NATIONAL AUDIT OFFICE

Report by the
Comptroller and Auditor General

Financial Management of the European Union

HC 437 Session 1999-2000
28 April 2000

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John Bourn
Comptroller and Auditor General

National Audit Office
14 April 2000

The Comptroller and Auditor General is the head of the National Audit Office employing some 750 staff. He, and the National Audit Office, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources.

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Executive summary

1 The Annual Report of the European Court of Auditors (the Court) brings together the main findings from the Court's audit of the General Budget of the European Union. This Report by the Comptroller and Auditor General covers the findings set out in the Court's Annual Report for 1998 and outlines recent developments relating to reform within the European Commission (the Commission). The Court's Annual Report includes its observations on the financial management of Community activities by Member States, the Commission and other Community Institutions, and its Statement of Assurance on the reliability of the accounts of the Community and the legality and regularity of the underlying transactions. In 1998 Community expenditure totalled some 80.8 billion ECU (£57.0 billion). The Commission has overall responsibility for implementing the Budget but around 85 per cent of the expenditure is managed by authorities within the 15 Member States.

2 In May 1999 in the light of the findings in the Court's Annual Report for 1997 and other evidence, including the report of a Committee of Independent Experts, the European Parliament decided to postpone granting the Commission discharge for the 1997 Budget. Also during 1999 the Committee of Public Accounts undertook a fact-finding visit to the European Institutions responsible for the management and oversight of the Community Budget. In its report, the Committee concluded that fundamental changes were needed to bring about long overdue improvements in the standards of financial management and accounting and reduce the levels of waste, error and fraud in the Community's expenditure programmes.

3 The Court's Annual Report for 1998 draws similar conclusions to previous years. For the fifth year in succession the Court found significant weaknesses in the management of the Budget and an unacceptably high rate of error in the transactions underlying payments. However the Court acknowledged that the Commission had taken action in response to earlier criticisms and that in some areas, particularly the Structural Funds, its audit had largely covered transactions and events that occurred before the changes had taken effect.

4 In summary, the Court concluded in its Statement of Assurance for 1998 that:

- the accounts for 1998 reliably reflected the revenue and expenditure for the Community for the year and the financial situation at the end of the year, with four areas of qualification. These concerned the inaccurate or incomplete disclosure of fixed assets, debtors, commitments and provisional payments;

- taken as a whole the transactions underlying the revenue entered in the Community accounts for 1998 were legal and regular subject to a number of limitations, in particular on the completeness of the figures;

- taken as a whole the commitment transactions for 1998 were legal and regular, with one exception where the Commission entered into binding obligations greater than the amounts provided for in the Budget;

- there was an unacceptably high rate of errors which directly affected the payments made. Therefore for the fifth year in succession the Court declined to provide assurance that the transactions underlying payments were legal and regular.

5 As well as its work on the Statement of Assurance, the Court's Annual Report for 1998 examined wider issues relating to the efficiency and effectiveness of the revenue and spending programmes of the Community. During 1999 the Court also published four Special Reports detailing its audit results on specific topics. We consider that key conclusions emerging from the Court's work on the management of the Community Budget for 1998 were that:

- on the Common Agricultural Policy, farmers were being overcompensated as a result of the unnecessarily high levels of aid being paid in respect of skimmed milk powder and cereals;

- the Commission had made significant efforts to improve financial management and control of the Structural Funds but weaknesses remained in a number of areas, in particular in the evaluation and closure of programmes.

6 The Commission also published information on the management of the Community Budget in 1998 in its report on 'Protecting the Communities' Financial Interests and the Fight Against Fraud'. The report included details of cases of fraud

and irregularity investigated by the Commission. In 1998 Member States notified the Commission of just over 5,000 cases of irregularities involving 577 million ECU (£407 million). The Commission estimated that around one in five cases involved suspicion of fraud. As well as these cases, the Commission's anti-fraud unit opened 200 new investigations during 1998. In June 1999 the Commission established a new European Anti-Fraud Office, which is operationally independent and will have more staff than its predecessor.

7 The Court's Annual Report largely concerned the management of the Community Budget in 1998. However since then there have been major developments in relation to the management of Community funds, including the resignation of the Commission in March 1999. In the new Commission, the Rt Hon Neil Kinnock was appointed as Commission Vice-President with specific responsibility for administrative reform. Vice-President Kinnock set up a Task Force to develop a strategy for reform and modernisation, drawing on proposals from a range of sources including reports from the Committee of Public Accounts and the Committee of Independent Experts set up by the European Parliament. The reform strategy was approved by the Commission in March 2000. The United Kingdom Government has been supportive of the moves to improve financial management and control and reduce levels of fraud and irregularity.

The National Audit Office's conclusions

8 In relation to the Court's Statement of Assurance (Part 2):

- the Statement of Assurance provides a valuable assessment of the management of the Community Budget as a whole, and the increasingly sectoral approach that the Court is adopting is beginning to provide useful additional information about the position on particular categories of expenditure. The Court told us that producing separate opinions on different areas of the Budget would require substantial additional work. However we consider that there would be considerable value in moving in this direction and we urge the United Kingdom Government to support the further extension of this work;

- as in previous years, the qualifications to the Court's opinion on the reliability of the accounts are a matter for concern. This emphasises the importance of putting in place clear accounting policies, which are then consistently applied, to improve the reliability of the accounts. As changes to the Financial Regulation are not expected to take effect for at least two years, it is important for the Commission to make what improvements it can in the meantime;

- it is a matter of serious concern that the high level of 'substantive' errors found by the Court meant that it was unable to provide positive assurance on the transactions underlying payments for the fifth year in succession. The Commission and Member States need to act urgently to reduce the rate of error, in particular in expenditure on the Structural Funds and internal policies (mostly research and development) where the highest rates of error were found. Providing the Commission and Member States with more detailed information on error rates would help to highlight more clearly the scale of the problems and the progress being made to address them;

- many of the errors found by the Court relate to errors made in claims by final beneficiaries, which make them particularly difficult to tackle. It is far from clear that the Court will be able to provide assurance until there is substantial simplification of the schemes concerned. The moves already being made to simplify Common Agricultural Policy and Structural Fund schemes should play a key role in reducing the extent of errors, and further simplification in the future would be desirable;

- the high rate of error found by the Court in European Social Fund payment claims by applicants in the United Kingdom is a cause for concern. We welcome the action that has already been taken by the Department for Education and Employment to address the problems and recommend that it continues its efforts in this area.

9 In relation to other findings on the management of the Community Budget (Part 3):

- it is important that the Commission takes full account of the recommendations of the Court relating to fundamental improvements in financial control and accountability, as part of the ongoing reform process;

- in the light of the Court's findings on the failure to adapt the skimmed milk scheme to take account of market changes and on the overcompensation of farmers in the cereals sector, we urge the United Kingdom Government to press the Commission, Council and Parliament to work together to ensure that schemes achieve their objectives efficiently and effectively;

- on the Structural Funds, the Commission and Member States need to take action to close programmes which are still outstanding from the 1989 to 1993 period and to strengthen procedures to ensure that similar delays do not occur when programmes from the 1994 to 1999 period come to be closed;

- the Commission and Member States need to work together and share information about Structural Fund programmes, with the aim of identifying good practice in terms of selecting and monitoring projects, and assessing their impact on structural development and employment;

- the Commission needs to design and simplify schemes to minimise the risk of fraud and irregularity, and we urge the United Kingdom Government to press the Commission to make rapid progress in this regard;

- where fraud is suspected, the new European Anti-Fraud Office and authorities in Member States need to work constructively together to undertake quick and effective investigations.

10 In relation to the moves to reform financial management and control within the European Union (Part 4):

- the United Kingdom Government, through the Council of Ministers and its other links with the Community, should continue to seize all opportunities to facilitate and support the far-reaching programme of reform to ensure that its impetus is maintained and improvements in financial management are secured;

- although the Commission does not expect the full impact of the reforms to be felt for another two or three years, it is important that some indication of improvements in financial management and control are evident before then;

- implementation of some of the reforms will require changes to the Financial Regulation. We urge the United Kingdom Government to press the Commission and the other Community Institutions to work together to ensure that legislative hurdles to implementing the reforms are overcome in a timely manner.

11 The Comptroller and Auditor General has reported since May 1997 on a range of matters relating to the revenue due to and expenditure funded from the Community General Budget in the United Kingdom. The reports are summarised in Appendix 1. Recent reports focussed on the handling of the BSE crisis and the management of the Arable Area Payments Scheme. We will continue to give a high priority to examining the way that United Kingdom departments manage Community funds in the future and to co-operating with the Court.

Part 1: Introduction

1.1 The European Court of Auditors (the Court) published its Annual Report for the financial year 1998 in the Official Journal of the European Communities in December 1999. This report by the Comptroller and Auditor General summarises the Court's findings in its Annual Report arising from its audit of the General Budget of the European Union for 1998. It also sets out proposals for reform of financial management and control within the European Commission (the Commission) following the events that led to the resignation of all 20 Commissioners in March 1999.

The European Community General Budget

1.2 The operations and finances of the European Community are governed by European legislation and are overseen by the five Community Institutions (Figure 1). The level of Community revenue and spending each year is set in the Community General Budget. The procedure for setting, controlling and accounting for the Budget is set out in Appendix 2. In summary, the Commission prepares the draft Budget for approval by the Council of Ministers and the European Parliament (known together as the "budgetary authority"). The Commission implements the Budget and presents accounts to show how the Budget has been used. On the basis of the accounts and the Court of Auditors' audit reports, each year the Council and the Parliament assess the Commission's stewardship of Community funds and reach a decision on whether to discharge the Commission from any further responsibility for the Budget.

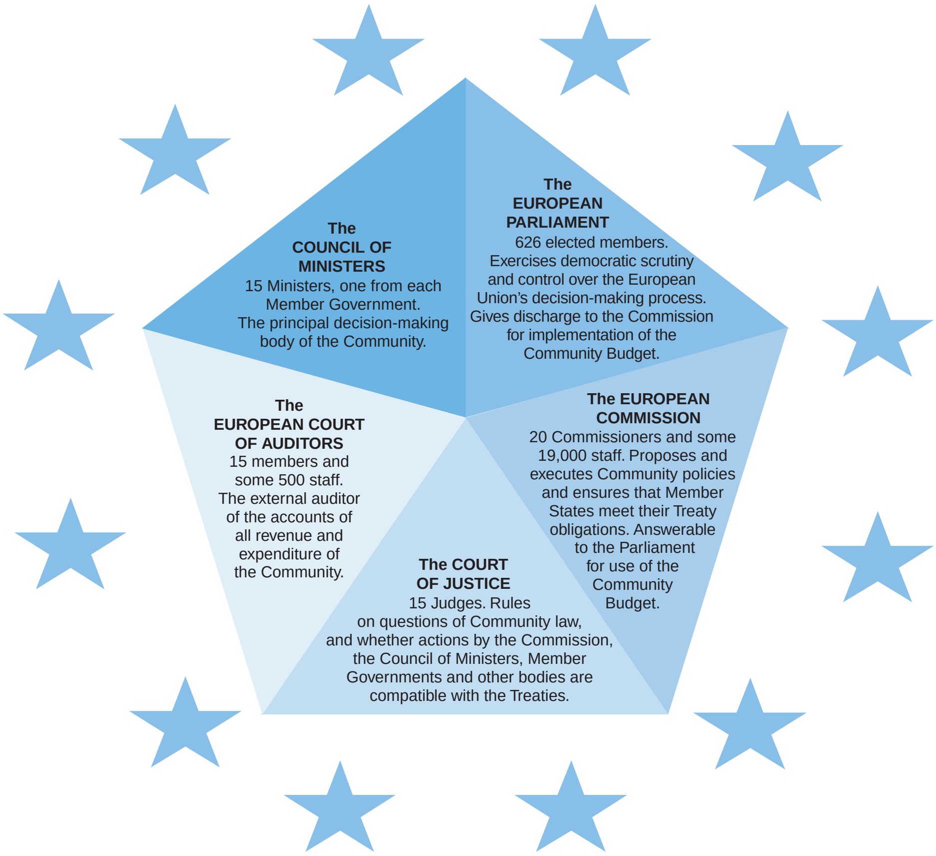
1.3 Some 85 per cent of Community funds are managed within the 15 Member States of the European Union by central governments, local administrations and other beneficiaries. The Commission is responsible for co-ordinating, stimulating and controlling the effective working of the financial mechanisms of the Community across the Member States. Under Article 280 of the Treaty establishing the European Community, Member States are required to take the same measures to counter fraud against the financial interests of the Community as they take to counter fraud affecting their own financial interests.

1.4 The total revenue available to the Community General Budget for 1998 was some 84.5 billion ECU (£59.6 billion), including 1.0 billion ECU (£0.7 billion) brought forward from 1997. Total Community spending was some 80.8 billion ECU (£57.0 billion), one per cent higher than in 1997. The surplus of 3.7 billion

The European Community Institutions

Figure 1

The five Community Institutions oversee the operations and finances of the European Union.



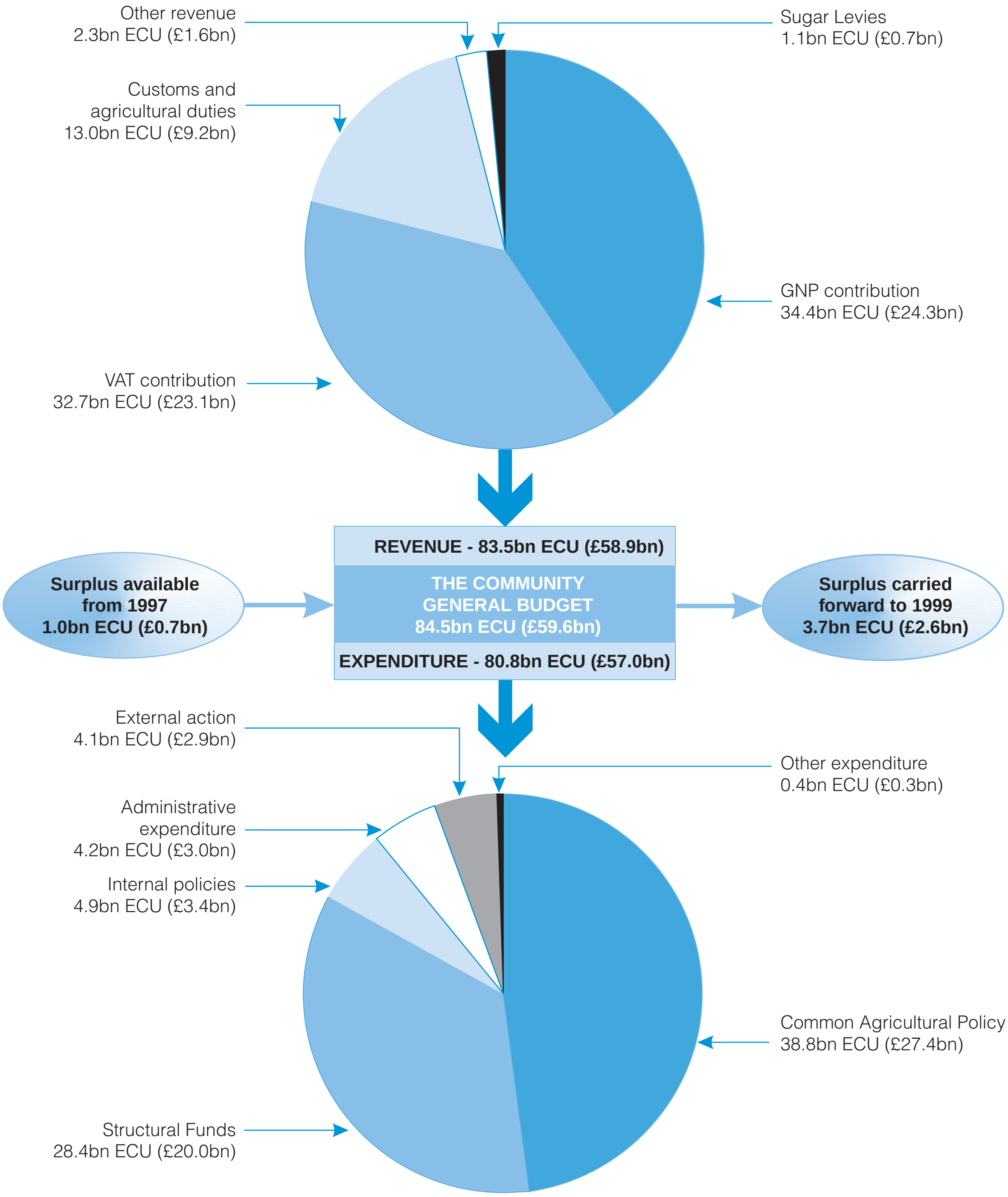
ECU (£2.6 billion) was carried forward to 1999. Figure 2 breaks down the revenue and expenditure for 1998 between the main headings used by the Community. The four main sources of Community revenue were:

- a Gross National Product contribution, based on the relative proportions of the Gross National Products of Member States;
- a Value Added Tax contribution, based on a uniform rate applied to Member States' net VAT receipts;
- customs and agricultural duties collected on trade with non-Member States and under the Coal and Steel Community;
- sugar levies collected on the production and storage of sugar commodities.

Figure 2

Revenue and expenditure of the European Community in 1998

The Community General Budget is funded by agricultural and customs duties, sugar levies, and contributions based on Member States' VAT revenues and Gross National Product. The Budget funds mainly agricultural support, and social and economic development.



Source: Data from the Annual Report of the European Court of Auditors 1998.

1.5 There were five main categories of Community expenditure:

- funding for Common Agricultural Policy measures;
- the Structural Funds, which aim to reduce disparities of wealth and employment opportunities between regions within the Community;
- funding for external action, including food and humanitarian aid;
- funding for internal policies, covering a diverse range of measures such as research and development and vocational training;
- administrative expenditure for the five Community Institutions and a number of other small bodies, such as European Schools.

1.6 Community revenue and expenditure by Member State is shown in Figure 3. The United Kingdom was the second largest net contributor to the Community General Budget in 1998, providing some 5.6 billion ECU (£4.0 billion). Figure 4 on page 12 analyses the United Kingdom's payments to and receipts from the Budget in 1998.

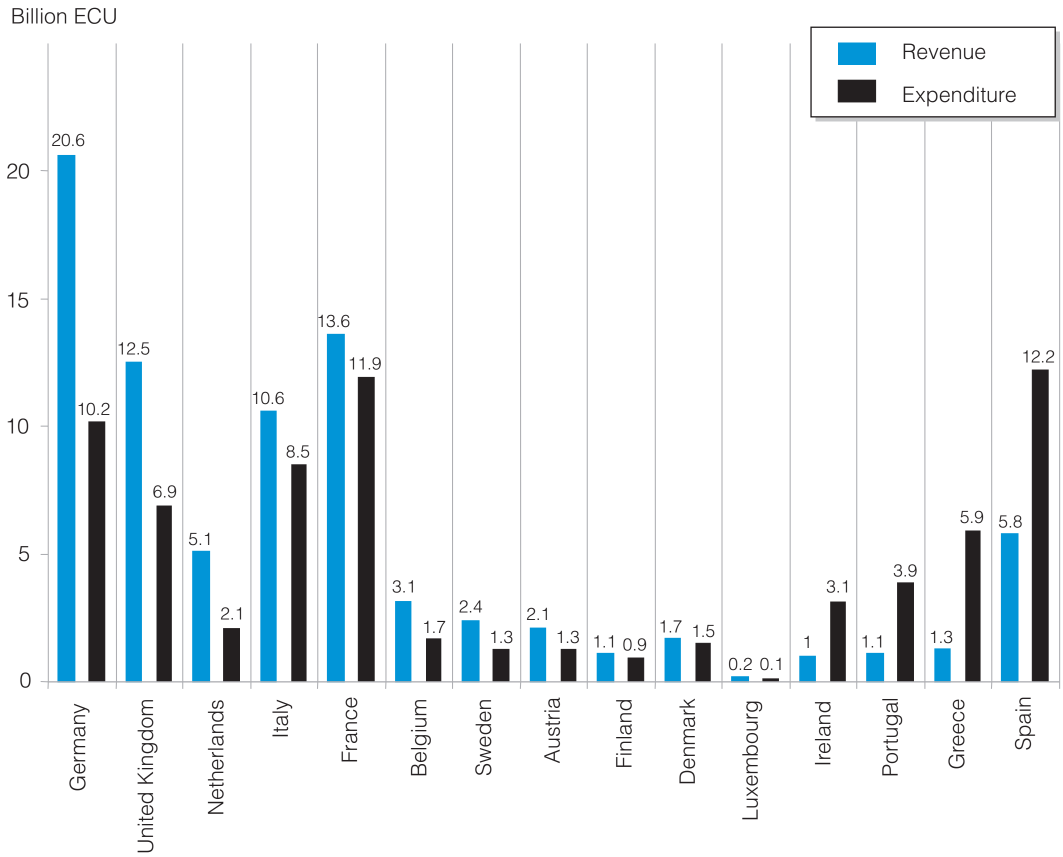
The European Court of Auditors

1.7 The Court is the external auditor of the European Community. In accordance with the provisions of the relevant Treaties, the Court examines all Community revenue and expenditure, to determine whether revenue has been received and expenditure incurred in a lawful and regular manner, and whether financial management has been sound. In addition, since 1994 the Treaty on European Union has required the Court to provide an annual Statement of Assurance on the reliability of the accounts of the Community, and the legality and regularity of the underlying transactions.

Figure 3

Community revenue and expenditure in 1998 by Member State

This figure shows Community revenue and expenditure in 1998 by Member State. Countries are shown in order of their net contribution to the Community General Budget. The United Kingdom was the second largest net contributor, providing 5.6 billion ECU (£4.0 billion).



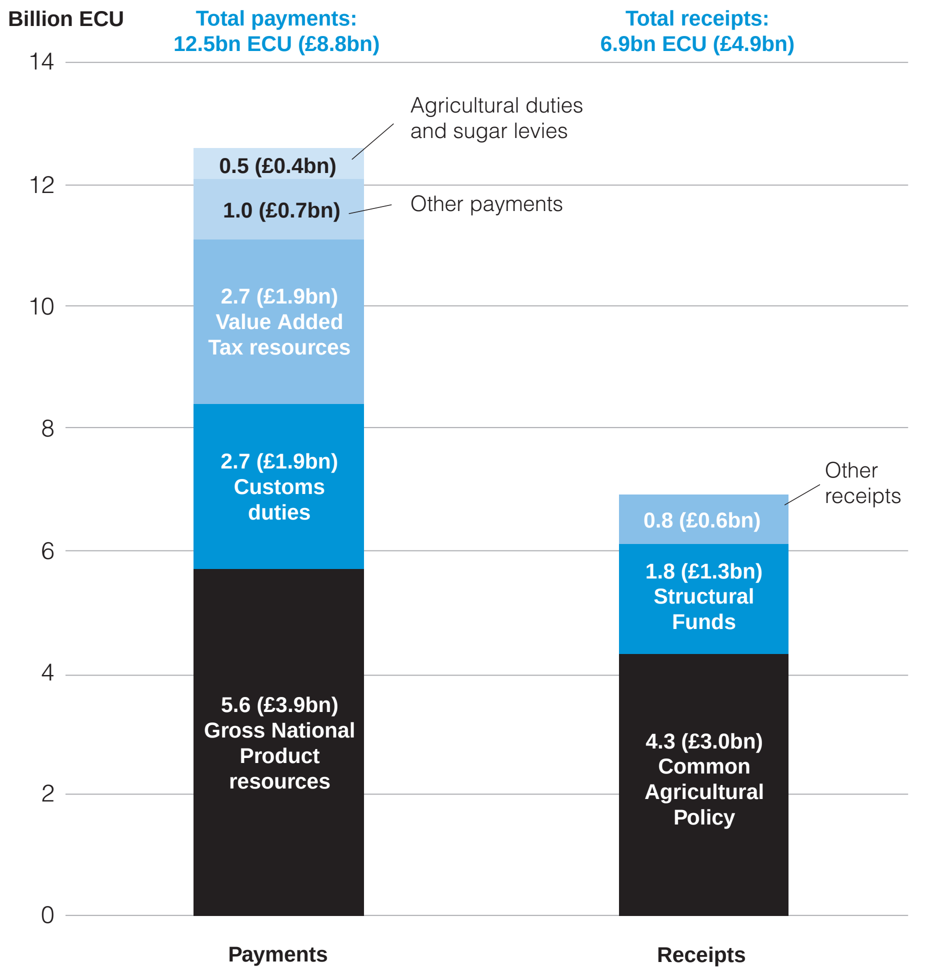
Notes: 1. Figures exclude expenditure on administration in the Member States.

2. The European Commission's accounting system (SINCOM) shows the first destination of Community payments. Payments made to one Member State in the first instance may subsequently be used by that Member State on transactions in another Member State.

Source: Revenue data from the European Union accounts; expenditure data from the European Commission's accounting system (SINCOM).

United Kingdom's payments to and receipts from the 1998 Community Budget

Figure 4



Notes:
1. Ownership of customs and agricultural duties and sugar levies ("traditional own resources") rests with the European Communities.
2. Member States are entitled to retain 10 per cent from levies and duties made available to the Commission to cover their collection costs.
3. The United Kingdom's Value Added Tax contribution is abated under the 1984 Fontainebleau agreement.
4. The Value Added Tax and Gross National Product contributions are initially forecast and then adjusted as final figures become available.
5. A conversion rate of £1 = 1.4175 ECU (the exchange rate at 31 December 1998) has been used.

Source: Revenue data from the European Union accounts; expenditure data from the European Commission's accounting system (SINCOM).

1.8 Established in 1977, the Court became the fifth Institution of the Community in November 1993. It consists of 15 Members, supported by some 500 staff. The Court's audit covers the Community Institutions and bodies set up by them, and the use of Community funds by national, regional and local administrations, as well as other recipients of Community aid in both the public and private sectors. This includes Community funds spent outside the European Union, such as development aid in Eastern Europe. The Court has rights of access to any body in receipt of Community funding, which includes some recipients of public money in the United Kingdom to whom the Comptroller and Auditor General has no right of access (such as farmers and training providers).

1.9 During 1998 the Court carried out around 400 audit visits to Member States and other countries, including 24 to the United Kingdom. During these visits, auditors from the Court examined selected Community transactions and systems for the management and control of European funds. The auditors have a right of access to any document or information relating to the financial management of the departments or bodies subject to the Court's examination, and can question any official responsible for Community revenue or expenditure. Following each visit, the Court sends a letter setting out its findings to the relevant authorities in the Member State concerned. The authorities have eight weeks in which to respond to the Court, which then takes account of the replies in discussing its findings with the Commission.

1.10 The Court publishes a summary of its audit findings on the efficiency and effectiveness of the revenue and spending programmes of the Community, along with the Statement of Assurance, in its Annual Report. The Annual Report brings together the main findings from the Court's audits in the previous financial year, which runs from January to December. In addition the Court publishes the results of audits on specific topics in Special Reports. The four Special Reports published in 1999 are listed in Appendix 3.

Progress on the European Parliament's discharge of the 1997 Community Budget

1.11 In its Annual Report for 1997 the Court declined to provide positive assurance as to the overall legality and regularity of the transactions underlying payments from the 1997 Community Budget. In May 1999, having considered the Court's Annual Report for 1997, the Council of Ministers' recommendations and other evidence, the European Parliament decided to postpone granting the Commission discharge for the 1997 Budget. The Parliament's decision was made in the light of the findings of an investigation into allegations of mismanagement within the Commission by a Committee of Independent Experts, which had prompted the resignation of the Commission in March 1999. The Parliament finally granted discharge to the Commission in January 2000. Further details of these and subsequent developments are given in Part 4 of this report.

Parliamentary scrutiny of European matters in the United Kingdom

1.12 The House of Commons Committee of Public Accounts considers the Comptroller and Auditor General's report on the Court's Annual Report. In the light of the Comptroller and Auditor General's report published in March 1999[1], the Committee undertook a fact-finding visit to the European Institutions responsible for the management and oversight of the Community Budget. In August 1999 the Committee issued its own report[2], which is summarised in Part 4 of this report.

1.13 The European Scrutiny Committee of the House of Commons considers European documents and, where they are of particular legal or political importance, can recommend that they are debated on the floor of the House or refer them to one of the European Standing Committees for questions to Ministers and debate. The Committee publishes a weekly report on the documents that it has considered, giving reasons for its judgement on the significance of documents and highlighting the issues raised. The Court's Annual Report is usually referred for debate in Standing Committee, although in January 2000 the Committee decided not to recommend a debate on the Annual Report for 1998 in anticipation of a wider debate on the Commission's proposals for reform.

1.14 The House of Lords European Communities Committee considers the same range of documents as the European Scrutiny Committee. More important documents are referred for further scrutiny to a sub-Committee, who may decide to conduct an enquiry, taking evidence and producing a detailed report on the merits of the document before them.

1 Audit of the General Budget of the European Union for 1997 and Related Developments (HC 279, 1998-99).

2 Financial Management and Control in the European Union, Committee of Public Accounts Twenty-ninth Report (HC 690, 1998-99).

Scope of the National Audit Office examination

1.15 This report:

- summarises the Court's Statement of Assurance on the accounts of the Community for 1998 (Part 2);
- highlights other significant findings on the management of the Community General Budget (Part 3);
- summarises the events that led to the resignation of the Commission in March 1999 and considers proposals for reform of financial management and control (Part 4).

1.16 In preparing this report, we visited the Court to discuss matters arising from its work, and the Commission to obtain its views on the Court's findings. We also sought comments from the United Kingdom's Ambassador to the European Union, HM Treasury, the Foreign and Commonwealth Office, and other relevant government departments.

Part 2: The Statement of Assurance

2.1 The Treaty on European Union has since 1994 required the European Court of Auditors to prepare each year a Statement of Assurance on the accounts of the European Community[3], which are the responsibility of the European Commission. In its Statement of Assurance for 1998, the Court declined to provide assurance as to the legality and regularity of the transactions underlying payments because of the unacceptably high rate of 'substantive' error it found. The conclusions in this, its fifth, Statement of Assurance were in essence similar to previous years and the Court has yet to provide assurance under this heading.

2.2 The Court's audit field comprises the Commission and the other four Community Institutions, and extends beyond them to the final recipients of Community funds in the 15 Member States and elsewhere in the world. Many of the transactions pass through several levels of administration and numerous different bodies.

2.3 The Court's responsibility to prepare a Statement of Assurance has similarities with the Comptroller and Auditor General's responsibility to certify and report on accounts in the United Kingdom, although there are important differences. In particular, the Treaty requires the Statement of Assurance to be global in nature, providing an overall opinion on the accounts of the Community as a whole. It is not intended to provide an assessment or arrive at a quantified conclusion on particular operational or geographical areas, such as individual spending programmes or Member States. Nonetheless, for the Statement of Assurance for 1998 the Court adopted a more sectoral approach than in previous years and provided the Commission with indicative rates of error for each of the five main categories of expenditure.

2.4 The Court carries out its audit in accordance with its audit standards and policies, which adapt generally accepted international auditing standards to the Community context. The standards and policies are publicly available and set out the principles that determine the way in which the Court plans, executes and reports its audit work. In 1998 the Court visited the United Kingdom on 24 occasions. Its work included examining 68 revenue and payment transactions for the Statement of Assurance. The Court's sample sizes were intended to provide

3 The consolidated accounts of the European Community comprise the revenue and expenditure account, balance sheet and explanatory notes.

a sufficient basis to draw audit conclusions about the accounts of the Community as a whole, but not about the United Kingdom or other Member States. The samples were also designed to generate useful additional information on the incidence of error in different areas of the Community Budget.

2.5 The National Audit Office audits European funds along with other monies passing through United Kingdom government departments and public bodies. The Comptroller and Auditor General gives a separate opinion on the financial statements of each body. This is based on a range of audit checks including tests on a sample of transactions, an assessment of control and accounting systems, and, where appropriate, reliance on the work of other auditors. The checks do not routinely extend to the final recipients of Community funds such as farmers, to whom the Comptroller and Auditor General has no right of access.

2.6 This part of the report summarises the Court's Statement of Assurance for 1998, which covered:

- the reliability of the accounts of the Community;
- the legality and regularity of the transactions underlying revenue, commitments and payments.

The reliability of the accounts of the Community

2.7 **The Court concluded that the accounts for 1998 reliably reflected the revenue and expenditure of the Community for the year and the financial situation at the end of the year, with four areas of qualification.** These concerned the inaccurate or incomplete disclosure of fixed assets, debtors, commitments and provisional payments. The Court has qualified its assurance on the reliability of the accounts of the Community every year since the Statement of Assurance was introduced in 1994. The significant problems found by the Court are detailed in Figure 5.

2.8 Overall the Court identified the following key problems:

- Community Institutions had failed to implement a consistent approach to identifying, valuing and disclosing the Community's assets and liabilities;
- the figure shown for amounts owed to the Community in respect of customs duties and agricultural levies was uncertain and probably overstated the amount recoverable;
- different parts of the Commission had applied different definitions of a commitment leading to inconsistency and inaccuracy;

- the financial statements did not accurately reflect the distinction between advance and definitive payments, and the Commission did not record advances as assets in the balance sheet before the relevant expenditure was incurred.

Figure 5

The Court's findings on the reliability of the accounts of the Community for 1998*

Problem	Effect
1. Disclosure of fixed assets	
■ The figure for fixed assets was understated because it did not include buildings purchased through leases by the Parliament and the Court of Justice.	Understatement of 540 million ECU (£381 million).
■ The amount shown for fixed assets was generally uncertain because Community Institutions failed to adopt a common approach for their disclosure. Assets were inconsistently identified, valued and classified. Only the Commission and the Court of Justice capitalised intangible assets. Only the Commission and the Court of Auditors calculated depreciation, and this was disclosed only in the notes to the accounts and not in the balance sheet.	Depreciation of 562 million ECU (£397 million) not disclosed, although this relates only to the Commission and the Court of Auditors.
2. Disclosure of debtors	
■ The Commission took no account of the extent to which amounts owed by Member States in respect of customs duties and agricultural levies were actually recoverable. On the basis of recent experience, the Court estimated that only around 10 per cent of customs debts were recoverable. Furthermore the relevant accounts of Member States contained significant errors.	Possible overstatement of 1 billion ECU (£705 million).
■ The balance sheet did not include amounts due to be recovered from farmers and other beneficiaries who had received Common Agricultural Policy payments to which they were not entitled.	Approximately 860 million ECU (£607 million) not disclosed.
3. Disclosure of commitments	
■ The figure for commitments included amounts where settlement deadlines had passed and there was no longer an obligation to make further payments.	Overstatement of approximately 660 million ECU (£466 million).
■ The figure for commitments did not include all legal obligations. Furthermore in one area the Commission had entered into legal commitments which exceeded the level fixed in the Budget.	Understatement of 350 million ECU (£247 million).
■ Certain off balance sheet potential liabilities were not disclosed – for example, in the field of external aid the Commission had entered into a series of multi-annual commitments which were not disclosed.	Understatement of at least 2.8 billion ECU (£2.0 billion).
4. Disclosure of provisional payments	
■ Advances and payments on account were not properly accounted for. Also, the accounts gave no indication of the extent to which advances had been utilised and paid over to final beneficiaries.	Understatement of at least 2 billion ECU (£1.4 billion).
■ The balance sheet did not reflect some amounts held on account or paid as advances to third parties acting as agents for the Commission, principally in the field of external aid.	Understatement of more than 600 million ECU (£423 million).

** Note: in some areas the Commission did not agree with the findings of the Court (see paragraphs 2.10 and 2.11).*

2.9 Underlying these problems was the failure of the Commission to provide an adequate and complete accounting framework, which would ensure that all transactions of the same kind were treated in a consistent and appropriate manner. As in previous years, the Court highlighted this weakness and recommended that the Commission should adopt and apply a clear accounting framework which was consistent with generally accepted accounting principles. The Court also called for improvements in the presentation of the financial statements, which it considered were in parts difficult for readers to understand and which did not provide a full picture of the financial position of the Community.

2.10 The Commission undertook to strive for improvements in the reliability and transparency of the Community's financial statements, stating that it had already taken action to address some of the problems which the Court had highlighted. For example, better monitoring over the past year had led to a fall in dormant commitments (where no payment had been made for at least two years) of around a third (900 million ECU (£635 million)). The Commission noted that it was looking into the recording and management of amounts due to be recovered from farmers, with the aim of ensuring that records were complete and debts promptly recovered. It was also drawing up a consolidated manual and regulation for accounting for its assets. The Commission undertook to do what it could to include in the financial statements for 1999 information on the extent to which advances had been paid over to final beneficiaries, although it noted that it was not legally obliged to do so.

2.11 In a few areas the Commission disagreed with the Court's interpretation of how the Community's finances should be reported, such as in relation to multi-annual aid programmes. The failure of the Court and the Commission to agree on such matters highlights the lack of clarity in the accounting framework. The Commission stated that it had undertaken to review its accounting framework as part of the ongoing revision of the Financial Regulation[4]. However it emphasised that this would be a lengthy process and that changes arising from the review were unlikely to affect the Community's accounts until 2001.

4 The Financial Regulation specifies the procedures to be adopted for establishing and implementing the Community Budget and for presenting and auditing the Community accounts. It has a similar function to Government Accounting which sets out financial rules for government departments in the United Kingdom. It can be amended only by a unanimous decision of the European Council.

2.12 During 1999 the Commission had difficulties in providing the Court with a final set of accounts to audit. The Court recommended that in future years the Commission should ensure that it has sufficient accounting staff and consider the possibility of employing external professional expertise to help prepare the financial statements to acceptable standards within a reasonable timescale.

The legality and regularity of the underlying transactions

2.13 The second part of the Statement of Assurance covered the legality and regularity of the transactions underlying Community revenue, commitments and payments.

Revenue

2.14 **The Court concluded that taken as whole the transactions underlying the revenue entered in the Community accounts for 1998 were legal and regular subject to restrictions in relation to the completeness of the figures (which are standard to revenue audit) and other limitations.** Specifically the Court did not undertake to provide assurance that all dutiable imports had been declared to customs authorities and had generated the corresponding revenue, or that the macro-economic statistics underlying the bulk of Member States' contributions to the Community were correct. In the United Kingdom only three minor errors were found in the revenue transactions examined by the Court.

Commitments

2.15 **The Court concluded that taken as a whole the commitment transactions for 1998 were legal and regular, with one exception.** During the year, the Commission entered into binding obligations greater than the amounts provided for in the Community General Budget. The commitments involved totalled 353 million ECU (£249 million) and, as in 1997, related to international fisheries agreements.

Payments

2.16 **The Court found an unacceptably high incidence of 'substantive' errors which directly affected the payments made and, for the fifth year in succession, the Court declined to provide assurance that the transactions underlying payments for the financial year were legal and regular.** The Court also found numerous other 'formal' errors which had no direct effect on the payments made, but where there had been a failure to comply with Community regulations.

2.17 As for 1997, the Court did not publish details of the rate of 'substantive' error it found. It stated however that the errors did not differ significantly in amount and nature from those found in previous years. In the 1996 Statement of Assurance (the last year for which error rates were published), the Court had found that the most probable rate of error affecting payments was 5.4 per cent; and that the error rate for the Structural Funds was substantially higher than for the Budget as a whole, while the rate was lower for the Common Agricultural Policy. Applying an error rate of 5.4 per cent would indicate that there may have been errors totalling 4.4 billion ECU (£3.1 billion) in 1998. The Court supplied the Commission with an indication of the error rate in different categories of expenditure, and we consider that providing more detailed information to the Commission and Member States would help them to gauge what progress was being made in improving the financial management of Community funds.

2.18 Authorities in Member States are responsible for managing some 85 per cent of Community funds, notably the Common Agricultural Policy and Structural Funds. As in previous years, the Court found that the majority of errors occurred in these areas of expenditure. However the Court also found 'substantive' errors in spending managed directly by the Commission, in particular payments relating to research and development.

Errors in Common Agricultural Policy payments

2.19 In 1998 expenditure on the Common Agricultural Policy represented nearly half of the Community General Budget (38.8 billion ECU (£27.4 billion)). While the rate of 'substantive' error found in agricultural expenditure was lower than in the Budget as a whole, the Court concluded that it was still significant. The Commission estimated that, extrapolating from the Court's results, the most probable figure for the errors in the Community Budget was just less than 1 billion ECU (£705 million).

2.20 Half of the 'substantive' errors found by the Court resulted from inaccuracies in the information provided by farmers and other final beneficiaries, mostly slight over-declarations of field sizes or erroneous recording of the number of animals eligible for subsidy. These typically had a relatively small impact on the value of the payments made. The Court also recorded as errors cases where there was insufficient evidence that the conditions for granting aid had been observed, and failure by paying agencies in Member States to apply Community legislation correctly.

2.21 The Court found that more than one in seven of the transactions examined was affected by a 'formal' error. Examples included farmers not maintaining proper registers of animals and olive mills failing to notify paying agencies of the start of milling. The Court noted that, while these errors had no direct effect on the payments made, they increased the risk that incorrect payments might be made. In the Court's view, errors were caused by the complexity of the regulations which had been frequently changed. Higher rates of error tended to be found in the smaller schemes with which those responsible for making and checking claims were likely to be less familiar.

2.22 The Commission told us that it was not surprised that the Court had found small measurement errors due to the unsophisticated approach by farmers to measuring fields and recording the movement of animals. It considered that controls in Member States were improving, for example with the use of aerial photographs and animal identification systems. The Commission expected these sorts of development would help to reduce the level of errors in claims in future years.

2.23 The Commission acknowledged that the regulations governing many schemes were complicated, as they had often been designed to meet very specific needs. For instance, the Commission told us that there were over 40 schemes for milk products alone. The number and complexity of schemes increased the risk of error and resulted in high administrative costs. Changes to the Common Agricultural Policy had been a key element of the Commission's Agenda 2000 reforms, with the aim of simplifying schemes so that they could be more easily and effectively managed, and the risk of error and fraud reduced. There had been extensive simplification in cereals and rural development schemes in particular.

Findings in the United Kingdom

2.24 The Court found both 'substantive' and 'formal' errors in the Common Agricultural Policy payments it examined in the United Kingdom, although the relevant United Kingdom departments did not always agree with the Court's conclusions about the classification or extent of the errors. Many of the errors found by the Court arose from problems with animal registers, in particular missing information on the date of purchase or sale of animals. The Court acknowledged that it was difficult for farmers to maintain accurate and complete records. There was no standard register and each farmer had his/her own differing documentation. Recognising this, the United Kingdom agriculture departments have designed standard record books for cattle and sheep, which were distributed to livestock farmers during the winter of 1999-2000.

2.25 In February 1999 the Comptroller and Auditor General reported on the administration by the Ministry of Agriculture, Fisheries and Food of the Arable Area Payments Scheme[5]. This is the largest Common Agricultural Policy scheme in England, with payments totalling some £1 billion each year. The report examined the Ministry's controls for detecting and preventing irregularities. We found that in-office checks were appropriate and well-targeted, field inspections had been effective in identifying many cases of irregularity, and remote sensing (the analysis of satellite imagery to determine land use) had become more cost-effective. The Comptroller and Auditor General noted that the Commission had the power to disallow expenditure under the scheme and recover the funds from Member States if it was not satisfied that the administration of the scheme met compliance requirements. Judging by the relatively small level of disallowance, the Ministry had been largely successful in safeguarding funds on this scheme.

Errors in Structural Fund payments

2.26 In 1998 expenditure on the four Structural Funds[6] represented around a third of the Community General Budget (28.4 billion ECU (£20.0 billion)). Aid is mainly provided to Member States in the form of funding for operational programmes, which can last for up to six years and which must be co-financed by the Member State concerned. At the beginning of a programme, the Commission usually makes an initial advance payment of 50 per cent of the first year's instalment of Community funding. Subsequent payments are made when the Member State declares to the Commission that a given proportion of previous funding has been disbursed in line with Community objectives and rules. Member States are required to provide the Commission with annual progress reports on the execution of programmes, and at the end of each programme an implementation report and declaration of expenditure, which is used to arrive at a final settlement.

2.27 The rate of 'substantive' error found by the Court in the Structural Funds was substantially higher than in the Budget as a whole and, on the basis of figures provided by the Commission, represented well over half the financial error found across the Budget. As in previous years, most of these errors were the result of

5 Arable Area Payments Scheme (HC 223, 1998-99).

6 The European Regional Development Fund, the European Social Fund, the 'Guidance' section of the European Agricultural Guidance and Guarantee Fund, and the Financial Instrument for Fisheries Guidance.

Member States claiming advances of Community funding on the basis of declarations from final beneficiaries which included items ineligible for Community funding or which in some other way failed to comply with the conditions governing the scheme.

2.28 The Court considered that the level of anomalies in expenditure declarations was too high. It recognised however that errors in expenditure declarations submitted by Member States to claim a further advance of funding did not necessarily mean that the payments ultimately made under the scheme were incorrect. This was because even after deducting ineligible items of expenditure, the level of eligible expenditure may still have justified the payment of the advance requested. Furthermore, at the end of the programmes the errors might have been detected and corrected before any final settlements were calculated and payments made. However the Court's work also indicated that the control procedures applied when programmes were closed were ineffective as a means of identifying and correcting earlier errors.

2.29 The 'formal' errors found by the Court arose mainly from weaknesses in Member States. They included inadequate documentation to support the expenditure declared, accounting systems that did not separately identify Community funds, unsatisfactory tendering procedures and long delays in making payments to beneficiaries. The Court's work also reaffirmed previously found weaknesses in the arrangements for planning, controlling and accounting for Structural Fund programmes.

2.30 While stressing that responsibility for controlling co-financed operations (that is most Structural Fund schemes) lay primarily with Member States, the Commission confirmed that it would continue its efforts to improve the financial management of the Structural Funds. It was working increasingly closely with authorities in Member States, including co-ordinating audits and sharing reports. The Commission had also distributed to Member States its audit manual, which set out a methodology for auditing management and control systems for the Structural Funds.

2.31 The Commission was confident that the measures introduced over the last two years (Figure 6) would lead to a reduction in the number of errors, by clarifying eligibility definitions, strengthening controls in Member States and improving procedures for the closure of programmes. Most of the payments examined by the Court for the 1998 Statement of Assurance had been made in respect of programmes that pre-dated the implementation of these initiatives. The

Commission considered that the measures had begun to have a positive effect and expected their impact to be fully felt when programmes from the 1994 to 1999 programming period were closed from 2000 onwards.

Measures designed to improve the financial management and control of the Structural Funds

Figure 6

- **Eligibility of expenditure** – following a decision in April 1997, the Commission introduced 'eligibility datasheets' to clarify the criteria for funding and to help Member States evaluate the eligibility of projects for Community funding.
- **National systems of control** – in October 1997, the Commission issued a new regulation aimed at strengthening arrangements for the financial control by Member States of operations co-financed by the Structural Funds. The regulation set out minimum control requirements and required Member States to establish a satisfactory audit trail and present an independent declaration at the end of each programme certifying the validity of the claim before the final payment is made.
- **Financial corrections** – also in October 1997, the Commission adopted a set of internal guidelines on making financial corrections and recovering funds shown to have been misused.
- **Financial arrangements** – in June 1999, the Commission introduced a regulation which is designed to make financial procedures simpler and more transparent, for example by providing for expenditure to be declared at final beneficiary (rather than Member State) level.
- **Closure of programmes** – following a Special Report by the Court in 1998, the Commission introduced detailed guidelines in September 1999 aimed at accelerating the closure of programmes.

2.32 The Court told us that progress to date in improving financial management and control of the Structural Funds had been modest. It considered that further changes might be needed to secure a reduction in the extent of error. Such measures could include the simplification of regulations, the development of a standard reporting package to help final beneficiaries to complete their claims correctly, and the introduction of clear sanctions, linked to recoveries, to discourage final beneficiaries in Member States from inflating claims.

Findings in the United Kingdom

2.33 Most of the Structural Fund transactions examined by the Court in the United Kingdom for the 1998 Statement of Assurance related to payments from the European Social Fund to higher or further education colleges. Over half of these payments were affected by 'substantive' errors, such as the inclusion of ineligible costs and students, and the use of estimated rather than actual teaching hours and attendance rates. Particular problems were caused by a system used by some colleges to calculate overhead costs.

2.34 Officials from the European Social Fund Unit of the Department for Education and Employment visited the Court in September 1999 to discuss the issues in more detail. The Department is to carry out similar checks at other colleges and make changes to address the Court's findings, including no longer using the problematic overhead costing system. The Commission has recognised that there are particular problems with the charging of overhead costs to Social Fund projects and intends to draw up an 'eligibility datasheet' to clarify the eligibility of costs in this area.

2.35 We have identified the Structural Funds as an area of high risk and in recent years our work has uncovered problems, in particular concerning the European Social Fund. In 1998 the Comptroller and Auditor General reported on the Department for Education and Employment's Programmes and Central Services Account for 1996-97[7], referring to problems with training schemes administered by Training and Enterprise Councils which are in part funded by the Social Fund. Our audit had found an increase in the amount of incorrect or uncertain payments, resulting for example from claims not being properly supported by evidence or including ineligible items.

Errors in payments relating to external action

2.36 The Community is a major aid donor, providing funding for humanitarian and food aid and support for developing countries across the world. In 1998 expenditure on external action represented five per cent of the Community General Budget (4.1 billion ECU (£2.9 billion)).

2.37 The Court found a low incidence of 'substantive' error in aid payments, but numerous 'formal' errors. There were particular problems with the procedures for awarding contracts and the supporting documentation. For example, for the PHARE[8] programme, the criteria actually used to evaluate tenders were sometimes different to those that had been notified to applicants. The Commission accepted that there had been problems with tendering arrangements but expected improvements to result from the introduction of the new joint management service, which had assumed responsibility for contracting and financial matters from September 1998. The Commission had sought to harmonise contract procedures to make them simpler and more transparent. However some changes would depend on revising the Financial Regulation.

7 Appropriation Accounts 1996-97, HC 251-IX.

8 Programme of economic reconstruction aid for Central and East European Countries.

Errors in payments relating to internal policies

2.38 The largest area of expenditure which is managed directly by the Commission is known as 'internal policies', two-thirds of which is funding for research and development. In 1998 spending on internal policies represented six per cent of the Community General Budget (4.9 billion ECU (£3.4 billion)).

2.39 The Court found a particularly high incidence of error in this area. Overall half of the payments examined were affected by errors. Around a third were affected by 'substantive' errors, often the inclusion of ineligible costs. The Court also found 'formal' errors in a fifth of the payments examined, mainly where the Commission had made no formal decision to fund projects.

2.40 The Court found particular problems with declarations of expenditure especially for research projects, with errors and inaccuracies (including deliberate overcharging) in almost two-thirds of declarations. On average, costs had been inflated by a third. The Court considered that the errors were largely caused by contractors incorrectly interpreting the eligibility of overhead costs, coupled with insufficient control by the Commission and the absence of contractually defined penalties in cases of overcharging. The Commission noted that it routinely checked a significant sample of contracts and that it intended to increase its audits. It would continue to seek to clarify the eligibility of costs to reduce the risk of overcharging.

Errors in payments relating to administrative expenditure

2.41 In 1998 administrative expenditure, mainly for the five Community Institutions, represented five per cent of the Community General Budget (4.2 billion ECU (£3.0 billion)). The cost of running the Commission accounted for over two-thirds of the total. The Court found a very low incidence of error in this area.

The National Audit Office's conclusions

2.42 In relation to the Court's Statement of Assurance for 1998, we conclude that:

- the Statement of Assurance provides a valuable assessment of the management of the Community Budget as a whole, and the increasingly sectoral approach that the Court is adopting is beginning to provide useful additional information about the position on particular categories of expenditure. The Court told us that producing separate opinions on different areas of the Budget would require substantial additional work. However we consider that there would be considerable value in moving in this direction and we urge the United Kingdom Government to support the further extension of this work;

- as in previous years, the qualifications to the Court's opinion on the reliability of the accounts are a matter for concern. This emphasises the importance of putting in place clear accounting policies, which are then consistently applied, to improve the reliability of the accounts. As changes to the Financial Regulation are not expected to take effect for at least two years, it is important for the Commission to make what improvements it can in the meantime;

- it is a matter of serious concern that the high level of 'substantive' errors found by the Court meant that it was unable to provide positive assurance on the transactions underlying payments for the fifth year in succession. The Commission and Member States need to act urgently to reduce the rate of error, in particular in expenditure on the Structural Funds and internal policies (mostly research and development) where the highest rates of error were found. Providing the Commission and Member States with more detailed information on error rates would help to highlight more clearly the scale of the problems and the progress being made to address them;

- many of the errors found by the Court relate to errors made in claims by final beneficiaries, which make them particularly difficult to tackle. It is far from clear that the Court will be able to provide assurance until there is substantial simplification of the schemes concerned. The moves already being made to simplify Common Agricultural Policy and Structural Fund schemes should play a key role in reducing the extent of errors, and further simplification in the future would be desirable;

- the high rate of error found by the Court in European Social Fund payment claims by applicants in the United Kingdom is a cause for concern. We welcome the action that has already been taken by the Department for Education and Employment to address the problems and recommend that it continues its efforts in this area.

Part 3: Other findings on the management of the Community Budget

3.1 As well as its work on the Statement of Assurance, the Court's Annual Report also included wider issues relating to the efficiency and effectiveness of the revenue and spending programmes of the Community. Given the size and complexity of the Community General Budget, the Court is not able to examine all aspects of each sector every year. Instead, it selects topics for examination on the basis of the significance of the area, the amount of money involved, the perceived risks, the political interest and the results of previous audit work. The Court's work in 1998 placed particular emphasis on following up findings from earlier reports. The Court publishes its detailed audit results on specific topics in Special Reports. In 1999 it published four Special Reports (see Appendix 3), compared with 23 in 1998.

3.2 The Commission also publishes information on the management of the Community Budget in its annual report on 'Protecting the Communities' Financial Interests and the Fight Against Fraud'. The report includes details of cases of irregularity the Commission and Member States have detected.

3.3 This part of the report:

- draws on the Court's Annual Report and Special Reports to set out the general themes and summarise the findings in two key categories of Community expenditure – the Common Agricultural Policy and the Structural Funds;

- outlines the key points from the Commission's report on irregularity and fraud within the Community and sets out how the Commission is seeking to tackle fraud and irregularity.

3.4 In its Annual Report for 1998, the Court drew attention to the need for fundamental improvements in internal control and called on the Commission to accelerate and deepen the financial management reform process. Specifically, the Court recommended that the Commission should:

- reform its financial control arrangements to enhance accountability by making managers within operational departments fully responsible for expenditure decisions;

- ensure that operational departments do not accept additional responsibilities without sufficient resources being made available for their proper discharge;

- greatly strengthen the internal audit function;

- strengthen accounting systems to improve the accuracy and presentation of financial information;

- set clear measurable objectives for programmes and performance targets that focus on outputs, outcomes and the costs involved in achieving them.

3.5 We endorse these recommendations which appear fully consistent with the problems reported in the Court's reports and the recommendations made in August 1999 by the United Kingdom Committee of Public Accounts (see Part 4).

The Court's examination of the Common Agricultural Policy

3.6 The objectives of the Common Agricultural Policy were set by the Treaty which established the European Community. They are: to increase productivity; to ensure a fair standard of living for the agricultural community; to stabilise markets; to guarantee security of supply; and to ensure reasonable consumer prices. Expenditure on the Common Agricultural Policy in 1998 totalled 38.8 billion ECU (£27.4 billion). The Court's most important findings from its examination of the Common Agricultural Policy in 1998 related to:

- skimmed milk and skimmed milk powder;

- the effects of reform in the cereals sector;

- fruit and vegetables.

Skimmed milk and skimmed milk powder

3.7 Skimmed milk is produced during the process of defatting whole milk to obtain cream. It is used either in liquid form or dehydrated to make skimmed milk powder. The European Union produces some 1.2 million tons of skimmed milk powder each year, nearly 40 per cent of world production. Just over a third is sold without subsidy. The rest is exported with refunds financed from the Community

Budget, or sold or taken into public storage for disposal within the European Union, for example as animal feed. In 1997 subsidy payments on export refunds totalled 171 million ECU (£114 million), on the use of skimmed milk and skimmed milk powder for animal feed 386 million ECU (£257 million), and on public storage 30 million ECU (£20 million).

3.8 The Court found that the regulations did not determine clearly the quality of skimmed milk powder which was eligible for aid. To avoid aid being paid for low grade, non-marketable powder, it recommended that there should be minimum quality standards, in particular with reference to protein content. The Commission agreed that aid should be linked more closely to the quality of skimmed milk powder.

3.9 The Court also concluded that the level of aid might be unnecessarily high. The level had remained unchanged since 1993 and had not been adjusted to take account of changes in market conditions and rising stocks. The Court found that the use of skimmed milk powder for animal feed was reducing, partly as a result of competition from cheaper alternatives, and as a result the size of intervention stocks had increased considerably in recent years. The Court recommended that a tendering procedure should be introduced to provide assurance that the subsidy was set at an appropriate level. The Commission's response was that it considered that aid was set at an appropriate level and that a tendering procedure would not be beneficial. The Commission noted, however, that it had submitted a proposal for a new regulation on the common market organisation for milk and milk products, with the aim of simplifying the existing legislation.

Effects of reform in the cereals sector

3.10 Cereals occupy around a quarter of the Community's agricultural area, with production totalling 200 million tons each year. Expenditure on cereals accounted for 14 billion ECU (£9.3 billion) in 1997, a third of the Common Agricultural Policy budget. The Court evaluated the results of the 1992 'MacSharry reform'[9], which was directed mainly at the cereals sector. The aim of the reform was to make cereals grown within the Community more competitive. This was to be achieved largely through a drastic cut in intervention prices, with farmers being compensated for the income losses caused by the reduction in prices. Lower prices were expected to discourage production and the stockpiling of cereals.

9 Ray MacSharry was the Commissioner responsible for agriculture at the time of the reform.

3.11 Overall, the Court concluded that the reform had brought improvements but that further measures were needed. It found that during the first years of the reform Community and international prices converged and the reform achieved its objective of making European cereals more competitive. Production remained at the pre-reform level, intervention storage was reduced, and more then half of exports were achieved without export refunds. However, from 1996 a sharp fall in international prices, coupled with stable Community prices, had led to a rise in production and the build-up of intervention stocks. The Court concluded that this situation could not be sustained in the long term.

3.12 The Court found that, as a result of the fall in market prices, farmers had been overcompensated for their income losses. Between 1993 and 1997 the amount of aid paid exceeded losses by more than 13 billion ECU (over £8 billion), because the regulation did not provide for aid rates to be adjusted to reflect changes in market prices. The Court also found that larger farms received more aid and recommended that, in order to improve the position of small farmers, there should be a ceiling on the amount of aid paid to individual farms. More generally, the Court recommended that the Commission should review the current system of aid based mainly on yield and farm area, and consider the possibility of setting standard net incomes for farmers.

3.13 In its response, the Commission acknowledged that cereal growers had been overcompensated. In 1996 it had proposed to reduce the compensation paid to farmers but neither the Council nor the Parliament had endorsed the proposal. The Commission therefore recognised the need to build on the reform and noted that there were to be further price cuts to enhance competitiveness. In March 1999 the Berlin European Council concluded that prices should be reduced by a total of 15 per cent in 2000-01 and 2001-02. And the Agenda 2000 proposals would address the issue to some extent by offering farmers only partial compensation for the planned price cuts.

Fruit and vegetables

3.14 Fruit and vegetables account for just under five per cent of annual expenditure under the Common Agricultural Policy. The sector is governed by two common market organisations, whose objective is to achieve a balance between supply and demand at prices that are fair to both producers and consumers. The Court previously reviewed the fruit and vegetables market in 1994 and recommended improvements to the operation of producer organisations, which aim to strengthen the position of their members in the market, market produce, organise withdrawals and act as a channel for Community aid. In 1998 the Court followed up its earlier work to examine the extent to which reforms implemented in 1997 addressed its previous findings. The Court considered that the reforms had been a move in the right direction, but concluded that it would be premature to draw definitive conclusions on the success or otherwise of the reforms at this stage.

The Court's examination of the Structural Funds

3.15 The four Structural Funds (Figure 7) aim to promote economic and social cohesion by providing financial assistance to the less developed regions of the European Union. In 1998 expenditure on the Structural Funds (plus other structural measures) totalled 28.4 billion ECU (£20.0 billion).

The Structural Funds

Figure 7

The **European Regional Development Fund** provides grants for projects to develop declining industrial regions and other undeveloped regions; expenditure of 11.8 billion ECU (£8.3 billion) in 1998.

The **European Social Fund** is designed to improve employment opportunities in Member States by providing financial support for vocational training and job creation measures; expenditure of 7.6 billion ECU (£5.4 billion) in 1998.

The Guidance section of the **European Agricultural Guidance and Guarantee Fund** is designed to provide financial assistance for measures to reform farm structures and develop rural areas, with the aim of improving the viability of individual farm holdings; expenditure of 3.5 billion ECU (£2.5 billion) in 1998.

The **Financial Instrument for Fisheries Guidance** is designed to control fishing and provide investment aid for the processing and marketing of fisheries and aquaculture products; expenditure of 400 million ECU (£288 million) in 1998.

3.16 In general the Court recognised and supported the initiatives taken by the Commission to improve financial management and control of the Structural Funds. However the measures had not taken effect at the time of the Court's work. As well as the problems relating to the Statement of Assurance (paragraphs 2.26 to 2.35), the Court highlighted weaknesses in a number of other areas including:

- closure of programmes;
- management of programmes;
- evaluation of the effect on employment.

Closure of programmes

3.17 All expenditure declared under Structural Fund programmes should be verified when programmes are closed. The Court found that at the end of 1998 a considerable number of programmes from the 1989 to 1993 programming period had not been closed, including 261 Regional Development Fund programmes which had received payments of nearly 1.4 billion ECU (£956 million). Closure procedures for the Social Fund were more advanced but there were still 94 programmes outstanding with payments of 360 million ECU (£254 million). The Court also found that there were Regional Development Fund measures of 519 million ECU (£366 million) outstanding from the period before 1989. The Commission expected to be able to close most of these programmes during 1999.

3.18 The Court noted that, except where extensions to the timetable had been granted, claims for the 1989 to 1993 programming period were supposed to have been settled by the end of August 1996. Although the number of outstanding programmes was declining gradually, the Court concluded that the Commission and Member States would need to make considerable efforts to complete closure before the start of the next (2000 to 2006) programming period.

3.19 The Commission noted that it would continue to strive to progress the closure of programmes – on average it was closing 180 a year. It highlighted a range of factors which could delay closure, such as incomplete supporting documentation from Member States or inconsistencies between, for example, a programme's final statement of expenditure and implementation report. There were also occasions where because of legal investigations projects were suspended and not closed.

Management of programmes

3.20 The Court highlighted a range of weaknesses in the systems for administering programmes, including:

- the Commission and Member States should clarify the criteria used for selecting programmes to be co-financed by the Structural Funds;

- the decentralised approach of managing programmes meant that the Commission was often unaware of how aid was used at national and regional levels;

- procedures for ensuring that activities financed by the Structural Funds conform with Community policies have proved ineffective;
- the Commission and Member States lacked the data needed to enable them to monitor and evaluate different projects, and to compare their impact in terms of structural development;
- the benefits of the assessments carried out part-way through programmes were limited because of a lack of practical suggestions for improvements that could be taken on board during the programming period;
- the indicators used to assess results and measure progress in achieving objectives were inadequate to evaluate the impact and effectiveness of Structural Fund measures.

3.21 In its response, the Commission highlighted new Structural Fund rules which it expected would address many of the points raised by the Court. The rules set out the content of monitoring and evaluation activities, and the respective roles of the Commission and Member States. The Commission also noted that it was taking action to improve Member States' monitoring systems and encourage them to quantify indicators and targets.

Effect on employment

3.22 Structural Fund measures (such as vocational training or support for specific groups like the long term unemployed) are intended to have a positive effect on employment and the job market. The Court found that methods of forecasting the effect of structural programmes on employment varied considerably, even within the same Fund or Member State. It considered that the value of the forecasts was undermined due to questions about the accuracy and reliability of the underlying data.

3.23 The Court also concluded that inadequate consideration was given to the indirect effects of structural measures (such as the relocation of jobs from one region to another) and to whether jobs were created or safeguarded on a temporary or permanent basis. The Court recommended that the Commission should always seek to assess the overall effect on employment and identify the specific impact of Community financed measures. The Commission acknowledged that, despite some progress in assessing the effect of structural measures, the quality of forecasts was variable. It was examining the approaches of different Member States, with a view to harmonising concepts and methodologies.

Fraud and irregularity

The Commission's findings

3.24 Irregularity, including fraud, generally results in a loss to the Community General Budget. Broadly the distinction between fraud and irregularity is that fraud is an intentional act and a criminal offence, whereas irregularity is any infringement of Community law resulting from an act or omission. The true scale of irregularity affecting Community programmes is not known, but each year the Commission publishes information about the irregularities it and Member States have detected[10].

3.25 In 1998 Member States notified the Commission of just over 5,000 cases of irregularity, involving 577 million ECU (£407 million). The number of cases and amounts of money involved were very similar to those in 1997. Over 90 per cent of the cases concerned either Community revenue or Common Agricultural Policy expenditure (Figure 8). The Commission estimated that around one in five cases involved suspicion of fraud. It concluded that organised crime was defrauding the Community General Budget, in particular in lucrative areas such as cigarettes, alcohol and olive oil where there was considerable scope for illicit profit.

Figure 8

Cases of irregularity notified to the Commission by Member States in 1998

Area of the Budget	Number of cases	Amounts involved (million ECU)
Revenue from customs and agricultural duties, and sugar levies	2,272	249
Common Agricultural Policy expenditure	2,412	285
Structural Fund expenditure	407	43

Source: Data from Protecting the Communities' Financial Interests and the Fight Against Fraud - Annual Report 1998.

10 Protecting the Communities' Financial Interests and the Fight Against Fraud – Annual Report.

3.26 As well as cases reported by Member States, the Commission's anti-fraud unit opened over 200 new investigations in 1998, generally on suspicion of fraud or other illegal activity either in Member States or within the Commission itself. The amount involved in these cases, plus others from previous years, was 442 million ECU (£312 million). Examples of cases of irregularity investigated by the Commission during 1998 are shown in Figure 9.

Figure 9

Examples of fraud and irregularity investigated by the Commission in 1998

- **Cigarette smuggling in Andorra**

  In recent years Andorra was identified as a major source of cigarette smuggling into the European Union, at an estimated cost to the Community and national authorities of some 400 million ECU (£282 million) a year in lost revenue. Inquiries by the Commission and national authorities revealed that Andorra lacked appropriate legislation to prevent and combat fraud. In 1998 Commission officials visited Andorra and found that the Andorran Government had taken action to improve fraud prevention, including enacting legislation to combat smuggling and implementing the mutual assistance protocol on customs matters between the Community and Andorra.

- **Exports of meat to Jordan**

  Analysis showed that an increase in exports of beef and veal to Jordan was not related to local consumption. Inquiries by the Commission in 1998 revealed that large quantities of meat cleared through Jordanian customs were not intended for domestic consumption. In most of the transactions examined, the final destination of the meat was Iraq. To circumvent the trade embargo, the operators involved were pretending to clear the goods through Jordanian customs and using forged or incomplete documentation to obtain export refunds totalling some 65 million ECU (£46 million).

- **Contract for guarding Commission buildings**

  The Commission's anti-fraud unit investigated allegations of improper personal involvement in the award of the contract worth 80 million ECU (£56 million) for guarding the Commission's buildings between 1992 and 1997. The investigation found that there had been irregularities in processing tenders and in drafting and implementing the contract. The Commission's findings were passed to the Public Prosecutor of Brussels, who in 1999 began a judicial investigation to establish any personal liability in the Commission or the company concerned. The Commission also initiated disciplinary proceedings against four officials.

Findings relating to the United Kingdom

3.27 In 1998 the United Kingdom notified the Commission of a total of 857 cases of irregularity involving 140 million ECU (£99 million), the bulk of which was detected in Community revenue. In its report on irregularity and fraud, the Commission highlighted particular problems with the funding of colleges in the United Kingdom by the European Social Fund. With the help of the national authorities, the Commission carried out investigations at a further education college which had received funding of over two million ECU between 1994 and

1996. The Commission found that European funds had been improperly used in that there was nothing to distinguish either the courses or students financed by the Social Fund from the normal activities of the college.

3.28 In the light of these findings, the Commission instigated proceedings to recover some of the European funding received by the college and asked the United Kingdom to review its procedures for approving projects. During 1999 colleges were issued with enhanced guidance on European funding. The Department for Education and Employment is now working with consultants to produce standard systems for applicants to use to record European Social Fund expenditure. These systems will apply when the new programmes are introduced in mid-2000.

Tackling fraud and irregularity

3.29 Following considerable pressure from Member States and the European Parliament for reform of anti-fraud systems within the European Union, the Commission established a new European Anti-Fraud Office in June 1999. The new Office (known by its French acronym OLAF[11]) will have more staff than its predecessor and is operationally independent, although for some tasks, such as the development of anti-fraud legislation, it remains an integral part of the Commission. The Office carries out investigations in Member States and the Commission, and since May 1999 has been able also to undertake investigations within other Community Institutions and bodies. The Office does not have the power to conduct criminal investigations and prosecutions which remain the responsibility of Member States.

3.30 A large proportion of the frauds detected in recent years has been the result of large-scale organised crime across national borders. Many of the initiatives to deal more effectively with fraud have therefore been directed at harmonising national criminal laws and penalties, and enhancing co-operation between judicial authorities in Member States. The Council adopted a convention on the protection of the European Community's financial interests in July 1995, and two protocols to the convention in September 1996 and June 1997. The convention specifies minimum rules that Member States should incorporate into their criminal law to deal with fraud against the Community General Budget. It also requires all Member States to ensure that such frauds are punishable with imprisonment and that offenders are extraditable. The convention and protocols only enter into force once ratified by all Member States. In September 1999 the United Kingdom became the sixth Member State[12] to ratify the convention.

11 Office européen de lutte antifraude.

12 Other countries who have ratified the convention are Germany, Austria, Spain, Finland and Sweden.

The National Audit Office's conclusions

3.31 In relation to the above findings on the management of the Community Budget, we conclude that:

- it is important that the Commission takes full account of the recommendations of the Court relating to fundamental improvements in financial control and accountability, as part of the ongoing reform process;

- in the light of the Court's findings on the failure to adapt the skimmed milk scheme to take account of market changes and on the overcompensation of farmers in the cereals sector, we urge the United Kingdom Government to press the Commission, Council and Parliament to work together to ensure that schemes achieve their objectives efficiently and effectively;

- on the Structural Funds, the Commission and Member States need to take action to close programmes which are still outstanding from the 1989 to 1993 period and to strengthen procedures to ensure that similar delays do not occur when programmes from the 1994 to 1999 period come to be closed;

- the Commission and Member States need to work together and share information about Structural Fund programmes, with the aim of identifying good practice in terms of selecting and monitoring projects, and assessing their impact on structural development and employment;

- the Commission needs to design and simplify schemes to minimise the risk of fraud and irregularity, and we urge the United Kingdom Government to press the Commission to make rapid progress in this regard;

- where fraud is suspected, the new European Anti-Fraud Office and authorities in Member States need to work constructively together to undertake quick and effective investigations.

Part 4: Reform of financial management and control in the European Commission

4.1 Parts 2 and 3 of this report largely focussed on the European Court of Auditors' Annual Report which covered financial management of the Community Budget in 1998. However since then there have been major developments in relation to the financial management of Community funds, including the resignation of all 20 Commissioners in March 1999. This part of the report:

- summarises the events that led to the resignation of the Commission;
- sets out proposals from the United Kingdom Committee of Public Accounts and the Committee of Independent Experts for reform of financial management and control;
- outlines the action being taken by the Commission and the United Kingdom Government to strengthen financial management.

Resignation of the European Commission

Refusal to discharge the 1996 Budget

4.2 In early 1998, following hearings which involved the Commission and the Court of Auditors, the European Parliament's Committee on Budgetary Control recommended that discharge for the 1996 Budget should be delayed. In the Committee's view, the Commission had not responded adequately to its recommendations on the tourism budget and there were continuing problems in a number of areas, including the European Community Humanitarian Office (ECHO), regional aid for small and medium sized enterprises, and grants to agricultural producers. Throughout 1998, the Committee on Budgetary Control followed up its specific concerns with hearings on individual items of expenditure. In November 1998 the Committee voted narrowly to recommend discharge. The recommendation called on the Commission to establish a new independent anti-fraud office, to review its disciplinary procedures, to prepare a draft code of conduct for the appointment of senior officials, and to propose a revised Financial Regulation. However in December 1998, the Parliament returned the matter to the Committee for reconsideration.

4.3 In January 1999 the Parliament considered a motion of censure against the Commission. If it had been passed by a two-thirds majority, such a motion would have compelled the Commission to resign. Shortly before the debate, a member of the Commission's staff made allegations of fraud and corruption within certain of the Commission's programmes. These highly publicised allegations, together with other evidence found by the Commission itself, intensified the Parliament's concerns. After a debate lasting two days, the Parliament pulled back from censuring the Commission and voted instead to establish a Committee of Independent Experts to examine specific allegations of fraud and mismanagement within the Commission.

First report of the Committee of Independent Experts

4.4 The Committee of Independent Experts[13] was asked to examine the way in which the Commission detected and dealt with fraud, mismanagement and nepotism. Its investigations centred on programmes directly administered by the Commission, some of which were then or had been the subject of investigations by the Commission's Financial Control Directorate General and anti-fraud unit, the Court of Auditors and the Parliament's Committee on Budgetary Control.

4.5 The Committee reported in March 1999. Although it found no Commissioner directly or personally involved in fraudulent activities, the report concluded that there were instances where individual Commissioners, or the Commission as a whole, bore responsibility for instances of fraud, irregularity or mismanagement. The Committee noted that the fact that Commissioners were not aware that there were serious problems was tantamount to an admission of a loss of control over the administration they were running. The Committee also found one clear case of favouritism by a Commissioner in the appointment of staff.

13 The members of the Committee of Independent Experts were: André Middlehoek (Chair - Netherlands; former President of the European Court of Auditors); Pierre Lelong (France; Member of Cour des Comptes and former President of the European Court of Auditors); Walter Van Gerven (Belgium; former Advocate-General from the European Court of Justice); Inga-Britt Ahlenius (Sweden; former Auditor-General of the Swedish National Audit Office); and Juan Antonio Carrillo Salcedo (Spain; former Member of the European Court of Human Rights).

4.6 On the Commission's management of its own programmes, the Committee of Independent Experts identified five general concerns:

- a mismatch between resources and responsibilities – the Committee concluded that the problems found in each of the cases they investigated could be traced back to a mismatch between the objectives assigned to the Commission and the resources which the Commission had been able, or had chosen, to employ in order to achieve the objectives;

- a failure of control mechanisms – the Committee found that the internal control mechanisms within the Commission had failed to work effectively;

- inadequate anti-fraud mechanisms – the Committee considered that the position of the anti-fraud unit within the Commission was less than clear and that there appeared to be competition between the anti-fraud unit and internal audit;

- weaknesses in administrative and disciplinary procedures – the Committee warned against over-reliance on informal administrative inquiries, which it believed were often started too late, took too long to complete, and even acted as a deterrent to the opening of disciplinary proceedings;

- a lack of clear responsibility – the Committee concluded that the Commission did not have effective procedures for establishing individual responsibility for the irregularities and fraud perpetrated by its staff, and that overall it was difficult to find anyone with a sense of responsibility.

In the light of these criticisms, all 20 Commissioners resigned in March 1999.

Proposals for reform of financial management and control

4.7 Following the resignation of the Commission, a range of proposals aimed at improving standards of financial management and control within the European Union were put forward, in particular by the United Kingdom Committee of Public Accounts and by the Committee of Independent Experts.

Report by the Committee of Public Accounts

4.8 In April 1999 the United Kingdom Committee of Public Accounts undertook a fact-finding visit to the European Institutions responsible for the management and oversight of the European Budget, to discuss the efforts being made to combat fraud and tackle weaknesses in financial control and accountability. The Committee's report[14], published in August 1999, called for improvements in standards of financial management and accounting to reduce the levels of waste, error and fraud in the Community's expenditure programmes. The Committee identified five main issues which needed to be addressed.

- There was a lack of clarity about who is accountable to whom and for what. The Committee called for a much clearer definition of the respective responsibilities of Commissioners and Commission staff and argued that better quality and more timely financial information was needed if the Commission and Member States were to fulfil their roles effectively.

- There was a cultural emphasis on devising policy without regard to effective management. Policies were often adopted without identifying the value to be added or the resource implications, and the emphasis had been on drafting complex regulations rather than determining objectives and evaluating outcomes. The Commission needed to simplify regulations, and ensure that proper assessments of the likely costs and benefits of policies were undertaken and clear, measurable objectives set for all new programmes.

- Staffing codes were outdated and inhibited effective management. They failed to ensure the appointment or promotion of staff on merit or that staff had the right skills, particularly financial skills. The Committee recommended that the Commission needed to draw up new guidance that emphasised the proper conduct of public business. The procedures to protect whistleblowers were also inadequate and the Committee proposed that these should be strengthened.

- Financial reporting, audit and follow-up arrangements were inadequate. The methods of reporting did not provide a clear picture of the Community's financial position. The Commission had too often failed

14 Financial Management and Control in the European Union, Committee of Public Accounts Twenty-ninth Report (HC 690, 1998-99).

to act on audit reports from the Court and the arrangements for following up the implementation of audit recommendations had not been properly applied. The Committee recommended further improvement in the quality of information provided in the Community's financial statements and called on the Commission to improve its procedures for following up audit reports.

- The Community's arrangements for investigating and prosecuting fraud had not been effective. The Commission had failed to create a culture which was intolerant of fraud and irregularity. The Committee urged that there should be maximum transparency in the work of the new European Anti-Fraud Office, established in June 1999. The Committee recommended that the United Kingdom Government should encourage greater collaboration between prosecuting authorities in Member States and the Anti-Fraud Office.

Second report of the Committee of Independent Experts

4.9 The Committee of Independent Experts published its second report in September 1999. It had been asked by the European Parliament to examine:

- the existing procedures for the award by the Commission of financial contracts, and contracts to hire interim or temporary personnel;
- the procedures for looking into allegations of fraud, poor management and nepotism;
- the Commission's treatment of cases of fraud, poor management and nepotism involving its own personnel.

4.10 The Committee's report included 90 detailed recommendations for strengthening arrangements for tackling mismanagement, irregularity and fraud and for promoting a greater sense of personal responsibility and accountability. Key proposals included:

- Treaty changes to allow the President of the Commission to reshuffle or dismiss Commissioners;
- making Directors General responsible for all operational matters, including internal control;

- setting up a professional, independent internal audit service, reporting directly to the President of the Commission;
- establishing a Committee on Standards in Public Life to assist in drawing up more wide-ranging codes of conduct and monitoring their implementation;
- clear rules to provide better protection for whistleblowers who exposed corruption and mismanagement;
- strengthening arrangements for investigating allegations of fraud involving Community funds, including the appointment of a European Public Prosecutor.

Action by the Commission to improve financial management

4.11 At the Berlin European Council meeting in March 1999 the Heads of Government of the Member States agreed to nominate Romano Prodi, the former Prime Minister of Italy, as the new President of the Commission, and asked him to draw up plans for reforming the management of the Commission. The President appointed the Rt Hon Neil Kinnock[15] as Commission Vice-President with specific responsibility for reforming financial management and developing new procedures for accountability.

4.12 The reform process aims to introduce a culture of change within the Commission to increase efficiency, accountability and transparency. In July 1999 the President agreed a new code of conduct with prospective Commissioners. By setting limits to their outside activities and interests, the code aims to maintain the independence of Commissioners in the discharge of their duties. And in September 1999 Commissioners voluntarily renounced certain diplomatic privileges relating to exemption from Value Added Tax. Also in September 1999 the Commission announced changes in the rules for appointing senior officials, designed to ensure that merit and experience (rather than nationality) would be the critical considerations.

15 Neil Kinnock was the Commissioner for Transport from 1995 to 1999 and Leader of the Opposition in the United Kingdom between 1983 and 1992.

4.13 To take forward the reform process, in September 1999 Vice-President Kinnock established:

- a ten member Task Force for Administrative Reform to define the reform strategy and oversee the implementation of agreed measures;
- a reform group of eight Commissioners;
- a network of 'reform correspondents' within the Directorates General to act as 'coaches' for reform.

4.14 In March 2000 the Commission approved the strategy for reform and modernisation which had been developed by the Task Force for Administrative Reform[16]. The strategy sets out three specific areas for action:

- priority setting, allocation and efficient use of resources;
- human resources development;
- audit, financial management and control.

Further details of the proposals for reform are set out in Figure 10.

4.15 The package of reforms set out in the strategy is supported by a detailed action plan which includes implementation deadlines stretching until mid-2002. Some proposals can be implemented through changes to administrative procedures or organisational arrangements, and moves have begun to set some measures in train. In particular the Commission intends to set up the new Central Finance Service, Internal Audit Service and Audit Progress Committee by May 2000. However a number of key proposals will require substantial modification of the existing legal framework, including the Financial Regulation and staff regulations, and are expected to take some two years to implement.

16 Reforming the Commission – a White Paper (March 2000).

Proposals for reforming the European Commission

Figure 10

Priority setting, allocation and efficient use of resources

The strategy aims to implement management systems and procedures to enable strategic priorities and policy objectives to be defined and translated into operational activities, and to integrate decisions on priorities with the allocation of resources. Specific proposals include:

- the introduction of systematic strategic planning, including a system of activity based management to assist in setting priorities and matching resources to them, and in promoting performance management;
- the appointment of a senior official with responsibility for devising more efficient and performance oriented working methods, with simplified administrative procedures, clear job descriptions, better performance information, and specified targets;
- a better balance between internal and external management of activities to secure the most efficient and effective way of delivering programmes and to ensure that accountability is maintained where management is devolved.

Human resources development

The strategy sets out plans for a comprehensive overhaul of human resources policies aimed at allowing staff to fulfil their potential and managers to manage effectively. Specific proposals include:

- recruitment, promotion and career development based on merit, including the introduction of a staff appraisal system to assess performance and clear procedures for identifying and dealing with under-performing staff;
- better matching of staff to jobs through increased mobility and a less rigid career structure, and a greater emphasis on training to ensure that staff have the skills they need;
- defining explicitly the rights and obligations of staff and establishing clear rules for whistleblowers who report alleged wrongdoing;
- the creation of a European Committee on Standards in Public Life to supervise staff codes of conduct and provide advice on ethical standards in all the Community Institutions.

Audit, financial management and control

The proposals amount to a radical overhaul of financial management and control systems aimed at creating a culture that ensures that managers take responsibility for the quality, regularity and efficiency of their actions. Specific proposals include:

- making operational departments responsible for their own expenditure by replacing the present centralised checking of expenditure by the Financial Control Directorate General with systems of internal control integrated within departments;
- creating a new Central Finance Service under the responsibility of the Budget Commissioner, to define and monitor financial rules and procedures, provide advice to operational managers and manage common financial management information;
- setting up a professional Internal Audit Service under the responsibility of the Commission Vice-President for Reform, to examine internal control and management systems and to provide advice to management;
- establishing an Audit Progress Committee chaired by the Budget Commissioner, to consider the findings of the Internal Audit Service and European Court of Auditors, and monitor the implementation of audit recommendations.

Agenda 2000

4.16 As well as the new measures for administrative reform outlined above, the Commission has continued to press on with the Agenda 2000 Initiative which aims to establish a framework for strengthening and widening the European Union. At the Berlin European Council meeting in March 1999, Member States adopted the legislative proposals put forward by the Commission to implement the Agenda 2000 reforms, including:

- continuing agricultural reform with a view to stimulating European competitiveness, ensuring fair income for farmers, simplifying legislation and decentralising the application of legislation;
- increasing the effectiveness of the Structural Funds and the Cohesion Fund by concentrating projects on more specific objectives and in the areas of greatest need;
- strengthening the pre-accession strategy for applicant countries by setting up financial mechanisms to support improved transport and environmental protection infrastructures, and to facilitate the long-term adjustment of agriculture and the rural areas of the applicant countries;
- adopting a new financial framework for the period 2000 to 2006 to enable the Union to meet the main challenges of enlargement while ensuring budgetary discipline.

Action by the United Kingdom Government to improve financial management

4.17 The United Kingdom Government, which seeks to influence the Commission primarily through the Council of Ministers, has been supportive of the moves to improve financial management and control and reduce levels of fraud and irregularity. In a statement to the House of Commons in March 1999, the Prime Minister identified the appointment of a new President and Commission as an opportunity for fundamental reform. The United Kingdom circulated to the Commission and other Member States a paper setting out what it saw as the priorities for reform, including more efficient management and reform of pay and personnel policies. The Government has also offered the Commission practical help and guidance.

4.18 In its positive response[17] in November 1999 to the report by the Committee of Public Accounts, the Government agreed that improvements were needed in the culture governing European spending and expressed confidence that the reforms being developed by the Commission would address many of the concerns raised by the Committee. It expected the reforms would lead to better financial management and create a greater sense of accountability and responsibility. The Government would support moves to promote stronger accountability and better financial management and reporting, through the Council of Ministers and other Community links.

4.19 The United Kingdom formally responded to the Court's Annual Report for 1998 in February 2000, providing detailed comments on the Court's findings. The Government reiterated its commitment to working with the Commission to improve financial management, with better prevention, detection and correction of errors. The United Kingdom also set out its support for the simplification and clarification of regulations and for new regulations to be fraud-proofed.

The National Audit Office's conclusions

4.20 The events of 1999 provided an impetus for wide-ranging reform of financial management and control within the European Union. We support the objectives of the reform programme and conclude that:

- the United Kingdom Government, through the Council of Ministers and its other links with the Community, should continue to seize all opportunities to facilitate and support the far-reaching programme of reform to ensure that its impetus is maintained and improvements in financial management are secured;

- although the Commission does not expect the full impact of the reforms to be felt for another two or three years, it is important that some indication of improvements in financial management and control are evident before then;

- implementation of some of the reforms will require changes to the Financial Regulation. We urge the United Kingdom Government to press the Commission and the other Community Institutions to work together to ensure that legislative hurdles to implementing the reforms are overcome in a timely manner.

17 Treasury Minute on the Twenty-ninth Report from the Committee of Public Accounts 1998-99 (Cm 4471).

Appendix 1: Reports by the Comptroller and Auditor General on European matters since 1 May 1997

This appendix summarises the reports by the Comptroller and Auditor General on European matters which have been published since the beginning of the 1997-98 Parliamentary session.

Ministry of Agriculture, Fisheries and Food: The Sheep Annual Premium Scheme in England (HC 273, 1999-2000)

The Sheep Annual Premium Scheme forms part of the Common Agricultural Policy. It seeks to guarantee sheep and goat producers in the European Union a common level of support. Payments to farmers are funded initially by Member States and reimbursed by the Commission. In 1998-99 payments of £142 million were made to sheep farmers in England.

The report reviewed problems in the administration of the scheme in England which led to the Commission refusing to reimburse £27 million in respect of payments to farmers in England for 1993 to 1996. The report examined how the difficulty arose – mainly due to the timing and coverage of the Ministry's farm inspections – and the action the Ministry has since taken to tighten up its application of scheme controls. By 1998, we noted, the Commission indicated that controls were compliant in areas of previous weakness. We also reported on the conduct of farm inspections and checking of flock records, and found that in 1998 these and other checks by the Ministry's inspectors of 34,000 claims led to some 2,000 claims from farmers being reduced and 400 rejected because of irregularities. We recommended that it was important for the Ministry to ensure inspectors were consistent in their assessments. Comparisons on the conduct and costs of farm inspections in other Member States could be used to benchmark the Ministry's performance.

Audit of the General Budget of the European Union for 1997 and Related Developments (HC 279, 1998-99)

Following the refusal of the European Court of Auditors to give a positive Statement of Assurance on the Community's accounts for a fourth successive year, the report stressed the need for improvements in the quality of financial reporting by European Institutions. Greater co-operation was needed between the European

Commission and Member States, to ensure that risk analysis effectively targeted customs controls on the major threats facing the Community General Budget and that the system for Value Added Tax on trade between Members States was more resistant to fraud and irregularity. The report also looked at some of the steps being taken by the European Commission and Member States to improve financial management and tackle fraud and irregularity.

Ministry of Agriculture, Fisheries and Food: Arable Area Payments Scheme (HC 223, 1998-99)

Under the European Union's Arable Area Payments Scheme, farmers may claim payments based on the areas used for growing certain crops. Most claimants are required to 'set-aside' – that is, take out of use – a proportion of their claimed land. In 1997-98 the Ministry of Agriculture, Fisheries and Food spent some £1 billion on arable area payments to farmers in England.

The report reviewed the Ministry's effectiveness in processing claims, the steps taken to prevent and detect non-compliance with the rules of the scheme, and the management of set-aside and other aspects of the scheme in England. We concluded that there was a wide disparity in the apparent efficiency of the nine regional offices administering the scheme. We found that the Ministry's in-office checks on applications were appropriate and well-targeted, but recommended improvements in the management, conduct and timeliness of field inspections. The report also noted that the European Commission had the power to disallow expenditure under the scheme and recover funds from Member States if it was not satisfied that the administration of the scheme met compliance requirements. Judging by the relatively small level of disallowance, the Ministry had been largely successful in safeguarding funds on this scheme.

BSE: The Cost of a Crisis (HC 853, 1997-98)

We examined the schemes introduced by the Ministry of Agriculture, Fisheries and Food and the Intervention Board following a Ministerial statement in Parliament in March 1996 about possible links between Bovine Spongiform Encephalopathy (BSE) in cattle and a new variant of Creutzfeldt-Jakob Disease in humans. The report noted that the pressure on the Ministry and the Board to respond quickly to this catastrophe had been intense. Expenditure on BSE related schemes had amounted to some £2.5 billion in two years, with a further £1 billion expected to be spent between 1998 and 2000. Some 2.6 million cattle were slaughtered in the first 18 months of the schemes from March 1996.

The report concluded that the speed with which the Over Thirty Month Scheme became fully operational, the increase in the weekly slaughter rates, and the slaughter and disposal of about 1.35 million cattle by March 1997 were impressive results in the circumstances. However we also found that existing incineration capacity was insufficient to deal with the quantities of animals slaughtered. Consequently, the meat and bone meal from some slaughtered cattle might remain in storage for five years and the final 20 per cent reimbursement from the European Union would not become available until these stocks were incinerated.

The Annual Report of the European Court of Auditors for 1996 (HC 679, 1997-98)

The report noted that the European Court of Auditors had again refused to give a positive Statement of Assurance on the Community's accounts and that a number of serious weaknesses had been identified. Transactions examined by the Court indicated that the most likely level of error was 5.4 per cent of total expenditure or £3.1 billion. The Court found particular problems in the Structural Funds and in the systems for recovering customs and other duties payable to the Community.

The report drew attention to the need for improvements in financial reporting arrangements within the Community. We concluded that there was no room for complacency so far as fraud and irregularity in the spending of European Community funds was concerned, and noted that the United Kingdom's Presidency of the European Union provided a valuable opportunity for the Government to influence the way in which Community funds were managed.

Customs and Excise: Reform of Customs Transit in the European Community (HC 566, 1997-98)

Customs transit is a set of procedures which enable customs and excise duties and Value Added Tax on imported goods to be suspended until the goods reach either their point of destination within the Community or are exported out of the Community. From early 1995, the European Parliament, Commission and Court of Auditors became increasingly concerned about the level of customs transit fraud within the Community. As a result in December 1995, the European Parliament exercised for the first time its new power to examine 'alleged contraventions or maladministrations in the implementation of Community law', by setting up a temporary committee of inquiry to investigate the problems occurring in the transit system.

We followed up the European Parliament's conclusions by assessing their significance for the United Kingdom, and the extent to which HM Customs and Excise had been able to contribute towards the necessary improvements in transit arrangements. We found that weaknesses in the systems for customs transit had resulted in estimated losses to national and Community budgets of more than 1.27 billion ECU (equivalent to about £960 million) from 1990 to 1996. The report noted that although transit fraud was not as great a problem for the United Kingdom as for some other Member States, significant cases might still arise.

Inland Revenue: Exchange of Information on Direct Taxation within the European Union (HC 276, 1997-98)

The report found that the Inland Revenue's arrangements for exchanging information with national tax authorities in other Member States were generally successful. The study was undertaken in conjunction with 11 other national audit institutions within the European Union, which examined the extent to which their national tax authorities exchanged information on direct taxation under the provisions of the Directive on Mutual Assistance. The combined results of the examination were presented to the Presidents of the European Parliament, Commission and Court of Auditors in October 1997. A copy of the report was appended to the Comptroller and Auditor General's report.

We found that the volume of information exchanged by the Inland Revenue compared favourably with that of the 11 other national tax authorities covered by the examination. The report also noted that the Inland Revenue had been able to recover millions of pounds of unpaid tax, and in one case prove a fraud totalling £219 million.

Appropriation Accounts 1996-97: Class XIII, Vote 2: European Social Fund (Scotland) (HC 251–XIII, 1997-98)

During the statutory annual examination of the Appropriation Accounts, we found weaknesses in the financial control arrangements for the administration of expenditure by the Scottish Office Development Department on training projects targeted at the unemployed and young people in Scotland. This expenditure was funded by the European Commission through the European Social Fund, which for 1996-97 provided assistance of up to 55 per cent of eligible costs for some 1,500 projects sponsored by around 300 qualifying organisations. Total expenditure amounted to some £48 million. The report described several weaknesses together with the action being taken by the Department to address the matters raised.

Appropriation Account 1996-97: Class III, Vote 1: Intervention Board Executive Agency (HC 251–III, 1997-98)

The Intervention Board Executive Agency administers some 2.5 million transactions under the Common Agricultural Policy, mainly payments to traders. The Board's expenditure of £4.2 billion in 1996-97 was offset by £3.2 billion in European Community funding. The Comptroller and Auditor General qualified his opinion on the Appropriation Account for 1996-97 because the Board had been unable to complete essential reconciliations between certain account balances recorded in its general ledger and subsidiary accounting records. As a result, the books of account included transactions with a gross value of £23.7 million, and a further balance of £6.9 million in receipt suspense accounts, for which there were no satisfactory explanations. The report noted that the Board's reconciliation difficulties stemmed from problems that it had encountered when it implemented a new integrated accounting system in May 1996. By October 1997, most of the difficulties had been resolved.

Ministry of Agriculture, Fisheries and Food: Protecting Environmentally Sensitive Areas (HC 120, 1997-98)

Over the last 50 years, agricultural intensification has had a dramatic effect on the landscape and on plant and animal life. To counteract this trend, the European Union has taken measures to protect the environment and reduce incentives for intensive farming. All Member States are required to operate schemes to promote environmentally friendly agriculture. In England, one of the measures adopted by the Ministry of Agriculture, Fisheries and Food is the Environmentally Sensitive Areas Scheme. The scheme aims to encourage farmers to safeguard areas of the countryside where the landscape, wildlife or historic interest is of national importance. The Ministry recovers up to 50 per cent of the amounts paid to farmers from the European Union.

The report examined the operation of the scheme and its effectiveness in protecting environmentally sensitive areas. We found that the Ministry had in recent years considerably underspent its budget for the scheme. This had resulted from inaccuracies in forecasting in two areas, one of which was where the Ministry had taken a cautious view of the likely timing of an increase from 25 to 50 per cent in the level of European Union support. We also found that levels of compliance monitoring in the United Kingdom were considerably higher than those required by European Union regulations. The report recommended that the Ministry should adopt a risk-based approach to the selection of field inspections to allow checks to fall to the European Union minimum.

Appendix 2: The procedure for setting, controlling and accounting for the Community General Budget

1 The Comptroller and Auditor General's report on the Annual Report of the European Court of Auditors and the Statement of Assurance for 1995, published in March 1997 (HC 332, 1996-97), described in detail the respective roles of the different Community institutions in setting, controlling and accounting for the Community General Budget. This year's report provides a summary of that procedure, which is shown in Figure 11.

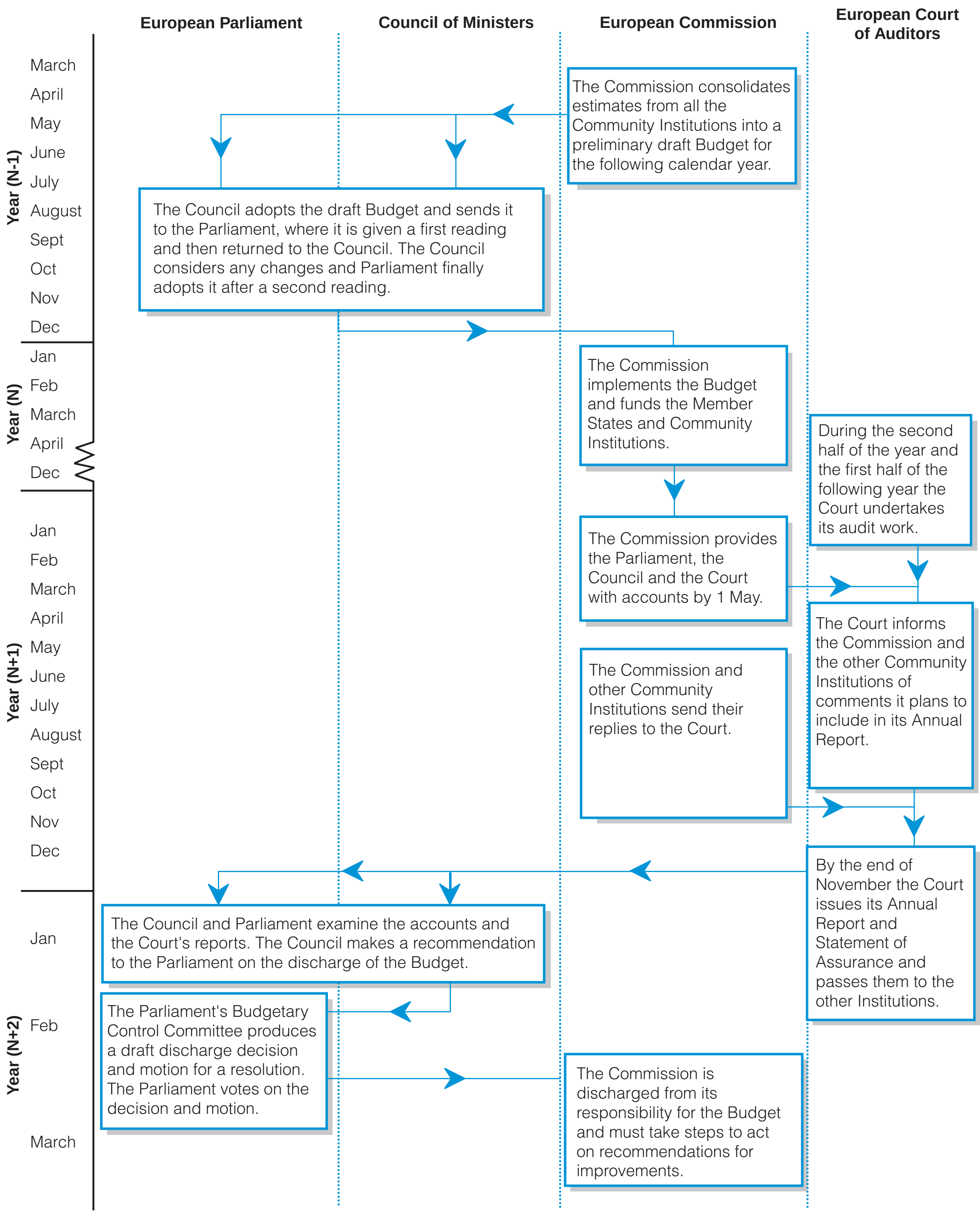
2 The Budget is set by a procedure involving the European Commission, the Council of Ministers and the European Parliament. The preliminary draft Budget is prepared by the Commission and presented to the Council which may make amendments, before establishing the draft Budget. The draft Budget is forwarded to the Parliament which can amend the Budget, although it has only limited powers of amendment in respect of 'compulsory' expenditure, which is necessary to fulfil the Treaty obligations of the European Union. Compulsory expenditure includes spending on the Common Agricultural Policy. Individual Member States influence the level of the Budget and their resulting contributions through their representatives on the Council. The budgetary framework is set by the 'financial perspective' laid down by the Council and by an inter-institutional agreement (between the Commission, Council and Parliament) on its implementation year by year.

3 Once adopted the Budget has the force of law and the Commission implements expenditure set out in the Budget under its own authority and in accordance with Financial Regulations approved by the Council. These regulations are intended to secure sound financial management and control of expenditure both within the Commission and in Member States, which administer around 85 per cent of expenditure.

4 Under its Rules of Procedure, the Parliament monitors the implementation of the Budget during the year. This is done through the 'Notenboom procedure' whereby the Commission is invited to comment on the level of implementation of individual appropriations in around September each year. Following a resolution by the Parliament, the 'Notenboom transfer' is made, through which the Commission adjusts the Budget with a view to maximising the effectiveness of appropriations. This procedure is also designed to inform the Parliament's discussions on the appropriations to be voted for the following year. Since 1987 the

Figure 11

Control of the Community General Budget



Commission has provided monthly data on the use of appropriations, as well as reports on agricultural spending. These are known as early warning reports and are designed to indicate whether spending is likely to exceed the appropriations provided. These mechanisms are an opportunity for the Commission to provide assurance to the Parliament that its wishes are being adhered to, or explain why variances have occurred.

5 By the beginning of May each year, the Commission is required to present to the Council, the Parliament and the Court of Auditors accounts of Community revenue and expenditure, and assets and liabilities, to show how the Budget for the previous year was implemented. The accounts form the basis for the Court's audit work in support of the Statement of Assurance. This, and other work by the Court on the income and expenditure of the Community during the previous year, is brought together when the Court reports in November.

6 The Court's Annual Report and Statement of Assurance are the starting point for the discharge procedure that completes the cycle of accountability for Community funds. In essence this requires the Council and the Parliament to give their opinion on the Commission's stewardship of Community funds, and then for the Parliament to decide whether formally to discharge the Commission from any further responsibility for the Budget.

7 The Parliament must decide by the end of the following April whether to discharge the Commission from any further responsibility for the Budget. This indicates acceptance that the Commission's stewardship of monies has been sound, expenditure lawful and regular, financial management effective, and appropriations utilised to further the objectives set when the Budget was adopted. The granting of discharge formally ends the budgetary process for a given year.

8 The Parliament can refuse to grant discharge if it is dissatisfied by the Commission's management of Community funds. Failure to give discharge is one of the strongest rebukes which the Parliament can give to the Commission and may precipitate a motion of censure. The Parliament can also postpone discharge until the Commission has taken action on key weaknesses identified by the Court of Auditors.

Appendix 3: Special Reports published by the European Court of Auditors in 1999

Special Report number	Subject covered
1/99	Aid for the use of skimmed milk and skimmed milk powder as animal feed
2/99	The effects of reform of the Common Agricultural Policy on the cereals sector
3/99	The management and control of interest-rate subsidies by the Commission
4/99	Financial aid to overseas countries and territories under the Sixth and Seventh European Development Funds