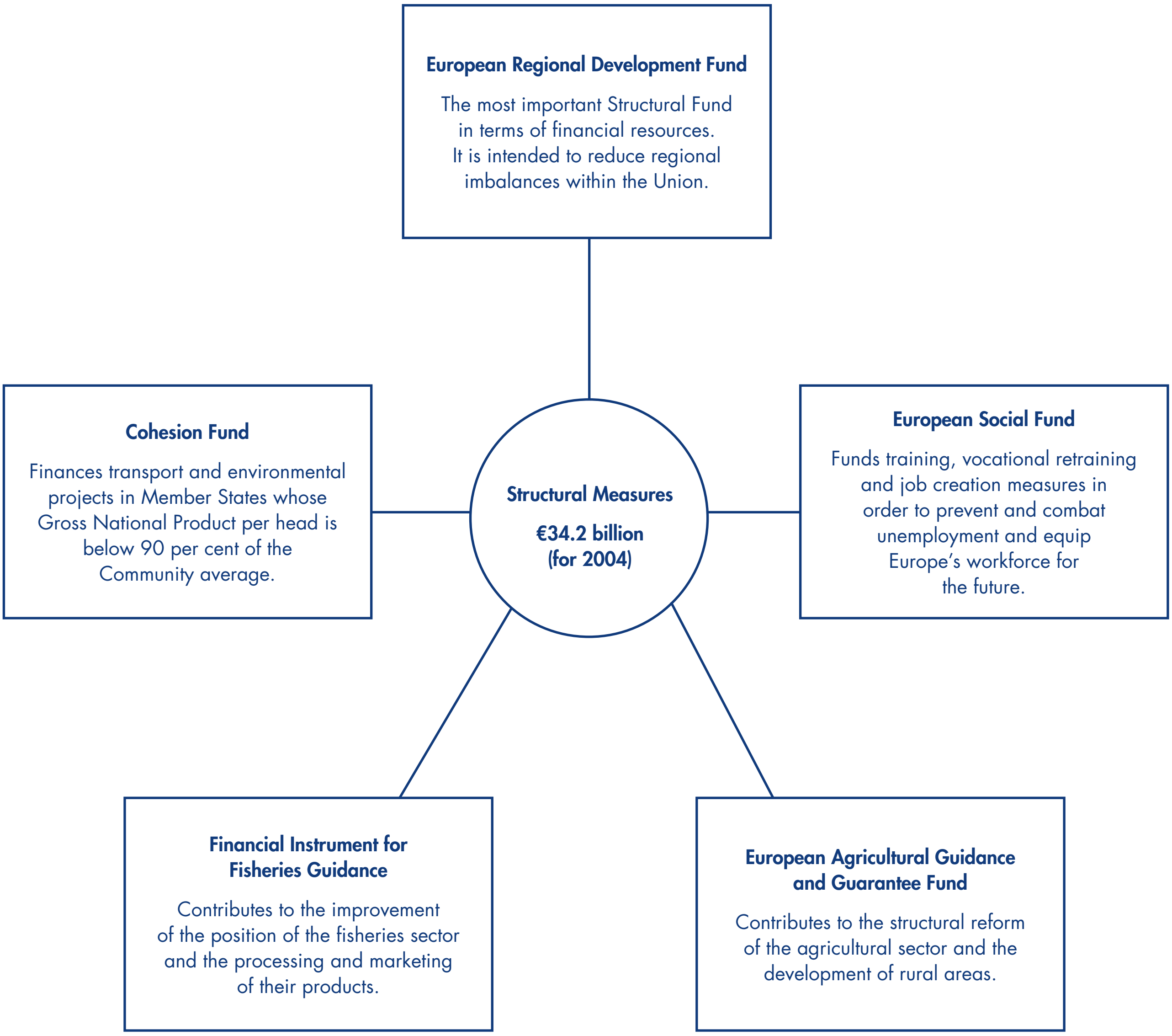
The Court's overall findings on Structural Measures for 2004

2.17 The Court noted that the Commission had continued its efforts to improve its internal control environment. The Court found weaknesses, however, in the management and control systems in its sample of programmes, which demonstrated the need for further improvement. It reported numerous errors of legality and regularity and identified a number of inherent risks to the legality and regularity of expenditure (see Figure 6), arising from:

- the shared management between the Commission and the Member States;
- the variety of bodies and authorities which intervene in the management process;
- the large number of programmes which may contain several thousand projects, implemented over a period of years; and
- the large number of conditions, often unclear, governing the eligibility of expenditure. As well as meeting the requirements for receiving Structural Measures funding, projects must also comply with national and other EU legislation such as on procurement and State aid.

20 Regulation (EC) No 2064/97, No 1260/1999, and 438/01.

11 Main components of the Structural Measures



Source: National Audit Office

NOTES

1 Just over five per cent of the Structural Funds budget is absorbed by four programmes, known as Community Initiatives[2], designed to try to find common solutions to regeneration and infrastructure problems affecting the whole Union. The remainder of the Structural Funds is spent on special support for fisheries and innovative actions.

2 Interreg III, Urban II, Leader+ and Equal.

12 The main responsibilities for the management and control of spending under Structural Measures

For the Commission:

- to ensure, in cooperation with Member States, that the financial control objectives set out in the regulations are achieved;
- to satisfy itself that the management and control systems in Member States meet regulatory standards and to review regularly the operation of the systems;
- to carry out checks on operations and systems, and to apply financial corrections when irregularities and deficiencies are identified which the Member State has failed to correct itself.

For the Member States:

- to put in place management and control systems which provide satisfactory certification of the validity of claims for payments (expenditure declarations), including in particular:
  - the provision of guidance to managing and paying authorities on the organisation of management and control systems including the definition, clear breakdown and adequate separation of functions within the organisation concerned;
  - a sufficient audit trail to allow the declarations of expenditure made to the Commission to be checked against accounting records;
  - carrying out day-to-day management checks during the implementation of a project and independent checks on a five per cent sample to verify the effectiveness of management and control systems and the accuracy of expenditure declarations;
  - the provision to the Commission, at the close of a programme, of a statement summarising the conclusions of checks made in previous years and an overall conclusion as to the legality and regularity of the operations underlying the final declaration of expenditure; and
  - the appropriate follow up of detected irregularities, including possible fraud, and the recovery of sums unduly paid.

Source: National Audit Office

Controls within the Commission

2.18 The Court examined the implementation of internal control standards with a direct link to the legality and regularity of underlying transactions at the four Directorates-General within the Commission responsible for Structural Funds. With the exception of the Directorate-General for Fisheries and Maritime Affairs, it concluded that the Directorates-General had implemented all, or virtually all, the basic requirements. The Directorate-General for Fisheries and Maritime Affairs had not complied with the baseline requirements for five of the eight standards tested, compared to three in 2003. The Director-General acknowledged the observations of the Court and reported that it had taken action to remedy the situation.

Controls within Member States

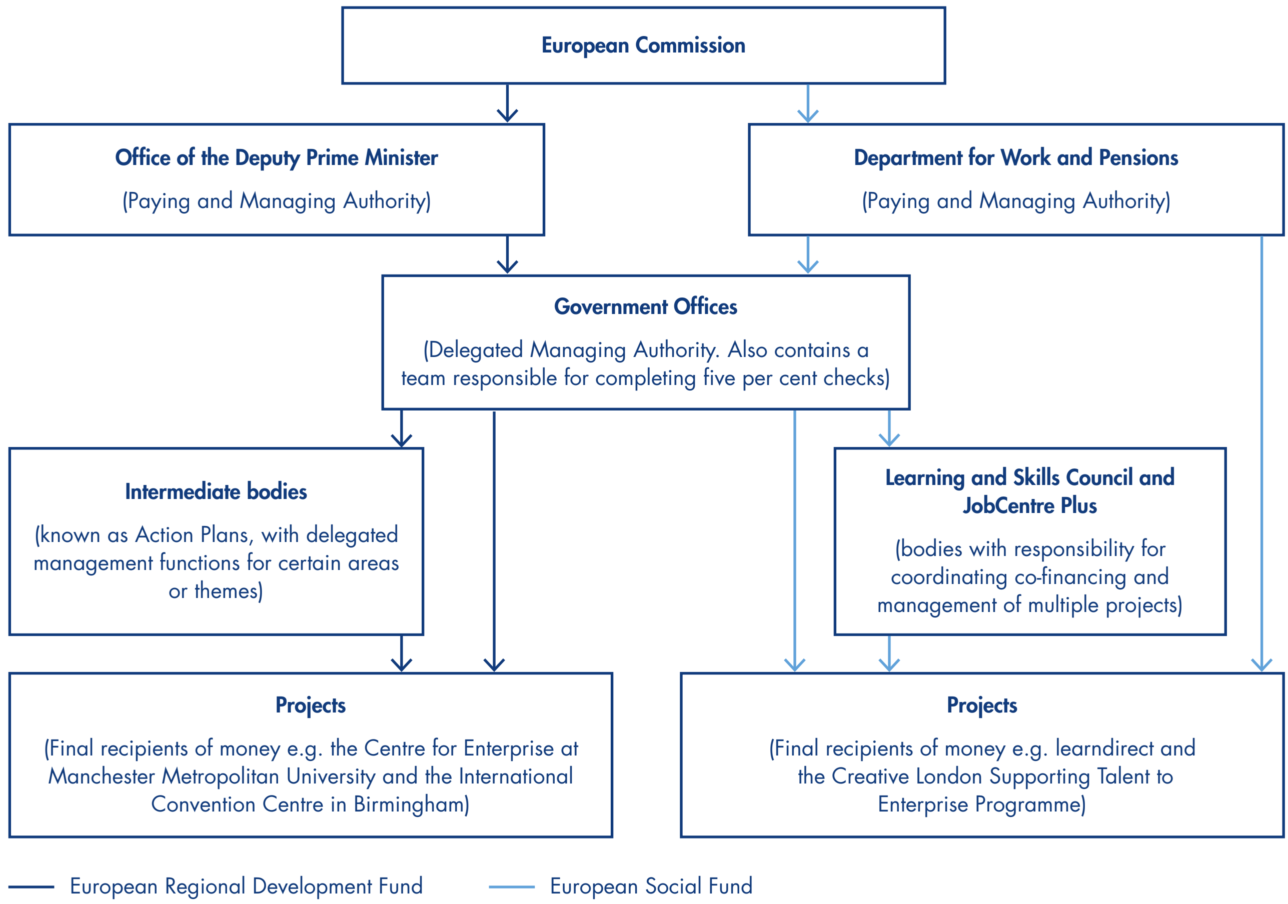
2.19 The Court examined the management and control systems of both the 1994-1999 and the 2000-2006 periods on the basis of a random sample of 15 Structural Fund programmes and one Cohesion Fund project. This sample of Structural Fund programmes was made up of seven programmes from the 1994-1999 period[21] and eight programmes from the current period, 2000-2006[22].

2.20 The Court's audit identified failures in management and control systems operated by Member States relating to both 1994-1999 and 2000-2006 periods. The problems identified included:

- in four of the sixteen programmes audited, the Court noted problems related to the definition, allocation and separation of functions;
- in nine of the sixteen programmes in its sample, the Court found the day-to-day management checks of operations were not working or contained shortcomings. The Court noted that if adequate checks were not performed there is an increased risk that expenditure that is not legal and regular will be declared to the Commission;
- in seven of the sixteen programmes examined, the Court noted in the absence of an adequate audit trail there was no straightforward basis for the certification of expenditure by the Member State.

21 Including the United Kingdom Objective 2 programme for Western Scotland.
22 Including the European Regional Development Fund Objective 2 programme in North-East England.

13 Management and control systems for Structural Measures in the United Kingdom



Source: National Audit Office

2.21 The Court examined 167 individual Structural Measures projects, under the programmes it selected for audit, and found wide-ranging errors regarding the legality and regularity of expenditure. The most frequently occurring issues were the declaration of ineligible items of expenditure, declaring expenditure twice, non-respect of the rules relating to State aid schemes and to public procurement, inadequate supporting documentation held at projects and failure to use a duly justified and equitable method for the allocation of overhead expenditure to projects.

2.22 In December 2004, a Working Group of the Contact Committee of Supreme Audit Institutions of the European Union Member States published *Report on the Parallel Audit of the Management and Control Systems for Assistance under Granted Funds*. The report was intended to help Member States in the development of their own management and control systems. The parallel audit concentrated on two requirements: the audit trail and the independent five per cent sample checks. The audit found that in most countries the execution and reporting of the independent sample checks complied with the governing regulation. Where this was not the case the Working Group stated that the relevant authorities had taken steps to ensure the required checks would be carried out. The Working Group concluded that there was a sufficient audit trail for most projects and that in most countries the execution and reporting of independent sample checks complied with the regulations. However, it expressed some concern that the legislative framework left room for ambiguous, or even contradictory, interpretations. The Working Group is currently carrying out a review of the processes in place within Member States for identifying, reporting and following up on irregularities; and will report to the Contact Committee in December 2006.

Performance in the United Kingdom in 2004

2.23 The Court examined two programmes in the United Kingdom: the European Regional Development Fund Objective 2 programme for North-East England (2000-2006 period) and the programme covering Western Scotland (1994-1999 period). The Court found some of the weaknesses outlined above. The results are summarised in **Figure 14**. The Court's work for 2004 suggested that improvements were needed in management checks carried out to verify the legality and regularity of expenditure and the assurance provided by expenditure certificates. In addition, the Court suggested that improvements needed to be made to provide an adequate audit trail.

2.24 Overall, both the Commission and the UK authorities considered that the administrative arrangements used for the UK programmes examined met the minimum requirements laid down for that period. However, they acknowledged some of the difficulties in managing these programmes.

2.25 Since the 1994-1999 programme, the United Kingdom authorities reported that they had widened the number, scope and depth of pre-payment checks and introduced post-payment checks on a sample of claims. The Office of the Deputy Prime Minister plans to issue further, more prescriptive guidance to the Managing Authorities and Paying Agencies, in particular recommending Managing Authorities make initial engagement visits to projects to ensure adequate controls are in place.

Closure of the 1994-1999 programmes

2.26 As mentioned at paragraph 1.2, expenditure on Structural Measures takes place in the context of programmes managed over a number of years and within an overall budget. Projects started in an earlier programme period may continue to receive their budgeted funding for up to two years if the project runs into the new programme period. At the end of each programme period, the Commission initiates the process of closing down the old programmes. This involves pre-closure audits to check compliance against regulations, checking the declarations made by the independent bodies accompanying final payment claims, and undertaking ex post audits of closed programmes. The Commission may apply financial corrections to recover ineligible payments from Member States.

14 Summary of the European Court of Auditors' findings on the operation of management and control systems for Structural Measures programmes it examined in the United Kingdom

The Court's conclusions

For **the European Regional Development Fund Objective 2 programme for North-East England in the 2000-2006 period**, the main weaknesses identified by the Court were:

- non-retention of expenditure records;
- no evidence of day-to-day management checks;
- no evidence of any checks performed by the Paying Authority.

For **the European Regional Development Fund Objective 2 programme for Western Scotland in the 1994-1999 period**, the main weaknesses identified by the Court were:

- the same reporting chain for the team responsible for the management and payment of Structural Funds assistance as the team responsible for carrying out independent checks;
- insufficient content and depth in the day-to-day management checks;
- certification of final expenditure despite a number of errors; and
- unsatisfactory risk analysis for the selection of projects for independent checking.

The United Kingdom's response

The United Kingdom authorities disagreed with some of the specific criticisms of the Western Scotland programme. While, for example, the normal functions of the Managing and Paying Authority have the same reporting line, the UK authorities believed that processes and procedures were sufficient to ensure full and proper separation of both functions.

Officials at the Commission and in the relevant UK government departments cited high turnover of staff, greater use of outsourcing and the nature of the projects – smaller, more skills-based as opposed to the larger infrastructure projects pursued in many other countries – as factors contributing to weaknesses identified in the United Kingdom. Departmental officials in the United Kingdom also acknowledged that project staff had not placed sufficient priority on carrying out day-to-day management checks.

Source: National Audit Office summary of the European Court of Auditors' conclusion

2.27 The Court observed last year that the variable quality of the closure documentation submitted by the Member States contributed to slow progress in closing the 1994-1999 programmes. In 2004, the delays persisted. **Figure 15** summarises the progress made in closing the 1994-1999 programmes. The Court reported that these delays were partly because Member States had been slow to respond to enquiries from the Commission but also because the Commission had failed to take timely action in a number of cases. The Court noted long delays (over eight months in some cases) by the Commission in reporting the results of its closure audits to the Member States. Such delays increase the time required by the Commission to make appropriate financial corrections and divert administrative resources away from current programmes. The Court urged that lessons be learned from the closure of the 1994-1999 programmes for the 2000-2006 period and beyond.

2.28 The Office of the Deputy Prime Minister and the Department for Work and Pensions recognised that there had been delays in closing the 1994-1999 programmes. This was due, in their view, at least partly, to the need to divert resources to the operation of the 2000-2006 programmes and additional requirements by the Commission for more information than that contained in the Regulations. The Department for Work and Pensions told us it had concerns about the quality of the Commission's guidance, and the speed with which the Commission responded to information requests and carried out its audits contributed to the delays in closure. The United Kingdom has established a Working Group, comprising officials from the relevant agencies, to assess and resolve problems as quickly as possible in respect of the 1994-1999 programmes. The Group is also developing procedures to aid closure of the 2000-2006 programmes in a more timely manner.

iii) Combating irregularities, including possible fraud

OLAF - the Commission's anti fraud body

2.29 The European Anti Fraud Office (known by its French acronym, OLAF – Office Européen de Lutte Anti Fraude) was established in June 1999 following the resignation of the Santer Commission. OLAF is administratively part of the Commission whilst retaining investigative autonomy. OLAF's mission is to protect the financial interests of the European Union, to fight fraud, corruption and any other irregular activity, including misconduct within European institutions.

2.30 To fulfil its mission, OLAF conducts internal investigations (within the Commission and/or other institutions in the European Union) and external investigations (in Member States). OLAF's Director-General is responsible for its investigative functions – both internal and external. To guarantee his independence, he does not have to take instructions from any government or institution, including the Commission. He can, where he considers that the Commission has taken action that challenges OLAF's independence, bring a case against the Commission before the European Court of Justice. OLAF's work is overseen by a Supervisory Committee, consisting of five individuals who are independent of European Institutions.

2.31 OLAF's investigations have three stages, described in **Figure 16 overleaf**.

15 Summary of the European Commission's progress in closing the 1994-99 programmes

Budgetary Area	Overall number of programmes	Closed before 2004	Closed at 31 December 2004	Closed at 31 March 2005	Programmes still outstanding
European Regional Development Fund (ERDF)	944	294	611	661	283
European Social Fund (ESF)	786	187	522	541	245
European Agricultural Guidance and Guarantee Fund – Guidance section (EAGGF)	388	93	230	232	156
Financial Instrument for Fisheries Guidance (FIFG)	52	8	11	17	35

Source: National Audit Office summary of the European Court of Auditors' report for the 2004 financial year

Irregularities reported in 2004

2.32 In 2004, the 15 Member States that formed the European Union up to 30 April 2004 notified the Commission of a total of 9,400 irregularities, including possible fraud, with a value of €978 million (£663 million). **Figure 17** shows the overall figures by area of the budget.

2.33 Figure 17 shows an overall increase of 12 per cent in the number of cases of irregularities, including possible fraud, reported to the Commission by the 15 Member States that formed the European Union in 2003. While the number reported under Traditional Own Resources and the Common Agricultural Policy showed a slight increase (one and five per cent respectively), their value decreased considerably. However, the number of cases of irregularities reported for Structural Measures increased by a third, and their value increased by over 40 per cent, in part due to Italy and Greece reporting an increased number of irregularities, including possible fraud, and in part because of the closure of the 1994-1999 programmes. In addition, the Commission has reinforced checks on the procedures to report irregularities.

2.34 Since 2000, the number of reported cases of irregularity, including possible fraud, has increased by 39 per cent from 6,723 to 9,400. The value of cases over the same period has decreased by 11 per cent from €1,099 million (£745 million) to €978 million (£663 million).

2.35 The ten new Member States that joined the European Union in 1 May 2004 reported to OLAF, for the eight month period to 31 December 2004, 75 cases of irregularities (including possible fraud) with a value of €5 million (£3 million). In its annual report *Protection of the financial interests of the Communities – fight against fraud – Commission's annual report* – the Commission reported that the ten accession states were well prepared to take on full responsibilities for implementing funds from the European Union correctly.

2.36 It also reported on the steps it had taken to reduce the length of preliminary assessments and investigations. In 1998, the average length of investigations was 29 months. In 2004, this had fallen to 22 months.

16 The three stages of an investigation by OLAF

Assessment Stage
This leads to the production of a summary report proposing, if there is sufficient substance to the allegations, that an investigation is launched. The assessment report is considered by the Executive Board of OLAF.

Investigative Stage
At this stage, a case is prepared, and evidence is gathered both for and against the allegation. A draft report is submitted to the Executive Board to assess whether the file should be forwarded to the courts or disciplinary authorities, whether action should be initiated to recover the sums involved, or whether the case should be abandoned.

A follow up stage
This stage is dedicated to the follow-up of cases transmitted to judicial authorities and cases requiring the recovery of funds.

Source: National Audit Office

17 Cases of irregularity, including possible fraud, notified to OLAF by Member States in 2003 and 2004

Area of the budget	2003		2004		Percentage change	
	Number of cases	Amounts involved € million	Number of cases	Amounts involved € million	Number of cases	Amounts involved
Traditional Own Resources	2,659	276	2,684	202	+1%	-27%
Common Agricultural Policy expenditure	3,237	170	3,396	82	+5%	-52%
Structural Measures expenditure	2,487	482	3,320	694	+33%	+44%
Total	**8,383**	**928**	**9,400**	**978**	**+12%**	**+5%**

Source: Data from OLAF's Protection of the European Communities' financial interests and the fight against fraud annual report, 2004

NOTE
Traditional Own Resources are explained in Figure 3.

Estimating the level of fraud

2.37 In last year's report[23], we reported that it was difficult to provide a precise breakdown between irregularities and fraud. We noted that OLAF's statistics are dependent on the quality of information supplied by Member States and that reporting between Member States was not consistent. OLAF was taking steps to estimate levels of fraud in individual sectors of the budget and had committed to developing a methodology to distinguish between fraud and irregularity.

2.38 In its report for 2004, OLAF assessed the effect of fraud on the Community budget based on estimates provided by Member States and its own analyses. OLAF estimated that, for agriculture, suspected fraud amounted to some €11 million (£7 million) and for Structural Measures to some €118 million (£80 million). During 2004, therefore, the estimated value of reported fraud in these areas was at least €129 million (£87 million). In reporting these figures, OLAF noted that it was difficult to attribute specific fraud levels to specific years when projects are spread over several years.

Responsibility for reporting irregularity and fraud in the United Kingdom

2.39 Responsibility for reporting irregularities in the United Kingdom is shared between the Department for Trade and Industry for Structural Measures and the Rural Payments Agency for CAP. Each quarter, the Department for Trade and Industry and the Rural Payments Agency send to OLAF reports detailing the number and value of the irregularities detected, what follow-up action they have taken, and whether the case has been resolved. For the fourth quarter of each year, the Department of Trade and Industry and the Rural Payments Agency must also produce an annual report listing any money that has been recovered from the previous year and explaining what has been done with the money that has been recovered.

2.40 During 2004, the United Kingdom reported 841 cases of irregularities (including possible fraud) to OLAF, a decrease of nine per cent compared to 2003. These cases represented some €48 million (£33 million), a drop of six per cent compared to 2003. There is no separate figure available for the level of possible fraud.

23 *Financial Management of the European Union* (HC 289, Session 2004-05).
24 Special Report 1/2005.

The European Court of Auditors examination of OLAF's work

2.41 In August 2005, the Court published its Special Report *Concerning the management of the European Anti Fraud Office* (OLAF)[24]. The Court assessed how OLAF had discharged its investigative duties and the contribution made by each of OLAF's departments to the investigative function. The Court's conclusions are shown in **Figure 18**. In arriving at its conclusions, the Court noted that, at the time it conducted its fieldwork, OLAF was 'clearing the burden …inherited from its predecessor, UCLAF'. The Court also noted that OLAF's re-organisation in 2002-03 was just starting to have an impact on performance.

2.42 In response, the Commission stated that the Court's conclusions on the management of case files did not take account of the progress made since the Court carried out its work. The Commission also commented that OLAF now devotes greater attention to planning its investigative activities.

18 The European Court of Auditors' conclusions on its investigation of OLAF

The Court concluded that:

- a change in OLAF's status is not justified as its current status does not impact on its independence;
- attachment to the Commission has enabled it to benefit from extended administrative and logistical support, and from the same regulatory anti-fraud provisions as Commission departments;
- resources allow it to follow up all the allegations that it receives;
- introduction of a computerised file management system has enabled operations to be recorded more easily and has clarified responsibilities but that the low level of management supervision resulted in long processing times and inconclusive reports (the most common weakness identified by the Court was a failure to quantify the level of fraud);
- preparation and follow-up of investigations was frequently rudimentary and, part from in the customs sector, still calls for improvements in both areas that are managed indirectly and where management is shared with Member States as the objectives pursued by investigators were vague;
- management information focuses more on the volume of reports than on results; and
- the role of OLAF's Supervisory Committee should be re-examined in order to avoid the risk of interference in on-going investigations.

Source: The European Court of Auditors' report Concerning the management of the European Anti Fraud Office (OLAF)

PART THREE

Developments in financial management and accountability

3.1 This Part of the report examines

i) the development of the 'roadmap' to an integrated internal control framework during the United Kingdom's Presidency;

ii) the changes being made to Common Agricultural Policy and Structural Measures; and

iii) progress with introducing a new accruals accounting system.

i) The development of the roadmap during the United Kingdom's Presidency

3.2 In its report, *Financial Management of the European Union*[25], the Committee of Public Accounts urged the United Kingdom Government to utilise the occasion of its Presidency (July to December 2005) to improve accountability for the use of European Union funds. It urged the Government to press for the simplification of the rules and regulations of the Common Agricultural Policy and the Structural Funds. It also urged that there should be particular emphasis on identifying why the Court has not provided a positive Statement of Assurance on the legality and regularity of the underlying transactions; identifying action needed to address these gaps; and examining the prospects for national authorities entering into "Contracts of Confidence"[26] and the likely value of such contracts for accountability.

3.3 Since the Committee's Report, there have been a number of developments:

- In June 2005, during Luxembourg's Presidency of the European Union, the Commission published A Roadmap to an Integrated Internal Control Framework, setting out its proposals for strengthening financial management and obtaining a positive Statement of Assurance. The roadmap was supported by an analysis of the gap between the current system of internal controls and that proposed by the Court.
- In September 2005, a panel of experts from all Member States met in Brussels to examine the issues raised by the Commission's roadmap. The Panel comprised officials from finance ministries, supreme audit institutions and the Commission.
- In November 2005, ECOFIN[27] published its conclusions on the Commission's roadmap.

25 Eighteenth Report of Session 2004-05 (HC 498).

26 "Contracts of Confidence" would be between the Commission and Member States. They relate to Structural Measures only and are voluntary. The Member State would establish a strategy for the audit of the funds. The Commission would assess this strategy before it is implemented and then review annual reports from the Member States on the outcome of the audit. In return, the Commission would reduce the number of its own audits carried out on programmes to which the contract applied. The idea is to reduce the overall burden of audit on Member States.

27 A committee of the Council of Ministers comprising the Finance Ministers from each Member State.

3.4 This process culminated in the Commission publishing its *Action Plan towards an Integrated Internal Control Framework* in January 2006. The Plan identifies four themes for action and a number of action points within each theme (Appendix 3).

- Simplification of the management of European Community funds and establishing common control principles – The Commission regard this as a key issue. The Commission plans to keep simplification of the regulatory framework under consideration during the negotiations on all the legislation for 2007-2013. We consider issue this in more detail in relation to the Common Agricultural Policy and Structural Measures in the next section.
- Strengthening management declarations and audit assurance – The Commission had originally proposed the introduction of ex ante and ex post declarations from Member States on how European funds had been spent, signed off by the Finance Minister. ECOFIN however did not accept the usefulness of national declarations. The Commission now proposes to ensure that existing declarations, and those to be included in forthcoming legislation, provide the maximum benefit in terms of assurance. The Commission would ask Member States to designate a national coordinating body per policy area to provide an overview of the assurance available in respect of Community funds under shared and indirect management in their member state. The Commission would also invite national Parliaments to ask their supreme audit institutions for audit and assurance on European Union funding at their level.
- Developing a single audit approach and determining the costs and benefits of controls – The Commission urges Member States to cooperate actively with the relevant parts of the Commission in deciding on their own audit strategies and sharing results. It also asks Member States to provide it with information by February 2007 on the cost of implementing controls over European Union expenditure. The Commission plans to launch its own pilot study to examine the benefits derived from different control strategies.
- Addressing known weaknesses in specific programmes. As part of its Roadmap of June 2005, the Commission published its analysis of the gaps in the current control frameworks governing the various programmes. The Commission's Action Plan seeks to address the gaps in the different sectors. By the end of 2006, the Commission plans to examine the present implementation of controls on the Structural Funds at sector and regional level, covering sample checks, paying authorities and winding-up bodies as well as the value of existing statements and declarations. The Commission also plans to strengthen existing guidance to enable beneficiaries and intermediaries to adopt a targeted approach to reducing error in the underlying transactions. The Commission asked Member States to implement for the Structural Funds the "Contracts of Confidence" to provide assurance for the current period, and also lay the groundwork for the next programming period.

Each of the action points set out in the plan is accompanied by a deadline date. More details on the development of the roadmap during the United Kingdom's Presidency can be found in Appendix 3.

ii) Efforts to simplify the Common Agricultural Policy and Structural Measures

3.5 In its report of April 2005, the Committee of Public Accounts recommended that the United Kingdom's Government top priority in seeking to strengthen the management of European Union funds should be the simplification of the rules governing the Common Agricultural Policy and the Structural Funds. It suggested that the level of errors identified by the Court each year was partly due to the complexity of programmes. It suggested that the European Institutions, in designing schemes and programmes, should consider the relationship between desired outcomes of a particular scheme, the complexity of the rules governing it and the consequential likelihood of errors occurring.

3.6 The Government, in response to the Committee's report, stated that the greater simplification of the rules and regulations governing the Common Agricultural Policy and Structural Measures was a key objective. The following sections review recent progress.

Common Agricultural Policy – introduction of the Single Farm Payment

3.7 In June 2003, two years before the Commission's publication of the Roadmap, the European Union agreed a package of reforms of the Common Agricultural Policy. A Single Farm Payment was established, largely replacing many of the existing direct subsidy schemes. The reform's rationale was to break the link between farm subsidies and production with the intention of removing incentives for over-production. Member States have flexibility when applying the Scheme. Links to farming activities can be maintained to avoid the abandonment of production. The Single Farm Payment is intended to allow farmers to produce to reflect market demand; promote environmentally and economically sustainable farming; simplify the Common Agricultural Policy for both farmers and administrators; and strengthen the European Union's position at World Trade Organisation negotiations.

3.8 In order to receive a payment under the Single Farm Payment, farmers have to maintain their land in good agricultural and environmental condition, judged against 18 compliance standards covering the environment, animal and plant health, and animal welfare. The Single Farm Payment is therefore focused on agri environment support and rural development.

3.9 In November 2005, the Court published its Special Report *concerning rural development: verification of agri-environment expenditure*[28]. The Court assessed whether the Commission had adequate assurance that the farming practices and techniques for which agri-environmental support is paid were verifiable and properly verified. The Court concluded that verification posed particular problems and was particularly resource intensive and technically demanding. For example, specialist expertise will be needed to assess whether the correct type of fertilizer had been used; it was not therefore possible to obtain reasonable assurance at a reasonable cost. It recommended that the European Parliament, Council and Commission should consider the Commission's own principle that 'if a measure cannot be adequately checked, it should not be subject to public payment'[29]. Payments under rural development are not covered by IACS.

3.10 The Commission agreed with the Court's conclusion that control over agri environmental measures was labour intensive and therefore costly due to the complexity of the measures. The Commission considered, however, that these costs were 'an acceptable price to pay for this policy'.

Structural Measures

3.11 As described at paragraph 2.20, the Court identified the complexity of the Structural Measures programmes as potentially increasing the risk of payment error. This complexity includes the variety of bodies and authorities which are involved in the management process; the large number of programmes which may contain several thousand projects, implemented over a period of years; and the large number of conditions, often unclear, governing the eligibility of expenditure.

3.12 In 2005, the Commission published proposals for a new Structural Funds Regulation to cover the programming period, 2007-2013[30]. The introduction of a new Regulation provides the opportunity for further improvements to the legislative framework governing the Structural Measures. The two major elements of change proposed for the 2007-2013 period are:

- a compliance assessment of the management and control systems of each Member State, carried out by the Supreme Audit Institution or other suitable body; and
- the introduction of an audit opinion on the management and control systems at the beginning of the period and then every year instead of at the end of the programming period.

3.13 The Regulation also focuses on the need for increased harmonisation[31] across Member States of auditing standards, such as methodologies and confidence and materiality levels. The Commission will emphasise to Member States the importance of applying these auditing standards as soon as possible, preferably before the start of the new period.

28 Special Report 3/2005 (2005/C 279/01).
29 The Commission arrived at this conclusion following two evaluations of the agri-environment programme between 1993 and 1999.
30 This needs to be agreed by the Council and the Parliament.
31 The need for greater harmonisation was identified in the Commission's gap analysis.

3.14 The Commission is proposing a Council Regulation is intended to raise the level of reporting which Member States have to make to the Commission, allowing for greater flexibility at national level. In addition, eligibility conditions for objectives 1 and 2 will be streamlined. However, the Commission also states that a certain number of eligibility criteria are necessary to ensure that EU money is being correctly spent and that it is difficult to find the correct level of general rules when dealing with expenditure over 25 Member States for a variety of different projects involving a range of bodies.

iii) The introduction of accruals accounting

3.15 In the Comptroller and Auditor General's last report on financial management of the European Union[32], he outlined the details of the Commission's Action Plan to modernise its accounting system to enable its accounts to be produced on an accruals, rather than a cash, basis[33]. The first set of accounts to be produced on this basis will be for 2005. The Commission expects the introduction of a new accruals accounting system to address a number of weaknesses highlighted in previous reports from the Court. The Action Plan has two strands: the adoption of a new accounting framework and the development of information systems required to implement it.

3.16 The Court, as part of its audit of the 2004 accounts, considered the modernisation of the accounting system of fundamental importance and therefore began an audit of the different phases of the project's implementation. The first phase of the Court's work focused on verification that the new accounting rules and guidelines were compatible with the Financial Regulation and international standards and a high level assessment by the Accounting Officer of the financial management systems of certain Directorates-General to ensure that they are capable of providing the central system with data which complies with the new accounting rules.

3.17 The Court reported that during 2004 the Commission had made significant progress towards introducing the accruals system by 2005. But, as in previous Annual Reports, the Court referred to the timetable to carry out the necessary preparatory work as very ambitious. The Commission responded that the project had met its target date of January 2005 for the new system to be in place. The Court also noted that the opening balance for 2005 had not been issued by mid-2005 and that at that point definitive balances were not available. The Court concluded that further progress needed to be made and that the shortcomings identified by the Court could affect the reliability of the 2005 financial statements. The Commission reported that the project had largely met the objectives set for the first eight months of 2005. The Commission also stated that it had every intention of taking the actions necessary to ensure completion of the work by 31 March 2006, in the line with the project's timetable.

32 HC 289, Session 2004-05.
33 COM (2002) 755, 17 December 2002.

APPENDIX 1

Response to the Committee of Public Accounts' report Financial Management in the European Union

Recommendations of PAC	Government Response
1 Historically, accountability and audit arrangements of the European Union have been characterised by inertia among the Institutions. Since the Committee's last visit, the Commission has started to implement a program of reform and there is movement to more accountable and transparent ways of working. The Commission is committed to change but there is still a long way to go to secure the standards that the European taxpayers are entitled to expect.	The Government agrees that the institutions of the EU have moved in the direction of a culture of accountability following the implementation of the reforms championed by Neil Kinnock. The major change agent was the introduction of the revised Financial Regulation, which came into force in January 2002 and the UK helped influence considerably. This regulation defined responsibilities, made officials accountable for expenditure, introduced more stringent audit provisions, and required all expenditure to be subject to objective setting and evaluation. These reforms are critical to the achievement of the standards of financial management that the European taxpayers are entitled to expect, but the Committee is right to state that there is still a long way to go before these reforms can bed down and we can visibly see the effects of a culture of accountability throughout the institutions of the EU.
2 The size of the European Union overall budget and the United Kingdom's contribution to it emphasises the need for strong financial management and frameworks of accountability. For the tenth year in succession the Court qualified its opinion on the reliability of the Community annual accounts and did not provide a positive opinion on the main five out of the six payment headings. The lack of a positive Statement of Assurance undermines public confidence in European Institutions.	The Government agrees with the Committee's conclusion
3 Despite the continued qualification of the Community accounts, the Commission has made some progress in improving financial management. The Court identified improvements in the quality of the annual reports intended to enhance the accountability of each Directorate-General and it noted that the Commission had made good progress in designing internal control systems. The introduction of a new accruals accounting system, with supporting IT, is another welcome development especially as the qualification on the reliability of the accounts was attributable largely to weaknesses in the previous accounting systems. The Commission has also established an Internal Audit Service which reports to an independent audit committee with six members, two of which are external appointments.	The Commission is still on a learning curve with regard to the Directorate-Generals' Annual Activity Reports, but we agree that improvements have been made. There is still some progress needed on internal control systems, but it is encouraging to note that the Court's assessment of these in its 2003 report indicated that it was satisfied with the introduction of internal control systems in the two Directorate-Generals responsible for more than 80% of the total budget – DG Agriculture and DG Regional Policy. The Government is also pleased to note that the Commission's new accruals accounting system was introduced successfully in January 2005. The Commission now has a full accruals accounting system, ahead of many Member States, and it has achieved this within the planned timetable and budget. The proof of the pudding will of course be whether the new system results in a clean bill of health for the accounts side of the Statement of Assurance in the Court of Auditors' report on the 2005 budget.

Recommendations of PAC *(continued)*

4 It is difficult to obtain a clear indication of the extent of the problems relating to the legality and regularity of European Union expenditure. It would be helpful if the Court's annual report could indicate more clearly its assessment of the legality and regularity of each area of the budget. In addition, the report could usefully give an indication of how much progress or otherwise the Commission is making both generally and under each of the six expenditure headings and it could also point to developments within Member States. Such enhancements could assist the Commission and the Member States in making the necessary improvements to move forwards to an unqualified opinion on the accounts. In the meantime, the Court could consider the scope for producing a separate Statement of Assurance for each expenditure heading and for each Member State.

Government Response *(continued)*

The Committee has identified one of the major problems of the current method of assessing the Statement of Assurance. It is not possible to compare and contrast the quality of financial management between budget sectors; nor is it possible to measure whether there has been any improvement or progress from year to year. However, the Government would urge caution in response to the Committee's comment (in paragraph 5 of the main report) that the Court should publish error rates. In the past, the Court used to publish a global error rate for the whole budget (the last occasion being 5.4 per cent for the 1996 budget), but it discontinued this practise as:

- any figure quoted was inevitably misinterpreted as relating to fraud rather than error;
- no account was taken of amounts which were later recovered (and indeed the Commission tended to interpret it as a target for recovery); and;
- it could not be (although was) compared from year to year as it was derived from a randomly-generated sample.

If error rates were to be published by budget sector and/or Member State, there would need to be some changes to the system to ensure that the problems described above were not repeated. The Court is already, under Article 248(1) of the Treaty on European Union, able to produce specific assessments for each major area of Community activity. This amendment was added under the Nice Treaty. There is no obvious scope in the Treaty at present for the Court to give a Statement of Assurance for Member States. However, legal advice suggests that the Nice amendment may be sufficiently wide-ranging to allow the Court to extend its assessment for the Statement of Assurance to include an opinion on Member States' supervisory systems and controls; indeed the last Statement of Assurance (for 2003) does touch superficially on Member States' systems.

5 A major factor contributing to the qualified audit opinion is the level of errors identified by the Court. This is partly due to the complexity of the schemes and programmes, particularly for payments under the Common Agricultural Policy and Structural Measures. In designing schemes and programmes, the European Institutions should consider the relationship between desired outcomes of a particular scheme, the complexity of the rules governing it and the consequential likelihood of an error occurring. There is also a lack of common understanding between the Commission and the Court about the definition of error. This should be resolved.

Achieving greater simplification in the Structural Funds Regulations has been one of the Government's main objectives in the negotiations on the Regulations for the next programming period (see also the response to Recommendation 11). However, while we have continually emphasised our concern to ensure there are proper safeguards against fraud, our main objective has been to achieve greater simplification with a view to reducing administration burdens of managing and delivering the Funds, and to improve the efficiency and effectiveness of spending.

Although it is clear that there are still difficulties in practice, a standard definition of irregularity does exist in Regulation 2988/95, which has been agreed by all Member States. The same applies to the definition of fraud, which appears in the Convention on the Protection of the Financial Interests of the European Communities (usually known as the "Fraud Convention"), which has been ratified by all Member States. Errors detected by the Court's annual audit are of two kinds: substantive (quantifiable errors directly affecting the amount of the transactions underlying the Community funds disbursed) and formal (errors without any directly quantifiable effect on the amounts of the transactions underlying the Community funds disbursed). The Government would welcome some refinement of this process, such as the introduction of a de minimis amount – for example, some errors in the agriculture sector are extremely small (less than 100 euros) and it may not always be economically sound to put in place the usual recovery procedures or fines. Expenditure in most irregularities or substantive errors is of course usually recovered at a later date, although this process may take considerable time.

Recommendations of PAC *(continued)*	Government Response *(continued)*
6 **The Barroso Commission has committed, as one of its objectives for the next five years, to move towards a positive Statement of Assurance in order to enhance accountability**. The European Institutions, led by the Commission and supported by the Member States, have agreed on the need for a road map intended to achieve this objective. The road map will be built on the principles of the Community Internal Control Framework recommended by the Court. Under the road map, the Commission would be responsible for promoting improvements in internal controls in partnership with Member States.	The Government welcomes the Commission's action to produce the "roadmap" and intends to work with the Commission, the European Parliament and the Court of Auditors, to take this forward actively during the UK Presidency of the Council later this year.
7 **The commitment by all parties concerned to progress towards a positive Statement of Assurance is welcome, but the scale of the task ahead is formidable**. The European Union's budget covers six expenditure headings and is spent by 25 Member States as well as third countries and the Institutions. Some of the Member states have federal structures and autonomous regions. With this variety of transactions and the number of bodies and systems which manage and control them it is far from clear how quickly this worthy ambition can be achieved.	The Committee is right to be cautious and it is clear that progress towards a positive Statement of Assurance, especially for those budget sectors where management is shared with Member States, will not be swift. The first step will be to gain agreement on a method and a timetable for taking forward the Commission's "roadmap". This will be a priority of the UK Presidency.
8 **There is scope for more value for money work and reporting by the Court**. The Court has a duty to examine "whether the financial management has been sound", corresponding broadly to audits of economy, efficiency and effectiveness by the Comptroller and Auditor General in the United Kingdom. The results of the Court's work in this area are included in its Annual Report and in Special Reports. But the scale of this is totally inadequate given the importance of ensuring the effective use of Community funds.	The Committee is right to identify this point. The Court does carry out some "value for money" work in its Special Reports, which the Government considers are useful pieces of work which can and do lead to substantial improvements in policies, processes and administration. There is little evidence of this effect in the annual "Statement of Assurance audit". In the past this relied entirely on an audit carried out on the basis of random transaction testing, which was inevitably going to detect problems. Recently the Court has expanded its method to include four "pillars": ■ Examination of control systems (e.g. the Integrated Administrative Control System in agriculture). ■ Analysis of the Commission Directorates-General annual activity reports (which include declarations of assurance). ■ Examination of the work of other auditors outside the normal control processes (e.g. independent auditors, or Member States' national audit offices). ■ Random transaction testing as before. However, there is as yet little evidence in the Court's annual report of results which would measure progress or pinpoint areas for improvement, with recommendations. Expanding the "systems" pillar would go some way to improve this.
9 **No independent review of the Court's work has taken place since it was set up in 1977**. Unlike the United Kingdom National Audit Office, the Court does not report on its own performance to anyone. The Court should therefore consider arranging a peer review of its approach and work to test the quality and relevance of what it does and demonstrate its willingness to learn from others.	The Government agrees that there would be benefits in carrying out a review or in introducing systems for ongoing external review. Processes of ongoing review and feedback similar to those recently agreed for our own National Audit Office could be considered for the Court of Auditors.

Recommendations of PAC *(continued)*	Government Response *(continued)*
10 The precise level of fraud against European funds is unclear at present. Differentiating between fraud and irregularity is complex. For example, Member States are required to report irregularities, including fraud, to the Office Européen de Lutte Anti Fraude (OLAF), the European anti-fraud office, but they do not do so on a consistent basis. OLAF's current work on a methodology to distinguish between irregularity and intentional fraud is clearly a priority.	It is unacceptable that the Commission cannot identify the likely level of fraud and the Government has pressed for some time for this work to be carried out. Without a reliable estimate, backed up by data, there is no effective riposte to misleading statements in the media. OLAF now has the resources and the expertise to analyse reported irregularities and identify cases of suspected fraud. We understand that OLAF now intends to publish an estimate of fraud in the Autumn and we welcome this. The Government has always supported OLAF's work to improve the reporting of irregularities by Member States. In the United Kingdom we take this very seriously, and the Government Departments responsible liaise closely with OLAF and HM Treasury to ensure that the requirements are met. We have also played our part in passing on our experience to the new Member States e.g. through a twinning project with Malta.
11 The United Kingdom Government should utilise the occasion of the United Kingdom Presidency to improve accountability in the European Union. Specifically, it should: ■ As a top priority, press for the simplification of the rules and regulations of the Common Agricultural Policy and Structural Funds to reduce the scope for fraud and error so as to increase the prospects of achieving a positive Statement of Assurance; ■ Support, and encourage other Member States to support, the development of the road map for a positive Statement of Assurance. In particular, attention should be focused on ■ identifying the reasons the Court is unable to provide a positive Statement of Assurance on the legality and regularity of the underlying transactions; ■ the action the Commission and National Authorities need to take in each of the areas which are a cause for concern, with a specific focus on the major areas of European Union spending, support for agriculture through the Common Agriculture Policy and the Structural Measures; and ■ the prospects of National Authorities entering into 'Contracts of Confidence' and the likely value of such contracts for accountability; ■ encourage, with other Member States and the Commission, an increased focus on value for money work in the Court given the importance of ensuring the effective use of Community funds; and	The Government fully intends to make these issues a priority during the UK Presidency. Simplification of the rules and regulations covering the Common Agriculture Policy and the Structural Funds remain a key objective. On the Common Agricultural Policy, Better Regulation is a headline priority for the UK Government during its Presidency of the EU, and a top priority for the Department for Environment, Food and Rural Affairs. Along with the improved use of impact assessments in policy making, simplification of existing legislation is a key part of this work. The main opportunities for simplification of the Common Agricultural Policy during the UK's Presidency will be: ■ to make progress on the agricultural priorities for simplification discussed by the CAP simplification Horizontal Issues Working Group in December 2004; and ■ to prioritise progress on the expected Commission Communication on Simplification in the agricultural sector, due in October 2005. Achieving greater simplification in the Structural Funds regulations has been one of the Government's main objectives in the negotiations on the next programming period (2007-2013). However, whilst we have continually emphasised our concern to ensure that there are proper safeguards against fraud in place, our main objective has been to achieve a greater simplification with a view to reducing administrative burdens of managing and delivering the funds, and to improve the efficiency and effectiveness of Structural and Cohesion Fund spending. Our concern for greater simplification in the Regulations which govern the Structural and Cohesion Funds covers the financial and audit controls, as well as the reporting and evaluation requirements. In particular, we have opposed the Commission's complex and bureaucratic proposals for performance reserves, on the basis that they would increase administrative costs without rewarding the most successful programmes. We have also sought a reduction in the requirements for the content of Operational Programmes.

Recommendations of PAC *(continued)*	Government Response *(continued)*
11 ***(continued)*** ■ support OLAF's efforts to obtain a clearer picture of the scale of irregularity, including fraud, by encouraging Member States to: i) fulfil their obligation to protect Community Funds as they protect National Funds; ii) deter crime against European interests by identifying those responsible and applying effective penalties and sanctions; ■ setting a good example to the other Member States by complying with OLAF's guideline for reporting irregularities; and ■ encouraging a programme of secondments to OLAF from a wide range of United Kingdom institutions, including the police force.	As already stated, taking forward the Commission's "roadmap" will be a top priority during the UK presidency. The major aim will be to obtain agreement with Member States, the Court of Auditors and the European Parliament, on a timetable and method for taking this forward. On the subject of the "contract of confidence", this has already been introduced as an option in the Structural Funds. It requires those bodies responsible for the management of the Structural Funds to obtain Commission approval of their management systems; to submit an audit strategy covering the whole of the current programming period; and to report annually on the implementation of that strategy. The intention is that this will go some way towards providing an annual assurance on the financial management of the funds and avoid the problems experienced at the end of the previous programming period. No Member State has yet signed up to this, but we are hopeful that in the UK, the National Assembly for Wales and the Office of the Deputy Prime Minister (which is responsible through the Government Office Audit Team for the audit of Structural Funds in England) will be in a position to sign up later this year. Although the "contract in confidence" is currently optional, the Commission has added its requirements to the draft financial control regulations for the next programming period (2007-2013). If this is agreed, this will apply to all Member States in future. There is clearly scope to extend this concept to other budget sectors, especially agriculture, but we are not aware of any proposals. The Government agrees that the Court should increase its focus on "value for money" work. It could achieve this by placing more emphasis on the "systems" pillar of the Statement of Assurance. Member States already have a legal requirement, under Article 280 of the Treaty, to "take the same measures to counter fraud affecting the financial interests of the Community as they take to counter fraud affecting their own financial interests". The United Kingdom takes the detection of fraud affecting the Community budget extremely seriously, and works hard to detect crime and apply effective penalties and sanctions. As already stated, we also take the reporting of irregularities seriously and we are happy to help OLAF's work in analysing fraud by identifying those cases where fraud is suspected. On the possibility of arranging a programme of secondments to OLAF, HM Revenue and Customs, which is the largest law enforcement authority in the UK and is experienced in dealing with EU fraud, currently has 8 officers on secondment to OLAF. Secondments are normally between 2-4 years. Secondments are always made following a request from OLAF, and a successful candidate will need to have the level of expertise and experience that OLAF is looking for. In addition, the Serious Fraud Office has sent staff on secondment to OLAF (although they have none there at present). The Serious Fraud Office is also engaging with OLAF on a course of mutual training, starting with two sessions by each organisation but hopefully leading to more in depth training both ways. They have had several meetings with OLAF about the UK's systems and approaches to fraud, which they have been interested in pursuing. We are aware that some Member States have seconded police officers to OLAF but these are normally national fiscal police or similar, and we have no equivalent national force in the UK. However, the UK is keen to help OLAF gain the expertise it needs in investigations by sending staff on secondment where appropriate.

APPENDIX 2

Special Reports published by the European Court of Auditors

Special Report 1/2005	The management of the European Anti-Fraud Office OLAF
Special Report 2/2005	EDF budget aid to ACP countries: the Commission's management of the public finance reform aspect
Special Report 3/2005	The Verification of Agri-Environment expenditure
Special Report 4/2005	The Commission's management of economic cooperation in Asia
Special Report 5/2005	Interpretation expenditure incurred by the Parliament, the Commission and the Council

APPENDIX 3

Developments during the United Kingdom's Presidency

The Commission published a 'roadmap to an integrated internal control framework' in June 2005

In April 2002, the European Parliament asked the European Commission and the European Court of Auditors to provide an opinion on introducing a 'single audit model' approach. In April 2004, the Court published a paper[34] setting out its proposals for such an approach. The paper proposed the introduction of an internal control framework for application both in European institutions and at the level of Member States. The framework would be based on:

- common principles and standards;
- internal controls which gave reasonable but not absolute assurance on the legality and regularity of transactions underlying the accounts;
- costs in accordance with the benefits that they bring; and
- a chain structure where controls are undertaken, recorded and reported to a common standard, allowing reliance to be placed on them by all participants.

Under the Court's model, one set of auditors would place increasing reliance on the work of another.

In January 2005, President Barroso made it a strategic objective of his Commission for 2005-2009 to strive for a positive Statement of Assurance[35]. In early 2005, Siim Kallas, vice President of the European Commission (Administrative Affairs, Audit and Anti Fraud) asked the European Commission to produce a 'roadmap' to an integrated internal control framework by July 2005 and for European institutions to reach agreement on the roadmap by November 2005. The European Parliament, within the context of its discharge of the European Commission's responsibility for the 2003 budget, asked the Commission to draw up an action plan for implementing a internal control framework.

The Commission, in June 2005, issued a communication – a roadmap to an integrated internal control framework – to the European Council, the European Parliament and the European Court of Auditors. It noted that the European Court of Auditors would not be able to give a positive Statement of Assurance unless it can gain reasonable assurance that transactions made at the level of the final beneficiary in Member States – such as a farmer, student, or enterprise – are legal and regular. The supervisory and control systems should provide reasonable assurance that the risk of error is properly managed. The Commission presented the 'roadmap' to ECOFIN in July 2005. ECOFIN agreed to set up a panel of experts, from all Member States, co-chaired by the Commission and the United Kingdom's Presidency, to consider the issues raised in the 'roadmap' communication. In preparation for this, the Commission issued an analysis of the gaps between the current control environment and that proposed by the Court and six issue papers **(Figure 19)**.

19 The Commission's issue papers supporting *the roadmap to an integrated control framework*

- Declarations and certificates: structure and timing to add value
- Declarations by central Member State authorities: limits and opportunities
- Integrating the internal control framework on a legal bases
- Control strategies and sampling methods
- Determining the cost and benefits of controls, and who should bear the control costs?
- Scope of the single audit approach at the EU level

Source: National Audit Office

34 Published in the Official Journal of the European Union C107/1, 30 April 2004.
35 *Strategic Objectives 2005-2009, Europe 2010: A Partnership for European Renewal, Prosperity and Solidarity.*

Expert Panel established to discuss the Roadmap – September 2005

In September 2005, the panel of experts met to discuss the roadmap and offer practical solutions on technical matters. The panel focused on three main areas – the role of the Commission and Member States under the Treaty (establishing the European Union); decentralised spending and control systems in Member States; and control strategies and sampling methods. Three working groups were also established, looking at general issues, operational issues, and audit issues. The panel's discussions formed the basis for the draft conclusions for ECOFIN.

ECOFIN published conclusions on the Roadmap – November 2005

In November 2005, the Council of the European Union's Economic and Financial Affairs (ECOFIN) committee published its conclusions on its assessment of the roadmap. In summary, it concluded that, amongst other things:

- Member States and the Commission should seek to optimise the effectiveness, economy and efficiency of the current control systems;
- Member States and the Commission should continue to undertake and improve controls over funds under shared management;
- there is a need for a strict distinction between internal controls and external audit; and
- the Council should reach an understanding with the European Parliament regarding the risks to be tolerated in the underlying transactions, having regard to the costs and benefits of the system.

ECOFIN also recommended that the European Council should examine the Commission's action plan to fill the gaps in the current control framework, as part of the discharge of the 2004 budget, due in the spring of 2006. It will also examine, during 2005, progress to improve internal controls further. The European Council considered ECOFIN's conclusions in December.

In January 2006, the Commission published its Action Plan

This process culminated with the Commission publishing its *Action Plan towards an Integrated Internal Control Framework* in January 2006. The Plan identifies four themes for action and identifies a number of action points within each theme. The action points are summarised in **Figure 20**.

20 Summary of Action Plan

Simplification and common control principles

1 The Commission will keep under consideration the simplification of the regulatory framework during the negotiations on all the 2007-2013 legislation. Council and the European Parliament are considered to support such initiatives.

2 The Council and the European Parliament should use the opportunity of the consultation on the revised Financial Regulation to give their opinion on the need to insert a budgetary principle on effective and efficient internal control providing a common standard.

3 The Court of Auditors should be able to develop its DAS-methodology so as to rely effectively on the Annual Activity Reports of the Commission services and the related synthesis report at Commission level, focussing on the management of the risk of error in the legality and regularity of the underlying transactions.

4 The Commission will initiate an inter-institutional dialogue in March 2006 on the basic principles to be considered regarding the risks to be tolerated in the underlying transactions. On this basis, the Council and the European Parliament should reach an initial agreement regarding these risks by end 2006.

Management declarations and audit assurance

5 Member States should designate a national coordinating body per policy area which can for example provide all stakeholders with an overview of the assurance available in respect of Community actions under shared and indirect management in their Member State. The cooperation of Member States is necessary when ensuring such a provision in forthcoming legislation, and steering its implementation via implementing rules and guidance, adapted to the arrangements for providing assurance on Community funds for the policy area.

6 Council and the European Parliament should carefully examine the appropriateness of internal control structures and procedures proposed in the new legislative proposals.

7 Member States should actively participate in enhancing the usability of independent audit results in the chain of control and integrate this aspect in its guidance for controlling EU-funds.

8 Member States should invite their national and regional Parliaments to ask their SAIs for audit and assurance on EU-funding at their level. The conclusions of these reports should also be made available to the Commission and the European Court of Auditors.

Single audit approach: sharing of results and prioritising cost-benefit

9 Member States are called on to continue to cooperate actively with the relevant Commission services in fixing audit strategies, audit guidance, planning of audits and sharing of the results and their follow-up.

10 Member States are asked to deliver data on costs for the control of expenditure under shared and centralised indirect management in good time and in a comparable format to be defined by the Commission.

11 Council and the European Parliament are asked to integrate the results of these pilot studies in their reflections regarding the risks to be tolerated in the underlying transactions.

Sector-specific gaps

12 Member States are called upon to cooperate with the Commission services in the implementation of actions, and where the actions involve changes to legislation the Council and the European Parliament should be open to considering such amendments.

13 Member States should ensure that the relevant information to be provided by the Authorities under article 13 for Structural Funds is delivered in accordance with the proposed time table. The issue of how Member States can provide assurance to the Commission in the most efficient and effective manner, will also be discussed during the bilateral annual meetings with the Member States' auditors.

14 Support is requested from Member States in developing and implementing the guidance for Structural Funds where it is most needed, and in its distribution and dissemination.

15 Member States should implement for Structural Funds the 'Contracts of Confidence' to provide assurance for the current period, and also to lay the groundwork for the next programming period. Those that do not should reflect on how to provide comparable assurance on the present period and how they will prepare their control systems for the next programming period.

16 As this is mainly an internal Commission measure, Council, European Parliament and Court of Auditors should benefit from the progress made in this domain through clearer and more coherent reporting in the Annual Activity Reports of the services.