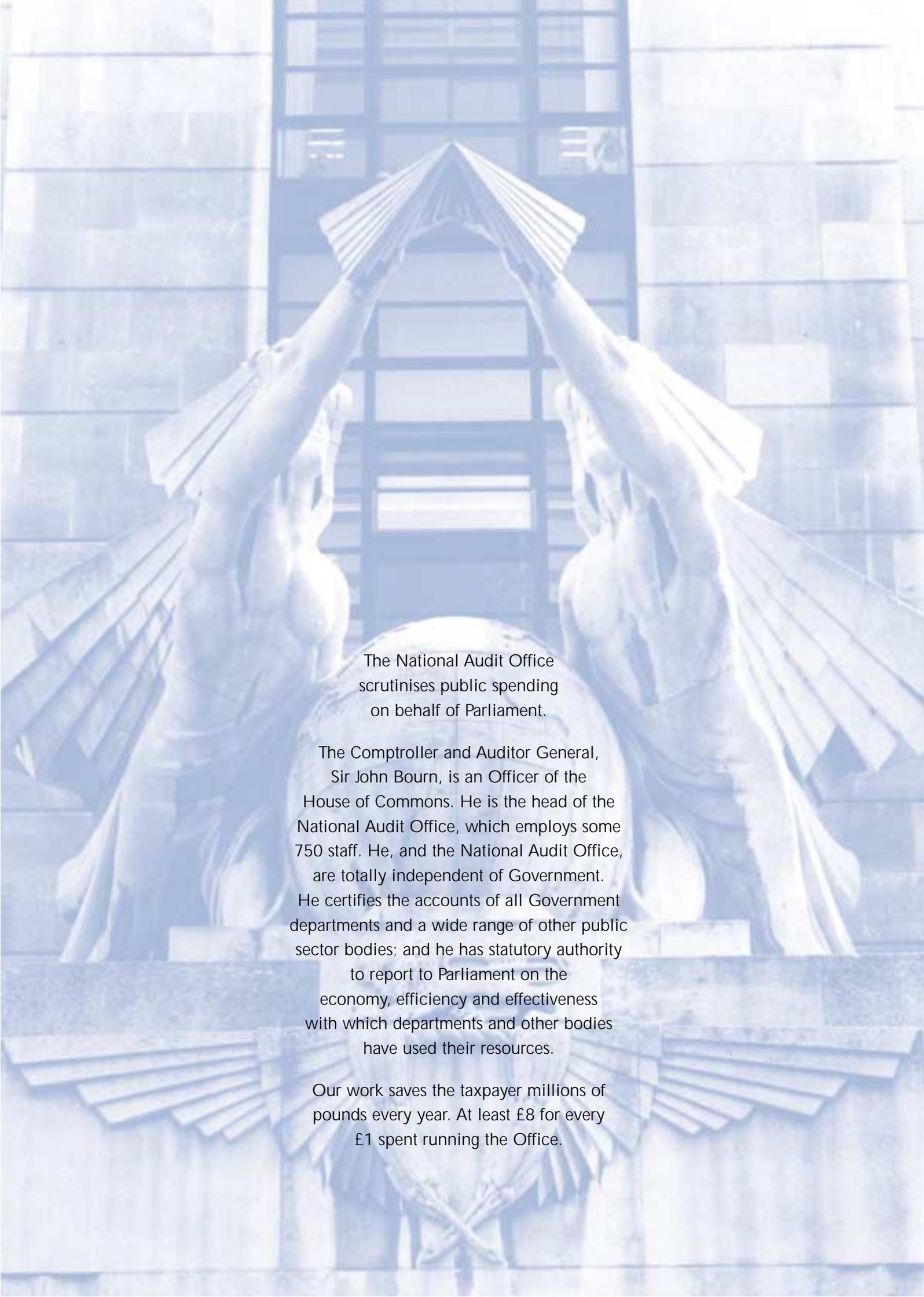


Financial Management of the European Union:  
**Annual Report of the European  
Court of Auditors for the year 2000**

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL  
HC 859 Session 2001-2002: 30 May 2002





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This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

*John Bourn*  
Comptroller and Auditor General

National Audit Office  
20 May 2002

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# executive summary

- 1 As in previous years, the National Audit Office has produced a report on the financial management of the European Union, drawing on the results of the audit by the European Court of Auditors (the Court) of the General Budget of the European Community<sup>1</sup>. This report summarises the findings in the Court's Annual Report for the financial year 2000 and draws on information provided by the European Commission on its reform strategy and the action being taken to tackle fraud and irregularity. The report also considers the implications of the forthcoming enlargement of the European Union.
- 2 In the year 2000, total actual outturn revenue in the Community General Budget was €92.7 billion (£57.9 billion)<sup>2</sup>. The European Commission has overall responsibility for implementing the Budget and drawing up the Community's accounts. But over 80 per cent of expenditure was managed by authorities within the 15 Member States of the European Union and in Third Countries. Great diversity was involved in terms of the administrative and accounting cultures, traditions and practices. The Commission was therefore dependent on the co-operation of the national authorities and other bodies involved, to fulfil its ultimate responsibilities for managing the budget.



- 3 The European Court of Auditors is required to provide the European Parliament and the Council with a Statement of Assurance concerning both the reliability of the accounts drawn up by the Commission and the legality and regularity of the underlying transactions. For the year 2000, the Court drew similar conclusions to previous years and for the seventh year in succession qualified its opinion on the reliability of the Community's accounts. The Court did, however, provide assurance on the legality and regularity of the transactions underlying revenue, commitments and administrative expenditure in the accounts, but declined to provide this assurance in respect of the other payments.

<sup>1</sup> *The European Community developed from the European Coal and Steel Community (ECSC) which was established in 1951; the European Economic Community (EEC) established in 1957 and the European Atomic Energy Community (Euratom), also established in 1957. In 1965 the Merger Treaty created a single set of institutions to run the three Communities and in 1992 the Treaty on European Union was signed in Maastricht and created the European Union, a concept comprising the European Communities in a political Union, and introducing the term European Community to refer to them.*

<sup>2</sup> A conversion rate of €0.6241 = £1 (the exchange rate as at 31st December 2000) has been used in this report.

- 4 For the year 2000, the Court endeavoured to provide more diversified information on the nature, location and causes of the problems affecting the management of the Community's funds and its Annual Report brought together all the principal findings and recommendations contained in Special Reports adopted by the Court during 2001, as well as the findings arising from its statement of assurance work.
- 5 The Court's report noted some positive developments. For the first time the Court gave positive assurance on the Community Institutions' administrative expenditure. It noted that improvements in the design of systems for managing and controlling expenditure on the Common Agricultural Policy had contributed to improved management of large amounts of EU funds. It also praised new developments in management of the structural funds that had helped the implementation of many urban developments throughout Europe.
- 6 But the Court noted that often major objectives behind Commission programmes and projects were not achieved. Objectives were often poorly defined and evaluation by the Commission of the achievement of objectives was inadequate. It also noted that whilst efforts had been made to simplify regulatory provisions and harmonise systems and procedures across Member States, there remain significant problems which prevented better management, reduction of administrative cost and the easing of the regulatory burden on final beneficiaries.
- 7 The Court found persistent weaknesses in checking by the Member States of Community operations in cases where programme management was shared with the Commission. The Court noted a continuing risk of dysfunction of control systems, particularly at the level of the final beneficiary of Community grants. It noted that improving the control arrangements in the Member States was central to ensuring the correct use of Community funds.
- 8 The Commission published a Reform Strategy in March 2000<sup>3</sup>, in the wake of the resignation of the previous Commission in March 1999 and the reports of the Committee of Independent Experts<sup>4</sup>. The Commission continued to implement the Reform Strategy throughout 2000 and 2001 and there is evidence that the Commission has made considerable progress in initiating

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<sup>3</sup> *Reforming the Commission - a White Paper (March 2000).*

<sup>4</sup> *The Committee of Independent Experts was established by the European Parliament and the Commission in January 1999 to examine the ways in which the Commission detected and dealt with fraud, mismanagement and nepotism. The Committee produced two reports, in March and September 1999.*

planned organisational changes, although two major areas of reform - amending the Financial Regulation and the Staff Regulations - remain to be completed. The Court intended to monitor the reform process in future audits. It considered that it would be premature to attempt any overall assessment of the process, given that changes in financial management and control had only recently taken effect and that decisions on aspects of staff management had yet to be reached. The Commission told us it felt it was too early to expect to see tangible impacts from the reform process.

- 9 More cases of suspected fraud or other irregularity were detected and reported by Member States to the Commission in 2000 than in the previous year. This does not necessarily mean that more fraud or other irregularity was occurring than previously; it could equally be due to more robust checking, better detection systems, and more diligent reporting by Member States. Different practices continue to exist between Member States in reporting fraud and irregularity to the Commission. The Court noted that robust working definitions, agreed and understood by all parties, needed to be established, in order to ensure suspected fraud and irregularity were reported on a common basis and to allow meaningful comparisons and trend analysis to be undertaken. The Court noted that the establishment of the new European Anti-fraud Office, commonly known by its French acronym OLAF<sup>5</sup>, had brought about improvements in procedures and that early staffing difficulties had been resolved. But there was a need to modify staff rules and procedures to facilitate investigations within the Community's own institutions.
- 10 The enlargement of the European Union in the next few years will impact on the operation of all the European Institutions. It is crucial for sound working mechanisms to be developed and for efficient and effective financial management in the new enlarged Community to be given appropriate priority, in key discussion arenas such as the Convention on the future of the European Union.

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5 Office Européen de Lutte Anti-Fraude (OLAF)

# Conclusions

- We welcome the Court's move towards providing more diversified information on the nature, location and causes of the problems affecting the management of community funds in its Annual Report. Developments of this kind should be continued to help the Commission and Member States to identify problem areas more easily and target management effort to address them more effectively.
  - The Court has again been unable to provide positive assurance on the legality and regularity of the great majority of Community expenditure and considers that improving Member State checks is central to ensuring the correct use of Community funds. The systems in the United Kingdom have recently been strengthened to comply with new regulations issued by the Commission in the key budgetary areas of the Common Agricultural Policy and the Structural Funds. However, errors and control weaknesses continue to be found and the departments and other authorities should constantly seek to improve the operation of the United Kingdom's systems.
  - Good progress has been made in implementing the changes set out in the Reform Strategy, broadly within the original timetable, although progress on the reform of human resources policy has been slower than envisaged. The two essential, and potentially most difficult, areas where reforms remain to be completed are recasting of the Financial Regulation and the Staff Regulations, both of which require approval from the Council of Ministers. The United Kingdom Government, through the Council and its other links with the Community, should continue to support the Commission in its efforts to implement the reforms and ensure that the momentum is maintained.
  - We recognise that the improved financial accountability and management which the Commission is seeking to achieve as part of its reform strategy, requires changes in culture, as well as organisational structures, and that the Commission and the Court consider it is too early to judge whether the reforms have been a success. Nevertheless it is important to identify any tangible improvements achieved by the reform process.
  - We note that different practices continue to exist between Member States in reporting fraud and irregularity to the Commission. We agree with the Court that robust working definitions, agreed and understood by all parties, need to be established, in order to ensure suspected fraud and irregularity are reported on a common basis and to allow meaningful comparisons and trend analysis to be undertaken. We welcome the Office Européen de Lutte Anti-Fraude's (OLAF) efforts to take this forward and urge the United Kingdom Government to play a full role.
  - We recognise the enlargement of the European Union in the next few years will have an impact on the operation of all the European Institutions. The United Kingdom Government should seek to ensure that financial management issues are given appropriate priority during the Convention on the future of Europe and in other bodies dealing with the enlargement process.
- 11 This report complements a number of earlier National Audit Office reports on specific aspects of interest on the revenue due and expenditure funded from the Community General Budget in the United Kingdom. The reports published since May 1997 are listed in Appendix 1. Recent reports have focused in particular on agriculture issues, including, agricultural fraud, the Sheep Annual Premium Scheme, the Arable Area Payments Scheme, and the measures introduced in response to the BSE crisis.

# Part 1

## Introduction

- 1.1 Each year the Comptroller and Auditor General reports to Parliament on the results of the European Court of Auditors' (the Court) audit of the General Budget of the European Community, which are set out in its Annual Report. This report summarises the findings in the Court's Annual Report for 2000, which was published in the Official Journal of the European Communities in December 2001<sup>6</sup>. It also outlines the progress that has been made in the past year to reform the European Commission (the Commission), other developments relating to financial management and control, and considers the issue of enlargement.
- 1.2 The activities and finances of the European Union are governed by European legislation and overseen by the five Community Institutions (**Figure 1 overleaf**). Annual budgetary decisions are taken in the context of the European Union's financial perspectives, which are multi-annual spending plans for broad categories of expenditure. The current financial perspective was agreed at the Berlin European Council in 1999 and covers the years 2000 to 2006. The level of revenue and expenditure is set each year in the Community General Budget, which is prepared by the Commission and approved by the Council of Ministers and the European Parliament. The Commission implements the Budget and presents accounts to show how the money has been used. On the basis of the accounts and reports from the Court of Auditors, the Council and the Parliament assess the Commission's stewardship of Community funds. The Council makes a recommendation to Parliament which has overall responsibility for deciding whether to 'discharge' the Commission from any further responsibility for the Budget. Further details of the procedures for setting, controlling and accounting for the Budget are set out in Appendix 2.
- 1.3 The Commission has overall responsibility for implementing the Budget, although over 80 per cent of Community funds are managed jointly by authorities within the 15 Member States of the European Union and in Third Countries. Under the Treaty establishing the

European Community, Member States are required to take the same measures to protect the financial interests of the Community as they take to protect their own financial interests.

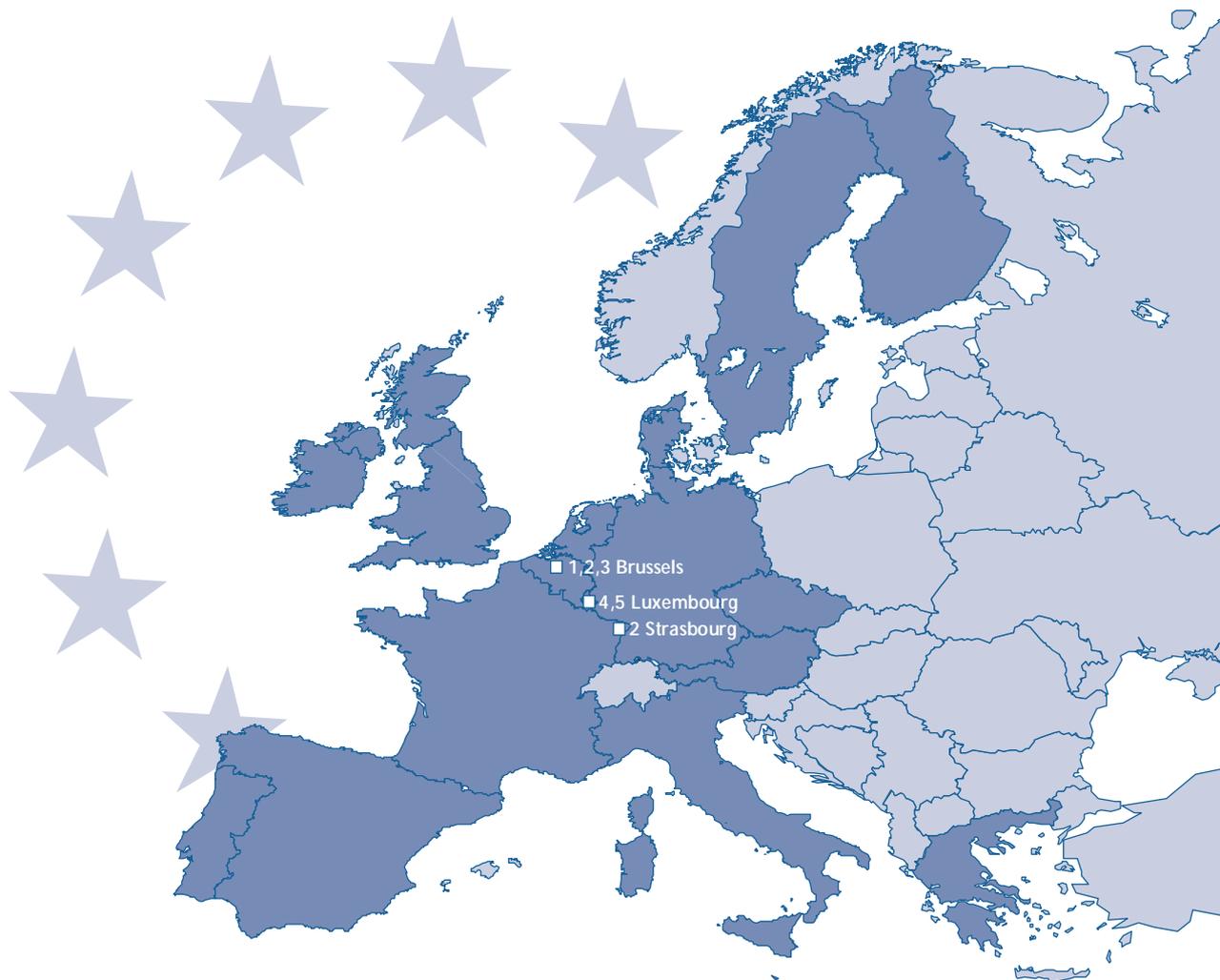
- 1.4 Community revenue and expenditure by Member State in 2000 is shown in Appendix 3. The United Kingdom was the second largest net contributor to the Budget, providing €6.2 billion (£3.9 billion).

## The European Court of Auditors

- 1.5 The European Court of Auditors is the external auditor of the European Union. In accordance with the relevant Treaties, the Court examines all Community revenue and expenditure to determine whether all revenue has been received and expenditure incurred in a lawful and regular manner, and whether the financial management has been sound. The Court also examines the Community's consolidated accounts to determine whether they are reliable.
- 1.6 The Court was established in 1977 and in 1993, under the Treaty of Maastricht, became the fifth Community Institution. The Court consists of 15 Members, one from each Member State, who are appointed for a six year term, and can be re-appointed. The Members elect a President from among their number, on a first among equals basis, to lead the Court for a period of three years. The Members of the Court are supported by some 550 staff, over 300 of whom work on audit related tasks. The Court's audit covers the Community Institutions and bodies set up by them, and the use of Community funds by national and local administrations in Member States and other recipients 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 a right of access to all bodies in receipt of Community funding, including final beneficiaries, such as farmers and training providers.

<sup>6</sup> Official Journal of the European Communities, C359 15 December 2001.

## 1 The European Community Institutions



### Community Institution

### Administrative spending in 2000

<p><b>1. Council of Ministers</b> 15 Ministers, one from each Member State. Senior legislative body of the Community.</p>	<p>€0.4 billion (£0.3 billion)</p>
<p><b>2. European Parliament</b> 626 elected members. Exercises democratic scrutiny and control over the European Union's decision making process. Gives discharge to the Commission for the implementation of the Community Budget.</p>	<p>€1 billion (£0.6 billion)</p>
<p><b>3. European Commission</b> 20 Commissioners and some 20,000 staff. Proposes and executes Community policies and ensures Member States meet their Treaty obligations. Answerable to Parliament for the use of the Community Budget.</p>	<p>€3 billion (£1.9 billion)</p>
<p><b>4. European Court of Auditors</b> 15 Members and 550 staff. External auditor of the accounts of all revenue and expenditure of the Community.</p>	<p>€0.07 billion (£0.04 billion)</p>
<p><b>5. European Court of Justice</b> 15 Judges. Rules on questions of Community law and whether actions by the Commission, the Council of Ministers, Member Governments and other bodies are compatible with the Treaties.</p>	<p>€0.1 billion (£0.06 billion)</p>

- 1.7 The Court publishes an Annual Report containing a summary of its findings on the management of Community operations, along with a Statement of Assurance on the reliability of the accounts of the Community and the legality and regularity of the underlying transactions. In addition, the Court publishes the results of audits on specific topics in Special Reports. The 18 Special Reports published during 2001 are listed in Appendix 4.
- 1.8 For its Annual Report and Statement of Assurance for the year 2000, the Court carried out nearly 500 audit visits to the Commission, Member States and other countries, including 33 to the United Kingdom, to examine selected transactions and systems for the management and control of Community funds. Following each visit, the Court set out its findings in a letter to the relevant authorities in the Member State concerned and took account of the Member State's replies in discussing its findings with the Commission.

## Discharge of the 2000 Community General Budget

- 1.9. The European Parliament voted to grant the Commission discharge for the 2000 Budget in April 2002, having considered the Court's Annual and Special Reports, the Council's recommendations and other evidence.

## The United Kingdom Parliament's scrutiny of European matters

- 1.10 The House of Commons Committee of Public Accounts may consider the National Audit Office's reports on the Court's work. The Committee publishes its own reports on European matters, most recently in July 1999<sup>7</sup> following a fact-finding visit to the European Institutions responsible for the management and oversight of the Community General Budget.
- 1.11 Two Parliamentary Select Committees are responsible for examining European Community documents and proposals for legislation. The Committees also carry out inquiries into other matters relating to the European Union.
- The House of Commons European Scrutiny Committee considers European documents and, where they are judged to be of particular legal or political importance, may 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 usually refers the Court's Annual Report for debate in standing committee. The Annual Report for 2000 was debated in February 2002, together with the Commission's 'Fight against Fraud' report and Action Plan 2001-03<sup>8</sup>, and also OLAF's annual Activity Report for the year beginning 1 June 2000.

- The House of Lords European Union Committee considers the same documents as the European Scrutiny Committee, referring more important documents to a sub-committee for further scrutiny. The sub-committee may decide to conduct an inquiry, taking evidence and producing a detailed report.

## House of Lords report, April 2001

- 1.12 In April 2001, the House of Lords European Union Committee produced a report entitled, 'The European Court of Auditors: the Case for Reform'<sup>9</sup>. The Committee looked at the Court's structure and organisation and evaluated their appropriateness, particularly in the light of forthcoming European Union enlargement. The Committee also considered the Court's role within the wider European inter-institutional system, how the internal audit reforms introduced by the Commission might impact on the Court's work, and the Court's audit methods and role in the prevention of fraud. In carrying out its work, the Committee visited both the Court and the Commission and consulted a wide range of members and officials. National Audit Office staff also gave evidence to the Committee.

## Scope of the National Audit Office examination

- 1.13 This report considers the progress made since the last report by the National Audit Office on the management of European funds for the financial year 1999<sup>10</sup> and in particular:
- summarises the Court's Statement of Assurance on the accounts of the Community for the year 2000 (Part 2);
  - highlights the Court's other significant findings on the management of the Community General Budget (Part 3); and
  - outlines the action being taken to reform the Commission, and to tackle fraud and irregularity, and the issues associated with enlargement (Part 4).

<sup>7</sup> *Financial management and control in the European Union, Committee of Public Accounts Twenty-ninth Report (HC 690, 1998-99).*

<sup>8</sup> *Protecting the Communities' Financial Interests - the fight against fraud: Commission's Twelfth Annual Report 2000 (No 9208/01) and Protecting the Communities' Financial Interests - the fight against fraud: Action Plan 2001-03 (No 9207/01)*

<sup>9</sup> *The European Court of Auditors: The Case for Reform, House of Lords Select Committee on the European Union, Twelfth Report, Session 2000-01 (HL Paper 63)*

<sup>10</sup> *Financial management of the European Union (HC 402, 2000-01, 27 April 2001).*

1.14 In preparing this report, the National Audit Office:

- reviewed the Court's Annual Report and Statement of Assurance for the year 2000, published in November 2001, and the Special Reports published during 2001;
- reviewed information published by the Commission on financial management, fraud and irregularity, the reform process, and enlargement;
- visited the Commission and the Court in December 2001 to discuss matters arising from the Court's reports and other issues relating to financial management and the reform process; and
- discussed with HM Treasury the Court's findings relevant to the United Kingdom and other issues relating to the management of Community funds.

# Part 2

## The Court's Statement of Assurance

- 2.1 The European Court of Auditors is required to examine the accounts of all revenue and expenditure of the Community and provide the European Parliament and the Council with a Statement of Assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions<sup>11</sup>. The Court carries out its examination in accordance with its audit policies and standards, which adapt international accounting standards to the Community context. The scope of the Court's audit comprises the Commission and other 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 funds pass through several levels of administration and numerous different bodies.
- 2.2 The Treaty requires the Court to provide a Statement of Assurance on the accounts of the Community as a whole. The Statement of Assurance is not therefore intended to provide a quantified conclusion on particular operational or geographical areas, such as individual spending programmes or Member States. This differs from the position in the United Kingdom where the Comptroller and Auditor General has a responsibility to give a separate opinion on the accounts of each government department or other public body he audits. Additionally, in the United Kingdom, Whole of Government Accounts (commercial style accounts covering the whole of the public sector) are being developed. The aim is to publish a consolidated, fully audited Whole of Government Account for the financial year 2005-06. This will supplement rather than replace accounts for individual bodies, and the Comptroller and Auditor General will continue to provide audit opinions on the accounts of individual bodies, as well as auditing the Whole of Government Account.
- 2.3 This part of this report notes the main revenue and expenditure characteristics in the 2000 General Budget of the European Community audited by the Court, and summarises the Court's Statement of Assurance for 2000 on the Community's accounts, covering the reliability of the accounts of the Community; and the legality and regularity of the transactions underlying revenue, commitments and payments.
- 2.4 Under the Treaty establishing the European Community, the European Commission is responsible for producing the accounts of the Community, which comprise a single consolidated revenue and expenditure account, a balance sheet and explanatory notes<sup>12 13</sup>. There is no requirement for separate, more detailed accounts covering different areas of the Budget or Commission departments.

### The European Community General Budget

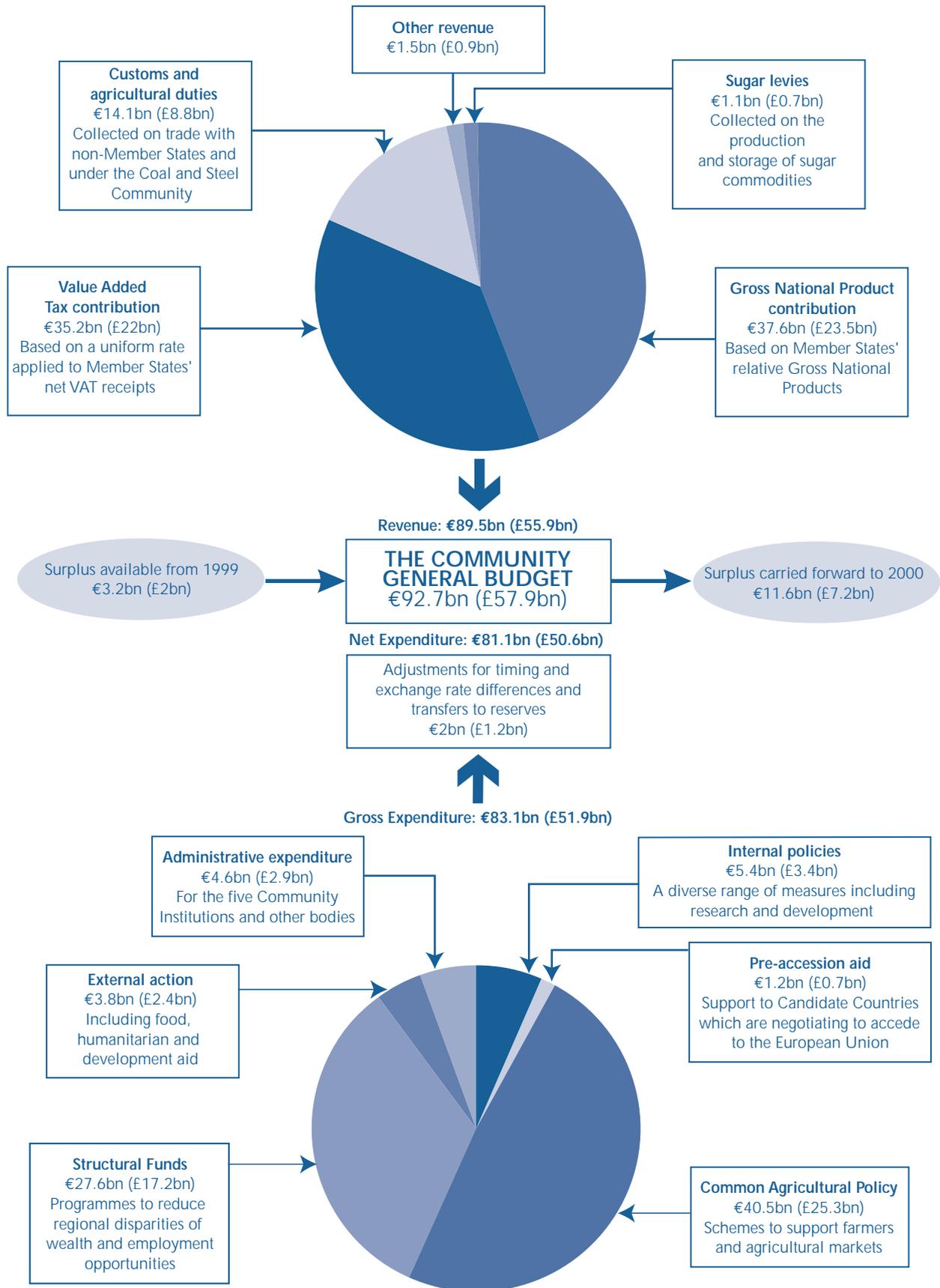
- 2.5 The total revenue available to the Community General Budget for the year 2000 was €92.7 billion (£57.9 billion), as against a final budget estimate of €89.4 billion (£55.8 billion), including a surplus of €3.2 billion (£2 billion) brought forward from 1999. Total net payments were €81.1 billion (£50.6 billion), leaving a surplus of €11.6 billion (£7.2 billion) to be carried forward to 2001. **Figure 2** analyses the main categories of Community revenue and payments in the year 2000.
- 2.6 The surplus of revenue over expenditure in the year 2000 was the highest in the last decade, and was made up of both higher than expected revenues of some €3 billion (£1.9 billion) which arose as a result of strong economic expansion in the period; and an underspend of some €8.6 billion (£5.4 billion), mainly in the structural funds. The surplus was used to reduce the revenue contributions required from Member States to finance the 2001 Community General Budget.

<sup>11</sup> Article 248 Treaty establishing the European Community

<sup>12</sup> The Community's accounts for 2000 were published in the Official Journal of the European Communities, OJ C370, 27 December 2001.

<sup>13</sup> Article 275 of the Treaty establishing the European Community requires the Commission to submit annually to the Council and the European Parliament the accounts for the preceding year. Article 279 provides for detailed guidance on procedures for presenting and auditing the accounts, to be laid down in a Financial Regulation to be approved unanimously by the Council on a proposal from the Commission after consulting with the European Parliament.

2 Revenue and expenditure of the European Community in 2000



Source: data from the Annual Report of the European Court of Auditors 2000, and the Financial Statements of the European Community 2000

## The reliability of the accounts of the Community

2.7 The Court concluded that the accounts for the year 2000 reliably reflected the revenue and expenditure of the Community for the year and the financial situation at the end of the year, subject to a number of significant exceptions where the Court was unable to give positive assurance on reliability.

2.8 The main exceptions found by the Court - and their financial impact - are detailed in Appendix 5. They included:

- the misstatement of the value of fixed assets, particularly in relation to some buildings and fixtures and fittings, although failings appeared less extensive across the European Institutions than those noted in previous years;
- incomplete information on the level of debtors and inadequately defined policies on the calculation and write-off of bad debts;
- the inability of the Commission to produce complete and reliable information distinguishing between advance and final payments, and thus a lack of clarity on the extent to which funds had been paid over to final beneficiaries or were being held by intermediaries;
- an overstatement of commitments due for payment, where the Court considered there was no longer any obligation for the Commission to make a payment; and
- weaknesses in the calculation of the new 'economic result' due to deficiencies in the Commission's accounting system

The exceptions where the Court was unable to give positive assurance were generally the same as those in previous years, the only new element in the year 2000 concerning the 'economic result'. The Commission introduced the economic result for the first time in 2000. It is intended to provide clearer information on the overall economic cost of the Community's activities for a financial year by adjusting the traditional cash-based outturn figure derived from the budget (ie revenue less expenditure for the financial year), to take account of accrued items such as depreciation, changes in the value of stocks, and gains and losses on transfers of fixed assets.

2.9 The Court has qualified its assurance on the reliability of the Community's accounts every year since the Statement of Assurance was introduced in 1994. The Court noted that one of the major factors leading to qualification was the failure by the Commission to define a suitable accounting framework for operational transactions, and transactions relating to the acquisition,

management and disposal of assets. As a result, transactions of the same kind have not always been treated in a consistent and appropriate manner.

### Revenue

2.10 The Court did not find material error in this area. Therefore it concluded that, taken as a whole, the amounts relating to revenue entered in the Community's accounts for 2000 were reliable. However, as in previous years, the Court noted that the scope of its audit was limited because VAT and GNP contributions to the European Community were based on macro economic statistics, calculated at Member State level, whose underlying data could not be tested directly. Such contributions represented over 80 per cent of Community revenue in 2000.

### Commitments

2.11 The Court found that during the year the Commission had entered into legal obligations in excess of the amounts provided for in the Community General Budget. The commitments involved totalled €213 million (£132.9 million) and related to international fisheries agreements and external actions. For other commitments totalling some €79.5 billion (£49.6 billion), the Court concluded that the amounts entered in the accounts were reliable.

### Payments

2.12 The Court found that the Commission was unable to produce complete and reliable information distinguishing between advance and final payments. It noted that, following similar findings in its report on the financial year 1999, the Commission had said that it would take steps to set out detailed rules for each sector of activity and would apply classifications for different types of payment, in advance of revisions to the Financial Regulation being approved. The Court found no progress in these areas. The Commission responded that it was aware of the problem and was working with the accounting departments and main operational units to find the best accounting procedure to follow in the future.

### The accounting system

2.13 As in the previous two years, the Commission experienced difficulties in providing the Court with a set of accounts for audit. The first version, produced to meet the deadline of 1 May 2001, had omissions and inconsistencies and the Commission presented a corrected version in September 2001. The Commission considered that it had made considerable improvements in the quality of the first set of accounts, as compared to the situation for the 1999 year of account.

2.14 The Court noted that many of its observations concerning the introduction of a new accounting Information Technology system, known as SINCOM 2, in 1999, continued to be of concern during 2000. The Court found that the Commission was still not making comprehensive, periodic reconciliations between data in three local SINCOM 2 sub-systems and the central systems, and had not issued any written instructions to managing departments, despite undertakings given by the Commission to do so in response to the Court's findings in 1999. The Commission acknowledged that it had fallen behind on this but stated that it intended to issue written instructions by October 2001. The Court also found that other operational shortcomings, which it had highlighted previously, persisted: for instance, the system did not integrate certain basic accounting functions such as control accounts for debtors, creditors and fixed assets. The Commission accepted that it had missed deadlines on remedying these issues but noted that since the Court's audit visit, it had made significant progress in alleviating operational deficiencies. The Court also noted security weaknesses in relation to level of access for system users and recording technical interventions. The Court recommended that the Commission should give higher priority to strengthening SINCOM 2's internal control mechanisms as a matter of urgency. The Commission noted that it had addressed many of these issues since the Court's audit visit, and had drawn up an Action Plan to strengthen security. The plan included actions such as stepping up password management and limiting access profiles, in line with the Court's recommendations.

## The legality and regularity of the underlying transactions

2.15 The second part of the Statement of Assurance covered the legality and regularity<sup>14</sup> of the underlying transactions. As in previous years, most of the errors found by the Court concerned the Common Agricultural Policy and Structural Funds, which together represented some 82 per cent of gross expenditure and were managed by authorities in the 15 Member States. But there were also errors in spending managed directly by the Commission, such as programmes for research and development.

2.16 The Court reported that it had found an unacceptably high incidence of 'substantive' errors, which directly affected the amount or validity of the payments made. As a result, for the seventh year in succession, the Court

declined to provide assurance on the reliability of amounts entered in the accounts in respect of payments, except those relating to administrative expenditure. The Court also found many 'formal' errors which had no direct effect on the value of payments made, but where there had been systems weaknesses or failure to comply with the terms of Community regulations.

## Errors in Common Agricultural Policy payments

2.17 In the year 2000 payments in relation to the Common Agricultural Policy represented some 49 per cent of gross expenditure (€40.5 billion (£25.3 billion)). The Court examined the whole range of agricultural expenditure in its audit on a sample basis, carrying out testing at paying agencies<sup>15</sup>, other public bodies and the final beneficiaries. The Court concluded that the audit did not provide evidence of improvement in the level and types of error compared to its findings in earlier years.

2.18 As in previous years, the Court noted that most errors occurred at the final beneficiary level, normally an individual farmer and involved over-declarations of field sizes or numbers of animals eligible for subsidy. The Court told us that one third of errors identified in relation to agricultural payments were for amounts in excess of €10,000 (£6,241) and almost one fifth related to payments of over €100,000 (£62,410).

## Errors in Structural Fund payments

2.19 In 2000 expenditure on structural measures (predominantly the four Structural Funds<sup>16</sup>, which aim to promote economic and social cohesion, principally by providing financial assistance to the less developed regions of the European Union) represented some 33 per cent of gross expenditure (€27.6 billion (£17.2 billion)). Aid is mainly provided to Member States in the form of funding for programmes, which can last for up to six years and must be co-financed by the Member State concerned. The Commission makes advance payments during the course of a programme, based on expenditure declarations from final beneficiaries in Member States that a given proportion of the funding has been disbursed in line with Community objectives and rules. At the end of each programme, Member States are required to provide the Commission with an implementation report and a complete declaration of expenditure, which is used to arrive at a final settlement and close the programme.

<sup>14</sup> Legality concerns compliance with European Community legislation; regularity concerns compliance with rules and regulations (including national legislation) put in place as a requirement or consequence of the legislation, which directly govern the activities conducted by the body being audited.

<sup>15</sup> Paying agencies are the bodies in Member States responsible for the administration of Common Agricultural Policy programmes, in particular processing payments to final beneficiaries

<sup>16</sup> 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.

- 2.20 The Court once again found a high incidence of 'substantive' errors in Structural Fund transactions, with the most frequent errors being the same as those found in previous years. They included claims for costs and activities which were not eligible for funding, claims where the costs declared exceeded those actually incurred, and claims where expenditure was not justified by supporting documentation. The majority of errors were found in Member States at the final beneficiary level.
- 2.21 Although incorrect payments made during the lifetime of a programme can be corrected at the closure stage when Member States submit the final expenditure declaration, there is a risk that not all errors will be detected and the level of payment adjusted appropriately. For its 2000 Report, in addition to examining transactions relating to programme activities which were still live, the Court also examined a sample of measures closed in 2000. The Court found significant errors in some closed programmes, where a high proportion of ineligible expenditure, included in the final expenditure declarations presented by Member States, had gone undetected by the Commission, leading to overpayment and a loss to the Community budget.

## Errors in payments relating to internal policies

- 2.22 In 2000 expenditure on internal policies represented some seven per cent of gross expenditure (€5.4 billion (£3.4 billion)). Expenditure on internal policies is managed directly by the Commission through contracts with external organisations in the public or private sectors. The Commission supports projects by funding a proportion of the eligible costs incurred by contractors, up to a specified limit.
- 2.23 The Court concentrated its audit on the European Community 5th Framework Programme for Research and Technical Development, which accounts for the majority of expenditure on internal policies. The Commission supports projects on the basis of costs actually incurred. The Court found that the contractual arrangements were detailed and complex and demanded a significant administrative effort from both the Commission and contractors. The Court also noted limitations on controls operating to prevent overpayments in that the Commission was only able to examine a relatively small number of claims, relying on plausibility checks to verify the remainder. The

Commission has set a target of checking at least ten per cent of contractors and has also introduced pilot external audit certificate requirements on two programmes from 2001 with the aim of strengthening control.

- 2.24 As in its 1999 Report, the Court noted that where the Commission detected errors it did not have the powers to impose penalties but could only seek to reclaim overpayments plus interest. The Court concluded that there was little incentive for claimants not to overcharge, as there were no contractual penalties and no risk other than having to repay any amounts found to be overpaid. The Commission had responded that it could terminate contracts in the event of serious financial irregularities and felt that explanation and education were the best ways of eliminating errors made by contractors.

## Errors in payments relating to external action

- 2.25 In the year 2000 expenditure on external action (largely humanitarian aid and support for development projects) represented some five per cent of gross expenditure (€3.8 billion (£2.4 billion)). Most spending on external action is managed directly by the Commission but increasing use is made of intermediaries, including non-governmental organisations, to manage programmes. The EuropeAid Co-operation Office was set up with effect from 1 January 2001 as part of the Commission's reform process to improve financial management and control. EuropeAid has a remit to implement the external aid instruments of the European Commission and is responsible for all phases of the project cycle.
- 2.26 In the area of External Action, the Court tested only a small number of transactions in relation to its Statement of Assurance work, but in addition is carrying out a cyclical programme of in-depth audits on different elements of the budgetary programme. In the year 2000 the Court carried out an in-depth audit of the Tacis programme<sup>17</sup>. The Tacis programme is aimed at the New Independent States and Mongolia, and generally involves grants for technical assistance contracts to promote the transition of the recipient countries towards functioning market economies. The Court found a relatively well-developed system for controlling payments, but considered that the Commission could improve its monitoring and inspection procedures.

<sup>17</sup> The Tacis programme was launched in 1991, as a Technical Assistance programme to the countries of the Commonwealth of Independent States (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, the Russian Federation, Turkmenistan, Ukraine and Uzbekistan) and Mongolia. It has developed into a wider instrument of co-operation, based on Partnership and Co-operation Agreements.

## Errors in pre-accession aid

2.27 The Court introduced a chapter on pre-accession aid in its 2000 report, reflecting the reclassification of expenditure undertaken by the Commission. Actual expenditure on pre-accession aid to the Candidate Countries seeking to join the European Union was low in 2000, at €1.2 billion (£0.7 billion), some one per cent of gross expenditure. This fell well short of the budget forecast of €1.6 billion (£1 billion) reflecting delays in starting up two major new programmes - the Instrument for Structural Policies for Pre Accession (ISPA) and the Special Accession Programme for Agriculture and Rural Development (SAPARD). Most of the expenditure which was incurred related to the existing pre-accession Phare<sup>18</sup> programme.

2.28 The Court decided not to include pre-accession expenditure in its Statement of Assurance work for 2000, as there was limited expenditure on the two new programmes, and it had carried out an intensive review of the Phare programme as part of its 1999 Statement of Assurance work.

## Errors in administrative expenditure

2.29 In the year 2000 administrative expenditure, mainly on the five Community Institutions, represented about six per cent of gross expenditure (€4.6 billion (£2.9 billion)). The expenditure, principally staff costs, procurement and expenditure relating to fixed assets, is managed directly by the Commission and the other Institutions. The Court found a low incidence of error in this area and concluded that the audit results were generally satisfactory. The Court therefore gave positive assurance in respect of the Institutions' administrative expenditure.

## The Court's findings in the United Kingdom

2.30 The Court examined four revenue and 29 payment transactions in the United Kingdom for the 2000 Statement of Assurance. The Court found a variety of 'substantive' errors, directly affecting the amount or validity of the payments made; and 'formal' errors, with no direct monetary impact, but where there were systems weaknesses or failures to comply with Community regulations. The actual monetary value of substantive errors identified by the Court varied widely.

2.31 On the revenue side, the Court examined four transactions and found two were free of errors, one had a substantive error and one a formal error. Of the 29 payment transactions tested across agricultural, rural development and structural fund payments the Court found that eleven cases (38 per cent) were free of errors; six cases (21 per cent) contained both substantive and formal errors; five cases (17 per cent) had substantive errors only; six cases (21 per cent) contained formal errors only; and in the final case (3 per cent) testing could not be completed due to Foot and Mouth Disease restrictions in place at the time of the audit. Examples of errors found by the Court in the United Kingdom were:

### Substantive errors

- in relation to the Common Agricultural Policy - an over-declaration of 0.31 hectares on a claimed area of 16.71 hectares - amounting to 1.86 per cent of the claim. The monetary effect of the over-declaration was £63.89;
- in relation to the Common Agricultural Policy - a farmer had not maintained a flock register which is a condition for the payment of ewe and goat premium subsidies. The whole claim of £5,170.62 was therefore ineligible; and
- in relation to the Structural Funds - a lack of supporting documentation for expenditure claimed, leading to an over-payment of £42,442, some 13.37 per cent of the claim.

### Formal errors

- in relation to the Common Agricultural Policy - the failure of a farmer to return an animal passport to the relevant regional office within the deadline of seven days following the death of the animal; and
- in relation to the Common Agricultural Policy - the failure of a farmer to maintain a herd register containing all necessary information.

2.32 Member States can respond formally to the results of the Court's audit and they can accept or contest its findings. Agreed errors are generally corrected by the Member State but the Court also informs the Commission which can enforce corrective action.

<sup>18</sup> The Phare programme originated in 1989 to provide assistance to Hungary and Poland for economic restructuring (Council Regulation 3906/1989, December 1989), and was subsequently expanded to include assistance to all the Candidate Countries of Central and Eastern Europe, as well as other states in these regions, including Albania and the states of the former Yugoslavia.

# Part 3

## The Court's other findings

- 3.1 As well as the Statement of Assurance, the Court's Annual Report for 2000 also included information on wider issues relating to the management of the Community General Budget. Much of the Court's audit work concerned the efficiency and effectiveness of the revenue and expenditure programmes of the Community. During 2001 the Court published 18 Special Reports (Appendix 4), detailing its findings on specific topics.
- 3.2 This part of this report draws on the Court's Annual and Special Reports to highlight the main findings and issues of relevance to the United Kingdom in the areas of Community revenue; the Common Agricultural Policy; and the Structural Funds.

### The Court's examination of Community revenue

#### Customs duties

- 3.3 Goods entering the Community are normally liable for customs duties on import. In the year 2000 such duties amounted to €13.1 billion (£8.2 billion). The Court's examination gave rise to observations on customs valuation; anti-dumping duties; and mutual assistance notices.

#### Customs valuation

- 3.4 Customs valuation is the procedure applied to determine the value of imported goods to the Community for the purpose of calculating customs duties. It is intended to provide a fair, uniform and neutral basis for the valuation of imported goods and relates to about 95 per cent of the duties on imports to the Community. Consistent application of the rules on customs valuation is therefore important in ensuring that the customs union operates as intended.

- 3.5 The Court<sup>19</sup> found that Member States had experienced difficulties in operating procedures uniformly. For example, some Member States, including the United Kingdom, used qualified accountants to assist in customs valuation, whilst others did not. The Commission, which has also experienced difficulties in supervising and monitoring individual authorities, accepted that a lack of uniformity in the application of customs valuations would be detrimental to the financial interests of the Community and it committed itself to continuing to encourage information exchange with, and amongst, Member States.

#### Anti-dumping duties

- 3.6 Community regulations set out that a product is considered to be dumped if its export price in the Community is lower than the normal selling price in the exporting country. If there is an injury to the Community's interest then an anti-dumping duty can be imposed. €139 million (£87 million) of such duties were collected during the year 2000 in the same way as normal customs duties.
- 3.7 The Court's examination found a number of weaknesses in the control of the existing systems, at both Member State and Commission level. In the United Kingdom it found there had been insufficient use of computer and risk analysis tools to check on imports subject to anti-dumping duties. The United Kingdom Customs and Excise computer system was unable to differentiate between different types of anti-dumping duty. The Commission noted that such anomalies were being followed up and Customs and Excise commented that the addition of new profiles to the computer system in the United Kingdom should resolve this problem.

<sup>19</sup> Special Report 23/2000 'Valuation of imported goods for customs purposes'.

## Mutual assistance notices

3.8 The Court also considered that United Kingdom had not adequately followed up a sample of mutual assistance messages which it examined. Mutual assistance messages are circulated by the European Anti-Fraud Office, between Member States when cases need co-ordinated enquiries or interventions to be made by several national administrations. The Court found that the United Kingdom had set a risk threshold of £1 million (€1.6 million) for taking action on such cases and thus had only dealt with three of the sample of ten examined by the Court. The Court and the Commission were concerned about the threat this might pose to the protection of the Community's financial interests. In its response to the Court's Annual Report, the United Kingdom Government noted that the £1 million was only an indicative guideline for cases that would be dealt with by its fraud Investigation Team. The large number of other mutual assistance cases that are not of sufficient value or gravity to pursue as fraud cases are reassigned to other areas of Customs for appropriate action. However, the department is reviewing its systems for taking action on mutual assistance notices, and the National Audit Office intends to review progress in this area during the audit of HM Customs and Excise accounts for 2001-02.

3.9 The National Audit Office keeps issues affecting customs duties under regular review. In February 2001, we reported on Regulating Freight Imports from Outside the European Community<sup>20</sup>, where one of the issues examined was how Customs and Excise manage the risks to revenue at the frontier. The report covered some £20.6 billion of revenue on imports of which some £2 billion related to customs duties due to the European Union. We are currently examining how Customs and Excise tackle fraud on the revenue from indirect taxes and the results will be published in 2002-03. Part of our work will look at how Customs are working with other Member States to tackle fraud on VAT and Excise duties.

## The Court's examination of the Common Agricultural Policy

3.10 The objectives of the Common Agricultural Policy were set by the Treaty establishing 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. Gross expenditure on the Common Agricultural Policy totalled €40.5 billion (£25.3 billion) in 2000.

3.11 Key findings from the Court's examination of Common Agricultural Policy expenditure related to:

- financial penalties imposed in 2000;
- the Integrated Administration and Control System (IACS);
- the control of Bovine Spongiform Encephalopathy (BSE); and
- milk quotas.

## Financial corrections imposed in 2000

3.12 Authorities in Member States are responsible for administering Common Agricultural Policy schemes in accordance with European Union regulations. The Commission can disallow expenditure where it considers that a Member State has not complied with the regulations or exercised adequate financial control. Member States (and their taxpayers) bear the cost of amounts disallowed which represent failures in their administration of schemes.

3.13 During 2000 the Commission imposed financial corrections totalling €188 million (£117 million) on Member States in respect of Community financing for 1996-98. This included €5.2 million (£3.2 million) on the United Kingdom which related to shortcomings in the quality of checks in the cereal, flax and hemp sectors.

## The Integrated Administration and Control System

3.14 The 'Integrated Administration and Control System', commonly referred to as IACS, aims to improve the effectiveness of the Commission's control over agricultural expenditure. It was introduced in 1993, with a deadline for completion of 1 January 1997 (except for the three new Member States - Austria, Sweden and Finland - which had an extra year). It currently covers expenditure on all arable crop and livestock schemes and requires the unique identification and registration of discrete areas of agricultural land. Farmers submit an annual application for aid to the national agency, providing information on the use of their land, or the number of animals they hold, which the agency should check against the details held on a computerised database. IACS also provides for penalties on claimants when the rules of schemes are breached. The Commission and the Court regard IACS as key to reducing the incidence of error and fraud, and it has been expanded gradually to cover sectors, such as cotton and flax which were previously administered on a traditional basis.

3.15 The Court concluded<sup>21</sup> that IACS had been well designed and had become an essential tool for controlling agricultural expenditure. However, there were shortcomings in co-ordination between Commission departments and Member States. There was also evidence of implementation weaknesses in Member States. In particular, the Court was concerned that cross checks to prevent over or double payment on applications for assistance were not being carried out comprehensively. The Court was also concerned about weak and incomplete databases in some Member States, and poor quality field inspections. The Court found that the regulations relating to IACS were imprecise, intrinsically complicated and had been amended 80 times between 1992 and 1999. In the United Kingdom there has been a delay in implementing a bovine identification and registration database and cross checks of suckler cow applications were not carried out.

3.16 The Commission considered that most of the problems identified by the Court were relatively minor. It noted that it was working to simplify schemes so that they could be more easily and effectively managed and it intends to resolve other problems by issuing revised guidance and providing further interpretations of the various regulations.

### The Joseph Bowden case

3.17 In February 2002 the National Audit Office reported to Parliament on instances of fraudulent claims against the Common Agricultural Policy by a farmer, Joseph Bowden<sup>22</sup>. This case was not referred to in the Court's report but was one of the largest cases of fraud in the United Kingdom involving an individual claiming subsidy under Common Agricultural Policy schemes. The amount involved in the charges to which Joseph Bowden pleaded guilty was £157,000 (of which some £120,000 were EU monies), although had he succeeded in all his activities he might have received some £415,000 of public money (some £373,000 of which might have been EU monies). The purpose of the report was to identify the actions taken by those responsible for administration of the schemes to prosecute and to prevent recurrence of the irregularities.

3.18 The charges to which Joseph Bowden pleaded guilty were discovered following a tip-off to the police in 1996 which was passed to the Ministry. The charges related to claims made for support under Common Agricultural Policy schemes in 1994, 1995 and 1996. The National Audit Office noted weaknesses in the procedures of the Ministry for Agriculture Fisheries and Food and the

Intervention Board which were the authorities responsible for administering the schemes at that time, in particular:

- prior to 1996, no cross checks by the Ministry and the Board were carried out between Arable Area Payments and Fibre Flax Subsidy Schemes to identify if claims had been submitted for the same area of land. In 1996 manual cross checks were introduced to detect possible duplicate claims on the same field. These checks used unique field identifiers from Ordinance Survey maps;
- under the Arable Area Payments Scheme, map references identifying fields were required and these were all checked. Under the Fibre Flax Subsidy Scheme, only 20 per cent of field identifiers were checked and unique field references were not required. Fields could be referred to by name, for example, top meadow or bottom pasture. So a grower could supply contracted processors with different names for the same field; and
- inspections did not adequately identify the crops being grown.

3.19 Since 1996 new financial controls have been introduced over the operation of the schemes to help prevent similar frauds. In particular, under IACS, there is now a single system handling all grant claims which enables cross checks for duplicate claims to be carried out and followed up; the validity of map references is checked as a matter of routine; and applicants are required to provide more information to support claims. In October 2001, the Rural Payments Agency, formally took over the responsibilities as the European Union Paying Agency for all Common Agricultural Policy schemes in England. The Agency is modernising and centralising the administration of these schemes in England and changes will include significant new information technology systems which will increase the level and ease of automated checking of claims. The new systems and structures are expected to be in place by 2004, and in the meantime existing systems will be maintained to provide appropriate checks.

### The control of Bovine Spongiform Encephalopathy (BSE)

3.20 The Court reported on measures to control BSE in 1998<sup>23</sup> and recommended that the Commission should develop a strategy to manage the crisis and that proper animal identification and registration should be enforced. A follow up report<sup>24</sup> by the Court in 2001 reviewed BSE measures introduced and implemented by

<sup>21</sup> Special Report No 4/2001 'The implementation of the Integrated Administration and Control System'.

<sup>22</sup> Agricultural fraud: the case of Joseph Bowden, HC 615, 2001-2002.

<sup>23</sup> Special Report No 19/1998 'The Community financing of certain measures taken as a result of the BSE crisis'.

<sup>24</sup> Special Report No 14/2001 'Follow up on the Court's Special Report no 19/1998 on BSE'.

the European Union in order to identify and manage the risk of BSE occurring and posing a risk to animal and human health. It also considered the action that the Commission had taken to identify and eradicate BSE.

- 3.21 The Court considered that although the Commission's strategy for dealing with BSE was basically sound, its effectiveness was limited by a number of factors. The institutional procedures required for passing legislation had restricted and delayed the implementation of BSE control measures, and in the Member States the implementation of BSE related legislation had been inadequate in some areas. The measures available to the Commission to enforce the implementation of such legislation were insufficient. In addition, animal registration and identification systems were not fully operational in all Member States by the January 2000 deadline.
- 3.22 The Court noted that the United Kingdom had most BSE cases (99 per cent), and received most European Union funding (43.7 per cent) in relation to BSE measures. The Court found that the legislation put in place in the United Kingdom to combat BSE as early as 1988 was not adequately implemented. However, between 1998 and 2000, the United Kingdom systems had fewer weaknesses than those in any other Member States. Nevertheless, rendering standards, which aim to reduce the chance of animal feed containing BSE, remain an area of weakness.
- 3.23 The Commission generally agreed with the Court's findings although it was unsure how willing Member States would be to give the Commission greater emergency powers to impose decisions, or powers to impose financial penalties for non-compliance.

## Milk quotas

- 3.24 The Court reported on the milk quota regime which was introduced in 1984 at a time when there was considerable over production of milk in the European Union. The regime capped production by introducing individual milk quotas for producers, based on the distribution of a national milk quota established by the Council for each Member State. A dissuasive levy applies to milk quantities produced in excess of individual quotas.
- 3.25 The report<sup>25</sup> sought to assess the effectiveness of the quota regime in reaching the goal of controlling milk production in the European Union and achieving market equilibrium. The Court found that the quota

regime had resulted in a reduction in milk production and a stabilisation at quota level but that there was flexibility in the implementation of the regime with numerous differences between Member States. Consumers were paying a higher price for milk than the world market price and substantial financial support would be required for the disposal of milk surpluses. The Court's examination of the quota system in the United Kingdom, noted that the United Kingdom had failed to declare the amount of levy due to the Community for the four years 1994-95 to 1998-99 within regulatory time limits, leading to advances of expenditure for each following year being reduced proportionately, until the matter had been resolved.

- 3.26 The Commission disagreed with the Court about the purpose of the milk quota scheme. It considered that it was a cost effective means of supporting a range of social and political objectives, such as supporting farmers in marginal production areas. It did not view it as a means of achieving a free market. The Commission argued that any major problems with the scheme were being dealt with, and that issues relating to the implementation of quotas in individual Member States would be addressed through the Clearance of Accounts procedure<sup>26</sup> which provides the means for the Commission to accept the accounts presented to it by Member States and agree the legality and regularity of the underlying transactions.

## The Court's examination of the Structural Funds

- 3.27 The four Structural Funds aim to promote economic and social cohesion, principally by providing financial assistance to the less developed regions of the European Union. In the financial year 2000 expenditure on the Structural Funds totalled €27.6 billion (£17.2 billion). The two largest Structural Funds are:
- the European Regional Development Fund, which aims to address regional imbalances by providing grants for projects to develop declining industrial regions and other undeveloped regions; and
  - the European Social Fund, which aims to improve employment opportunities in the Member States by providing financial support for vocational training and job creation measures.

<sup>25</sup> Special Report No 6/2001 'Milk quotas'.

<sup>26</sup> The Clearance of Accounts procedure for the Common Agricultural Policy is a two step procedure between the Commission and Member States. Member States' paying agencies present annual audited accounts to the Commission. The Commission then provides 'accounting clearance' whereby it accepts the accounts without prejudicing subsequent decisions which may be necessary to recover expenditure which does not comply with Community rules. Secondly the Commission undertakes 'compliance clearance' to ensure that the transactions underlying the accounts are legal and regular and at this stage the Commission can make adjustments to correct any errors it identifies.

3.28 New methods of recording expenditure on the Structural Funds were adopted for the year 2000. Expenditure was no longer sub-divided by individual fund but into Chapters which showed the priority objectives of the Funds. The Court accepted that information provided by the Commission in relation to structural measures was more comprehensive than in previous years but considered that new rules designed to accelerate and simplify the programming procedure had not produced the desired results. In the case of several programmes adopted in 2000 commitments and the corresponding payments were not made until 2001.

## Financial control

3.29 High levels of error in the Structural Funds expenditure have existed for some years and prompted the Commission to introduce in 1997 Regulation 2064/97 aimed at strengthening Member States' financial control over operations co-financed by the Funds. The regulation sets out minimum control requirements and provides for a greater degree of verification of the costs claimed. Specifically, Member States must check at least five per cent of expenditure before programmes are closed and provide an independent declaration at the end of each programme certifying the validity of the claim before the final balance is paid.

3.30 The Court's audit of the implementation of the regulation<sup>27</sup> found it was a positive step in helping to ensure that only eligible expenditure was co-financed by the European Union. However, the Court found many cases where Member States were not applying the regulation correctly, in part because the Commission had not issued clear and timely guidance. In the United Kingdom arrangements for complying with Regulation 2064/97 have been put in place for each of the Structural Funds. For example for the European Regional Development Fund, Government Offices for the Regions are to check expenditure in the course of programmes and internal auditors from the Department for Transport, Local Government and the Regions will provide the independent declarations at the end of programmes. The Court told the National Audit Office that it had found some weaknesses within the United Kingdom's arrangements which were similar to those in other Member States. The Court was also concerned to ensure that there was clear separation of duties in the operation and audit of programmes. The Court recognised that human resource constraints and the need to set up new audit arrangements had caused some initial weaknesses in this area which were being addressed.

3.31 The Court's audit also covered regulation 1681/94 which introduced an information system for reporting detected irregularities. The Court found systems weaknesses in the application of the regulation by Member States and recommended that they should review their systems to ensure that cases detected were communicated and progress reported. In some Member States, including the United Kingdom, there was confusion as to whether a payment or claim was necessary before an irregularity could be recognised. Moreover, the Court found that a department was unable to provide a list of cases of irregularity identified from 1994 to 1998 as closed cases had been deleted from its database.

3.32 In March 2001, the Commission issued two new regulations<sup>28</sup> laying down detailed rules for the management and control of assistance granted under Structural Funds and setting out procedures for imposing financial corrections<sup>29</sup> in the event of irregular use of funds. The effect of the regulations should be to improve controls at Member State and Commission level, and to strengthen the enforcement procedures available to the Commission. The Court told us that the introduction of these regulations represented a step forward, but that the new system would only become effective if the Commission used its powers to impose sanctions when control weaknesses were found.

3.33 The Commission considered the effects of the new regulations would be seen in the new 2000-06 programming cycle. The Court told us that it considered it would be beneficial for the Commission to devote more resources to checking Structural Fund claims. The Commission told us that during 2001 it had carried out an extensive review of Regulation 2064 in all Member States and that from September 2002 it would focus on reviewing the independent opinions provided by Member States on Structural Fund projects which were being closed at the end of their lifecycle.

<sup>27</sup> *Special Report No 10/2001, 'concerning the financial control of the Structural Funds'.*

<sup>28</sup> *Commission Regulation (EC) No 438/2001, laying down detailed rules for the implementation of Council Regulation (EC) No 1260/1999 in respect of the management and control system for assistance granted under the Structural Funds; and Commission Regulation (EC) No 448/2001 laying down detailed rules for the implementation of Council Regulation (EC) No 1260/1999 in respect of the procedure for making financial corrections to assistance granted under the Structural Funds.*

<sup>29</sup> *Financial corrections may involve simply correcting the error which has been made, plus payment for any interest lost to the Community; or, in the case of systematic control weaknesses can involve the application of a Flat Rate Correction to all transactions, the level of the correction varying from two to twenty-five per cent, depending on the seriousness of the control weakness.*

## The URBAN initiative

- 3.34 The Court's examination of a Community initiative to provide support to urban areas<sup>30</sup> (the URBAN initiative) found that projects supported under this initiative could equally well have been carried out under existing Community measures. This would have avoided the creation of new procedures and management structures. For example in the United Kingdom the Single Regeneration Budget programme supports similar projects to those under the URBAN initiative. Lack of co-ordination between such projects had in some cases led to a proliferation of interventions and an increase in management costs.
- 3.35 The Commission accepted that there had been a degree of overlap between the URBAN programme and other projects in the United Kingdom. However, it maintained that there were differences between the various programmes, in terms of both scope and selection criteria.

## Closure of programmes

- 3.36 As in previous years, the Court found that the process of finalising expenditure on programmes which had reached the end of their planned lives was slow. Amounts outstanding for periods prior to 1994 totalled €1.1 billion (£671 million). The Court accepted that there had been improvements in the closure process in some Member States, for example Italy and the United Kingdom. However, it reiterated its findings from previous reports that shortcomings at Member State and Commission level were the root cause of the delays. It recommended that the Commission should cancel automatically all amounts for programmes approved before 1 January 1994 where application for final grant had not been received.
- 3.37 The Commission noted that the Court's figures showed progress made by the Commission in winding up assistance operations for the pre-1994 period. The Commission commented that it was doing everything it could to wind up all other programmes from this period. It said that it intended to complete examinations currently in hand but that it considered the Court's recommendation to cancel amounts had an unclear legal basis.

## Conclusions

- 3.38 The Court's work on the Statement of Assurance and in its Special Reports provides a useful assessment of the management of the Community General Budget as a whole. In particular, we note that:
- the Court has moved towards providing more diversified information on the nature, location and causes of the problems affecting the management of Community funds in its Annual Report. Developments of this kind should be continued to help the Commission and Member States to identify problem areas more easily and target management effort to address them more effectively; and
  - the Court has again been unable to provide positive assurance on the legality and regularity of the great majority of Community expenditure and considers that improving Member State checks is central to ensuring the correct use of Community funds. The systems in the United Kingdom have recently been strengthened to comply with new regulations issued by the Commission in the key budgetary areas of the Common Agricultural Policy and the Structural Funds. However, minor errors and control weaknesses continue to be found and the departments and other authorities should constantly seek to improve the operation of the United Kingdom's systems.

# Part 4

## Other financial management issues

- 4.1 This part of the report deals with other major financial management issues which the Community is currently facing. The topics addressed are:
- the progress being made to reform the Commission, in particular to strengthen financial management and control;
  - the action being taken to tackle fraud and irregularity, including the work of the OLAF; and
  - issues relating to enlargement.

### Reform of the European Commission

4.2 In March 1999 all 20 European Commissioners resigned following a period of rising concern about the Commission's financial management. Throughout 1998 the European Parliament withheld discharge for the 1996 Budget, and in January 1999 considered a motion of censure against the Commission. If such a motion had been passed by a two-thirds majority, it 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, which 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 instead voted to establish a Committee of Independent Experts to examine specific allegations of fraud and mismanagement within the Commission. The Committee reported in March 1999, and although it found no Commissioner directly or personally involved in fraudulent activities, in the light of the general criticisms which it raised about the Commission's management of its own programmes, all 20 Commissioners resigned. The Committee of Independent Experts published a further report in September 1999.

- 4.3 The new Commission issued its White Paper on Reform in March 2000<sup>31</sup>, in the wake of these events. The Commission intended to put the entire programme of changes in place by the second half of 2002. The Comptroller and Auditor General's reports published in April 2000<sup>32</sup> and April 2001<sup>33</sup> outlined the action the European Commission proposed to take and the progress it was making.
- 4.4 The United Kingdom Government, which seeks to influence the Commission primarily through the Council of Ministers, has been supportive of the moves to reform the Commission, to improve financial management and control, and to reduce levels of fraud and irregularity. The Government is committed to working with the Commission to improve the management of Community funds, and attaches great importance to reforming the Financial Regulation and the Staff Regulations.
- 4.5 The Commission's strategy for reform and modernisation was supported by an action plan, setting out 98 specific tasks with implementation deadlines stretching into 2002. In a report published in February 2001, the Commission concluded that there had been substantial progress in implementing the reforms, which were generally on schedule. However, the Commission recognised that much remained to be done before change was fully implemented across the Commission and tangible results were evident.
- 4.6 The Court did not systematically review progress on the reform process in its Annual Report for 2000, although it followed up on some specific aspects, such as the development of the European Anti-Fraud Office (OLAF). In December 2001, the Court told us that the reform programme, when fully implemented, should address many of the weaknesses which the Court has highlighted in its annual reports. The Court noted that, although progress was being made in setting up new systems, it

<sup>31</sup> *Reforming the Commission - a White Paper (March 2000).*

<sup>32</sup> *Financial management of the European Union (HC 437, 1999-2000).*

<sup>33</sup> *Financial management of the European Union (HC 402, 2000-2001).*

would be some time before it would be possible to assess whether the intended improvements in financial management and other areas were being achieved.

- 4.7 The Commission's strategy for reform set out three specific areas for action - audit, financial management and control; priority setting, allocation and efficient use of resources; and human resources development. This section of this report outlines the progress being made by the Commission to implement the proposed reforms in each of these areas.

## Audit, financial management and control

- 4.8 In the Reform Strategy White Paper, the Commission noted that problems had arisen because financial management and control systems were too centralised for the constantly increasing volume and variety of transactions that they had to handle. The proposals set out in the Reform Strategy amounted to a radical overhaul of financial systems, with the aim of restoring public confidence and creating a culture where managers took responsibility for the quality, regularity and efficiency of their actions. The Commission intended to decentralise approval for financial decisions from a centralised Financial Control Directorate General to the staff in individual Directorates General<sup>34</sup> responsible for implementing policies and programmes. Key reforms in this area focused on:

- the decentralisation of financial control;
- accounting reform; and
- internal audit.

### Decentralisation of financial control

- 4.9 The Commission began many of the planned actions in its Reform Strategy in this area during 2000, and 2001 saw the consolidation of the process. Managers in each Directorate General finalised proposals for redesigning their internal control systems, and presented them to the Financial Circuits Group, for feedback on their appropriateness, prior to implementation. The training of staff responsible for financial management in the operational Directorates General continued. The Commission intends that each Director General will sign an annual Statement of Assurance on the operation of control systems. The target date for this reform of April 2001 was not achieved, but the Commission now expects statements to be provided in April 2002, on the financial year 2001.

## Accounting reform

- 4.10 In order to be able to abolish centralised checking of expenditure by the Financial Control Directorate General, the Financial Regulation<sup>35</sup> must be modified. This requires the unanimous approval of the Council, after consultation with the European Parliament. Some slippage has occurred in this area, against the best case scenario the Commission foresaw in December 2000. At that time, the Commission told us that the earliest the new Financial Regulation could be in force was 2002. However, protracted consultation procedures on the content of the amended Financial Regulation continued throughout 2001, and the European Parliament did not adopt a formal opinion on recasting the Financial Regulation until November 2001. The Commission hopes that the new Financial Regulation will be approved by the Council by the end of 2002. This is still within the broad timetable set by the Commission in the White Paper, of securing agreement by the Council to amendments to the Financial Regulation in 2002. Under this timetable, the provisions of the new Financial Regulation should come into force in 2003.

- 4.11 For several years, the Court has highlighted inadequate accounting practices and the failure by the Commission to introduce an effective accounting framework, based on the principles of accruals accounting. The Commission has acknowledged to us that it does not have an adequate accounting framework and that improvements are needed to enable it to produce reliable, accurate and complete financial statements. The Commission initiated a study on this matter by a group of independent experts who reported in July 2000. However, the Court noted that the Commission had made little progress in taking its proposals forward, beyond drafting an Action Plan which had not been approved.

- 4.12 Both the Commission and Court support an eventual transition to accruals accounting, in line with best international practice. There are many tasks to be completed to achieve such a transformation, not least of which are setting up the technical infrastructure to capture all key accounting data; recruiting appropriately qualified staff to assist in developing an accounting framework; training staff to understand and use an accruals based approach; and promoting the idea of accruals accounting to key players within the various European Institutions. Both the Commission and the Court told us that more human resources would be necessary to support the successful and timely development of a new accounting framework.

<sup>34</sup> Directorates General are the main administrative units within the Commission.

<sup>35</sup> The Financial Regulation is the key piece of secondary legislation governing financial management and control in the European Union. The Regulation sets out procedures for agreeing and implementing the Community General Budget, and for presenting and auditing the Community accounts. Changes to the Regulation are proposed by the Commission and require the unanimous approval of the Council, after consultation with the European Parliament.

4.13 The United Kingdom recently went through a similar transformation in its public accounting approach with the introduction of Government Resource Accounting. The Commission told us that it hopes to learn from the experiences of Member States who are at the forefront of accruals accounting, such as the United Kingdom. We note, however, that the development of Resource Accounting in the United Kingdom public sector was a long and carefully planned process which took some years to carry through.

4.14 This relatively long development time was necessary to allow full consultation on the development of the accounting framework with key stakeholders, including Parliament, the Treasury, the National Audit Office, and individual departments and agencies; to train staff; and to allow for parallel running of the new and old systems to ensure that teething problems were ironed out before resource based accounting became the only system. The Community's financial statements already include elements of accruals accounting, particularly a balance sheet dealing with assets and liabilities, which did not exist in the United Kingdom public sector prior to the introduction of Resource Accounting. However, the Commission's operations covering 15 Member States and their associated diversity of financial systems, and a portfolio of programmes and projects administered by many different players at the central and national level, are of a relatively greater complexity than those in the United Kingdom. It is unlikely therefore that the Commission will find the process of introducing accruals accounting quick or easy. The Commission's current timetable appears overly optimistic and will need to be highly resourced if it is to be met.

#### Internal audit

4.15 Improving internal audit capacity within the Commission was another key reform area in the White Paper. The Internal Audit Service and Audit Progress Committee were set up during 2000 as planned, and an internal audit capability was established within each of the Commission's operational Directorates General.

4.16 During 2000 and 2001 more staff were recruited to the Internal Audit Service and the audit sections in the Directorates General, training took place and operational procedures were developed. Recruitment to the Internal Audit Service took place somewhat more slowly than had been hoped, but by December 2001, it was at about two-thirds capacity, although senior Internal Audit Service staff told us they did not expect to achieve their full staffing complement until the end of 2002. The Internal Audit Service carried out several audits of the Commission's work on procurement, building policy, the recovery process and discharge during 2000 and 2001.

#### Overall progress on audit, financial management and control reforms

4.17 Most of the organisational reforms in this area have been put in place, although the key task of amending the Financial Regulation remains to be completed. The Commission told us in December 2000 that it expected improvements in financial management resulting from the reforms would start to be evident in 2001, both in terms of fewer errors and better quality of service, for example more payments being made on time. However, during our visit in December 2001, the Commission felt that it was still too early to see evidence of such impacts, and that further time was required for the changes to bed in successfully. The Commission felt that important progress was being made in achieving a cultural change among its staff, whereby individuals would assume accountability for the resources under their control.

#### Priority setting, allocation and efficient use of resources

4.18 The second broad aim of the reform strategy was to develop a more effective method for setting priorities and allocating resources to them. The Commission considered that prior to the reform process, the allocation of resources was not linked to priorities. This was due both to the Commission making decisions on activities and resources separately; and to the Council and Parliament allocating the Commission additional tasks and activities without a corresponding increase in resources. The two main reform activities under this strand relate to:

- introducing Activity Based Management; and
- improving the balance between internal and external management of activities.

#### Activity Based Management

4.19 The introduction of Activity Based Management is a central pillar of the Commission's reform process in this area, integrating the Commission's decision-making processes into a consistent system which matches political priorities with financial and human resources. A unit with responsibility for strategic planning and programming was set up in July 2000, and the Commission approved a detailed step-by-step programme to implement Activity Based Management in July 2001.

4.20 The four main elements in the Commission's Activity Based Management system are:

- an **Annual Policy Strategy** - defining the political priorities and the necessary staff resources;

- an **Annual Commission Work-programme**, setting out clear and measurable objectives, supported by Annual Management Plans for each Service;
- **monitoring** of progress made throughout the year; and
- **evaluation activities**, with a view to informing decision-making for subsequent years. The results of the evaluation activities will be presented in each Service's Annual Report.

4.21 These elements will be introduced progressively and all elements should be fully operational by 2004. The first Annual Policy Strategy was adopted in 2001. Each Service will prepare Annual Management Plans from 2002 which will incorporate more detail year by year - in 2002 they will be broken down into an average of seven headings, rising to 25 headings in 2003. Evaluation activities will gradually be enhanced to serve the preparation in 2002 of the 2003 Annual Policy Strategy. The introduction of Activity Based Management is supported by the development of an information system called the Integrated Resource Management System. This system was operational in six Services by July 2001, and it will apply to the whole Commission by mid 2002.

#### External management of activities

4.22 The Reform Strategy White Paper identified that 'externalisation' could be a more efficient way of managing activities, rather than seeking to exercise centralised Commission control. The three forms of externalisation established by the Commission are use of dedicated Executive Agencies; use of networks of national agencies; and outsourcing to the private sector. In December 2000, the Commission adopted a draft regulation on devolution of responsibilities to Executive Agencies. In November 2001, it adopted draft measures for decentralising executive responsibilities to national public bodies which act as partners in implementing some Community programmes; and on outsourcing management through contracts let to the private sector.

#### Human resources development

4.23 The Reform Strategy set out plans for a comprehensive overhaul of human resources policies, with the aim of allowing staff to fulfil their potential and managers to manage effectively, changes which the Commission considered vital to enable it to carry out its work efficiently. Many of the proposals in this area, for example, those relating to promotion and pay, require careful negotiation and the Commission is required to consult with staff and their representatives. The White Paper envisaged that human resources reform would be one of the most time consuming elements of the reform process.

4.24 In December 2001 the Commission told us that much work had been done in this area, and progress was being made, albeit somewhat more slowly than envisaged. In October 2001, the Commission adopted a Global Package for the Reform of Personnel Policy<sup>36</sup> which marked the end of negotiations on the political substance of the reform of personnel policy which had been on-going since the beginning of 2000. The measures contained in the Global Package cover all staff issues raised in the Reform Strategy. Some changes involve amending the Staff Regulations which requires the approval of the Council, after consultation with the other institutions concerned, others can be made unilaterally by the Commission within the framework of the current Staff Regulations.

4.25 Key proposals for change within the current Staff Regulations included:

- the introduction of an annual staff appraisal system to assess performance and potential, and establishment of a clear and transparent link between merit and promotion;
- encouraging structured mobility as a normal part of working life, to provide flexibility in responding to the Commission's workload; and
- a significant increase in training provision, including the establishment of a central training office.

The Commission announced the introduction of these measures in December 2001.

4.26 Key proposals for change requiring amendment to the Staff Regulations included:

- development of a more continuous career system with two 'function groups' - Administrator and Assistant;
- a single pay scale comprising 16 grades, with simplified allowances; and
- double the number of promotions compared to the current system.

Where proposals require changes to the Staff Regulations, the timetable for reform is longer. The White Paper indicated that the Commission would submit a full proposal on reforms to the Council by the fourth quarter of 2001, however, the Commission's proposals were not adopted for transmission to the Council and Parliament until April 2002. The Commission hopes the amended Staff Regulations will be approved by mid 2003. Implementation would be unlikely to start before the beginning of 2004.

## Fraud and irregularity

4.27 Irregularity, including fraud, generally results in a loss to the Community General Budget and the European Union taxpayer. 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. However, the Court noted in its report that, as in previous years, Member States were not consistent in how they interpreted and reported cases of fraud and irregularity to the Commission, and urged the Commission to establish agreed definitions and reporting requirements. The House of Lords European Union Committee, also criticised the lack of a common definition of fraud and irregularity in its report<sup>37</sup>.

4.28 The Commission considers that although a definition of irregularity cannot be found in the various Community regulations which require Member States to inform the Commission of irregularity, a definition is available in other legislation<sup>38</sup>. However, the Commission recognises that Member States do report occurrences of fraud and irregularity on different bases, and is currently working with them to define a standard approach to distinguish between 'suspected fraud' and 'other irregularities'. A working group, set up under the auspices of the Advisory Committee for the Co-ordination of Fraud Prevention, held meetings in June and November 2001 on this issue.

4.29 The Community and the Member States are jointly responsible for the fight against fraud and other illegal activities detrimental to the Communities' financial interests. The European Anti-Fraud Office (OLAF) was established in June 1999, as part of the reform process, replacing the former anti-fraud unit. OLAF plays a co-ordinating and enabling role in fighting fraud within the Community. Member States are obliged to report to it cases of suspected fraud or irregularity valued at more than €10,000 in the Revenue sector, and €4,000 in the Agriculture and Structural Funds.

4.30 Each year OLAF publishes information about the frauds and irregularities which have been reported to it by Member States or Community institutions<sup>39</sup>. For the first time in 1999, the Commission classified the cases reported by Member States into fraud and other irregularity, although it recognised that the distinction between fraud and irregularity was not precise and that definitions varied from one Member State to another. However, in 2000, because of the differing practices in Member States, and the practical difficulties of distinguishing between fraud

and irregularity, OLAF did not produce a breakdown between the two elements. Thus the number of cases notified by Member States are reported in a single category covering both fraud and irregularity.

4.31 In total, Member States notified the Commission of 6,587 cases of fraud and irregularity in 2000, with an estimated value of some €1.1 billion (£0.7 billion). The cases concerned Community revenue, Common Agricultural Policy and Structural Funds expenditure. **Figure 3** provides breakdown by budget category.

### 3 Cases of fraud and irregularity notified in 2000

Area of the Budget	Number of cases	Amounts involved (€ million)
Revenue from customs and agricultural duties, and sugar levies	2,403	535
Common Agricultural Policy expenditure	2,967	475
Expenditure on structural measures	1,217	114
<b>Total</b>	<b>6,587</b>	<b>1,124</b>

*Source: data from Protection of the Communities' Financial Interests and the Fight Against Fraud, Annual Report 2000*

4.32 OLAF reported that in comparison with previous years the overall level of fraud and other irregularities detected or suspected in 2000 increased. The number of cases of reported fraud and irregularities detected in relation to revenue decreased slightly, but this was more than outweighed by increases in the number of cases relating to the Common Agricultural Policy and, particularly, the Structural Funds. The value of fraud and irregularity reported in 2000, increased in all sectors compared to that reported in 1999.

4.33 In 2000, the United Kingdom notified OLAF of 968 cases of suspected fraud and irregularity involving some €380 million (£237.2 million). Overall the United Kingdom reported the highest value of cases of suspected fraud and irregularity, and the second highest number of cases of all Member States. OLAF noted that many of the irregularities detected, related to the import of milk products from New Zealand, which had a considerable financial impact on the amounts established by the United Kingdom. Some Member States reported no cases of fraud or irregularity in

<sup>37</sup> See Footnote 9.

<sup>38</sup> Article 1(2) of Regulation (EC, Euratom) No 2988/95 states that, 'irregularity shall mean any infringement of a provision of Community law resulting from an act or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly or on behalf of the Communities, or by an unjustified item of expenditure.'

<sup>39</sup> Protection of the Communities' Financial Interests and the Fight Against Fraud, Annual Report 2000, COM (2001) 255, May 2001.

specific budget areas for 2000 - Greece in relation to revenue; Luxembourg in relation to the Common Agricultural Policy; and Belgium and Luxembourg in relation to the Structural Funds.

4.34 OLAF attributed the rise in the number of reported cases to more robust audit and control systems put in place by Member States, and noted that an increase in reported fraud and irregularity levels does not necessarily mean that actual fraud levels have increased. OLAF also noted that it was difficult to attribute frauds and irregularities to a particular accounting period or calendar year, and that the value of cases could change over the period of investigation as more information came to light. In addition, the picture could be distorted by the identification of a few high-value cases in a particular year.

4.35 A variety of factors can affect the value and number of suspected fraud and irregularity cases reported to OLAF and these raw data should be treated cautiously. As has been noted, there are different interpretations of fraud and irregularity in different Member States which can affect what is reported. Timing factors may also play a part in that some Member States may choose to investigate in greater depth before reporting a suspected case, or have a more protracted legal process before a suspected case is classified as a fraud. The overall robustness of procedures to detect fraud and irregularity and the diligence with which they are applied, may vary from one Member State to another, affecting the level of cases detected, and thus reported to OLAF. The level of transactions in individual Member States can also have an effect, in that all other things being equal, more instances of fraud and irregularity would be expected in a particular Member State collecting more revenue or spending more funds compared to others.

4.36 The majority of the cases reported by the United Kingdom related to revenue collection cases. The United Kingdom reported more cases than any other Member State in this area - 496 out of a total of 2,403 (20.6 per cent), and also reported the highest value of potential fraud or irregularity, €349.5 million (£218.1 million) out of a total of €534.5 million (£333.6 million), 65 per cent of the total. This was particularly affected by one very large case involving imports of dairy products from New Zealand.

4.37 In relation to the Common Agricultural Policy, OLAF's Fight Against Fraud report for 2000 showed that the United Kingdom reported the third highest level of cases by number, 393 out of 2,967 (13 per cent), and the fifth highest value of cases, €20.5 million (£12.8 million), out of €474.6 million (£296.2 million), four per cent. The greatest value of cases was reported by Italy, €281.2 million (£175.5 million), 59 per cent, which detected two large-scale suspected frauds relating to 2000.

4.38 The United Kingdom reported the sixth highest level of cases in relation to the Structural Funds, 79 out of 1,217 (7 per cent), with a value of €10.7 million (£6.7 million) out of a total of €114.4 million (£71.4 million), 9.4 per cent.

4.39 As well as cases reported by Member States, the various European Institutions reported 328 new cases, involving some €906 million (£565.4 million), most of which OLAF believed involved criminal conduct. Nearly 150 of these cases concerned expenditure managed directly by the Commission, amounting to some €170 million (£106.1 million).

## Tackling fraud and irregularity

4.40 OLAF is responsible for conducting administrative anti-fraud investigations in Member States, the Commission, and other Community Institutions and bodies. Its activities cover the detection and monitoring of frauds in the customs field, misappropriation of subsidies and tax evasion, insofar as the Community budget is affected by it, as well as the fight against corruption and any other illegal activity harmful to the financial interests of the Community. OLAF does not have the power to conduct criminal investigations and prosecutions, which are the responsibility of Member States. OLAF is operationally independent in terms of opening and conducting investigations but remains part of the Commission in other respects, for example in contributing to the development of anti-fraud legislation. OLAF has developed a four-pronged strategy to take forward the fight against fraud:

- an improved legal framework to support anti-fraud measures;
- improved co-operation with and between Member States, as the prime responsibility and legal sanctions for tackling fraud lies with individual Member States;
- development of improved information tools and intelligence - OLAF intends to provide European Union-wide information to all Member States and will link this to a risk analysis programme; and
- strengthened support to Member States in developing penal systems that are able to combat and prosecute complex financial fraud cases effectively.

4.41 Under Article 280 of the Treaty establishing the European Community, Member States share responsibility for combating fraud and should take the same measures to counter fraud affecting the financial interests of the Community as they take to counter fraud affecting their own financial interests. Member States undertook a wide range of legislative and administrative actions during 2000 to improve their measures for

countering fraud. In the United Kingdom initiatives included legislative measures to allow interest to be charged on customs debts and the implementation of a civil penalty regime for customs duty evasion; the establishment of a customs intelligence team to develop intelligence in all areas of commercial customs fraud and serve as a liaison point with other Member State customs intelligence services; and the establishment of a scheme to detect and recover wrongful payments under the European Social Fund which brought recovery rates close to 100 per cent.

### Staffing issues

4.42 The Court carried out follow up work on a Special Report which it had published in 1998 on anti-fraud work within the Commission<sup>40</sup>. In its 2000 Annual Report, the Court particularly focused on the period since OLAF was established. OLAF was set up in June 1999, but a Director (with the status of a Director General<sup>41</sup>) did not take up post as head of OLAF until March 2000. All of the staff from the Commission's previous anti-fraud unit transferred directly to OLAF, but delays were experienced in recruiting additional staff to bring OLAF fully up to its planned complement of 301 posts. The European Parliament blocked 76 posts until OLAF had reviewed the suitability of all the staff who had been transferred to it, and the Commission accepted the resulting transfer decisions. The Court considered that this conditionality curtailed the independence both of the Director and OLAF as a whole.

4.43 By June 2001, the staffing of OLAF was at 207 out of the complement of 301 which the Commission had planned to have in post by the end of 2001. By December 2001 240 staff were in post and a further 30 job offers had been made and recruits for these were in the pipeline. Permission to recruit the final complement of 30 staff had also been given by the European Parliament, so that recruitment could begin in 2002.

### Regulatory initiatives

4.44 The Commission considered that a large proportion of the frauds detected in recent years have resulted from large-scale organised crime across national borders. Many of the European Union's initiatives to tackle fraud have therefore been directed at harmonising national criminal laws and penalties, and strengthening co-operation between Member States. Work is underway to create 'Eurojust', a judicial co-operation

unit involving magistrates, prosecutors and police officers across the European Community, and a provisional unit (Pro-Eurojust) started work in March 2001. 'Eurojust' is intended to facilitate the proper co-ordination of national prosecuting authorities and support criminal investigations in cases of serious organised crime across national borders.

4.45 In December 2001, the Commission issued a consultative Green Paper on the establishment of an European Public Prosecutor to protect the Community's financial interests under criminal law. The European Public Prosecutor would be an independent judicial authority empowered to conduct investigations and prosecutions anywhere in Europe into offences against the Community's financial interests. The European Public Prosecutor would handle prosecutions in the national courts, with trial and judgement being in the hands of the national courts. The Commission is seeking views on the Green Paper by June 2002, and intends to prepare a proposal for legislation no later than the beginning of 2003.

4.46 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 Member States to ensure that such frauds are punishable with imprisonment and that offenders are extraditable. The convention and protocols can only enter into force when they have been ratified by all Member States, and the Commission considers it unlikely that this process will be completed in all Member States for some years. The United Kingdom was one of the earliest Member States to complete the process, ratifying the convention and protocols in September 1999. By March 2002 ratification was fully complete in eight Member States and partially complete in the other seven<sup>42</sup>.

4.47 In May 2001 the Commission adopted a draft directive to protect European Union funds under criminal law<sup>43</sup>. This is intended to give new impetus to the fight against fraud, corruption and money laundering, by bringing into force most of the provisions contained in the convention and two protocols, even if all Member States have not completed the ratification procedures. The Commission is able to do this under a new legal basis to the Treaty establishing the European Community,

40 *Special Report No 8/1998 concerning the 'Commission departments specifically involved in the fight against fraud, notably the Unit for the Co-ordination of Fraud Prevention'*

41 *Directors General head the Directorates General, the Commission's main administrative units.*

42 *In March 2002, ratification was fully complete in Belgium, Denmark, France, Greece, Portugal, Spain, Sweden and the United Kingdom, and was partially complete in Austria, Finland, Germany, Ireland, Italy, Luxembourg and the Netherlands.*

43 *Proposal for a Directive of the European Parliament and of the Council on the criminal law protection of the Community's financial interests, COM/2001/0272 final, OJ C240E, 28/8/01.*

introduced by the Amsterdam Treaty in 1999<sup>44</sup>, which brought the harmonisation of criminal offences and sanctions concerning fraud affecting the financial interests of the Community within the Community's competence.

## Enlargement

- 4.48 The approaching enlargement of the European Union is a matter which will impact on all the European Institutions. As well as the political and administrative issues associated with enlargement there are important issues concerning the financial management of the European Community, for example, the ability of new Member States to administer programmes in compliance with the Community's financial rules and regulations, ensuring the legality and regularity of transactions.
- 4.49 The Commission said in November 2001, following its annual review of the progress being made by Candidate Countries, that ten Candidate Countries - Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, the Czech Republic, and Slovenia - could complete accession negotiations by the end of 2002, joining the Union in 2004. The other two Candidate Countries which are currently negotiating their accession - Romania and Bulgaria - have later target dates for joining the Union. The Commission intends to issue an updated 'roadmap'<sup>45</sup> for negotiations with Romania and Bulgaria in late 2002, with a revised pre-accession strategy. Negotiations on accession have not yet begun with the final Candidate Country, Turkey, which the Commission has concluded has not yet met the political criteria for accession. **Figure 4** illustrates the timetable currently envisaged for European enlargement.
- 4.50 The reform process did not address the issue of enlargement specifically, but by introducing more flexible procedures in the key areas of audit, financial management and control; priority setting and resource allocation; and human resources, it should establish some of the necessary groundwork for managing the expansion process successfully. However, the process of integrating a large number of new Member States into the Union and maintaining efficient and effective functioning of all the key institutions will be a complex one.
- 4.51 The House of Lords discussed some of the implications of enlargement for the European Court of Auditors in its report (paragraph 1.12), and similar issues of how to achieve efficient and effective working practices with a larger number of Member States will affect all the European Institutions. The European Council meeting in Laeken in December 2001, decided to convene a Convention, presided over by Mr Giscard d'Estaing, and involving representatives from the Candidate Countries as well as existing Member States, to give structure to and broaden the public debate on the future of the European Union. The Convention met for the first time in March 2002, and is expected to complete its proceedings by March 2003, as part of the preparation for the next Inter-Governmental Conference in 2004. The main issues which the Convention will address concern: the division and definition of competence between European level institutions and Member States; the simplification of the instruments for carrying out the Union's activities; greater democracy, transparency and efficiency; and consideration of a constitution for European citizens.
- 4.52 The Commission is also addressing European governance issues, and published a consultative White Paper in July 2001<sup>46</sup>, requesting comments by March 2002. The White Paper considers how greater popular involvement can be achieved in European affairs; better policies for regulation and delivery of activities; the refocusing of policies and institutions; and how the European Union can contribute to better governance on a global scale.
- 4.53 The pre-accession Phare programme, which provides assistance for investment and institution building, is the main support mechanism for assisting Candidate Countries to improve their financial management and administrative procedures. One of the ways by which support is provided to Candidate Countries under Phare is through twinning projects, whereby experts from one or more Member State administrations, are seconded to work alongside their counterparts in the Candidate Country, to provide in-depth, long-term support. Twinning projects are intended to help Candidate Countries strengthen their institutional and administrative capacity, so that they are able to apply European Union legislative and regulatory requirements to the same standards as current Member States. Public finance is one of the main fields covered by twinning projects.

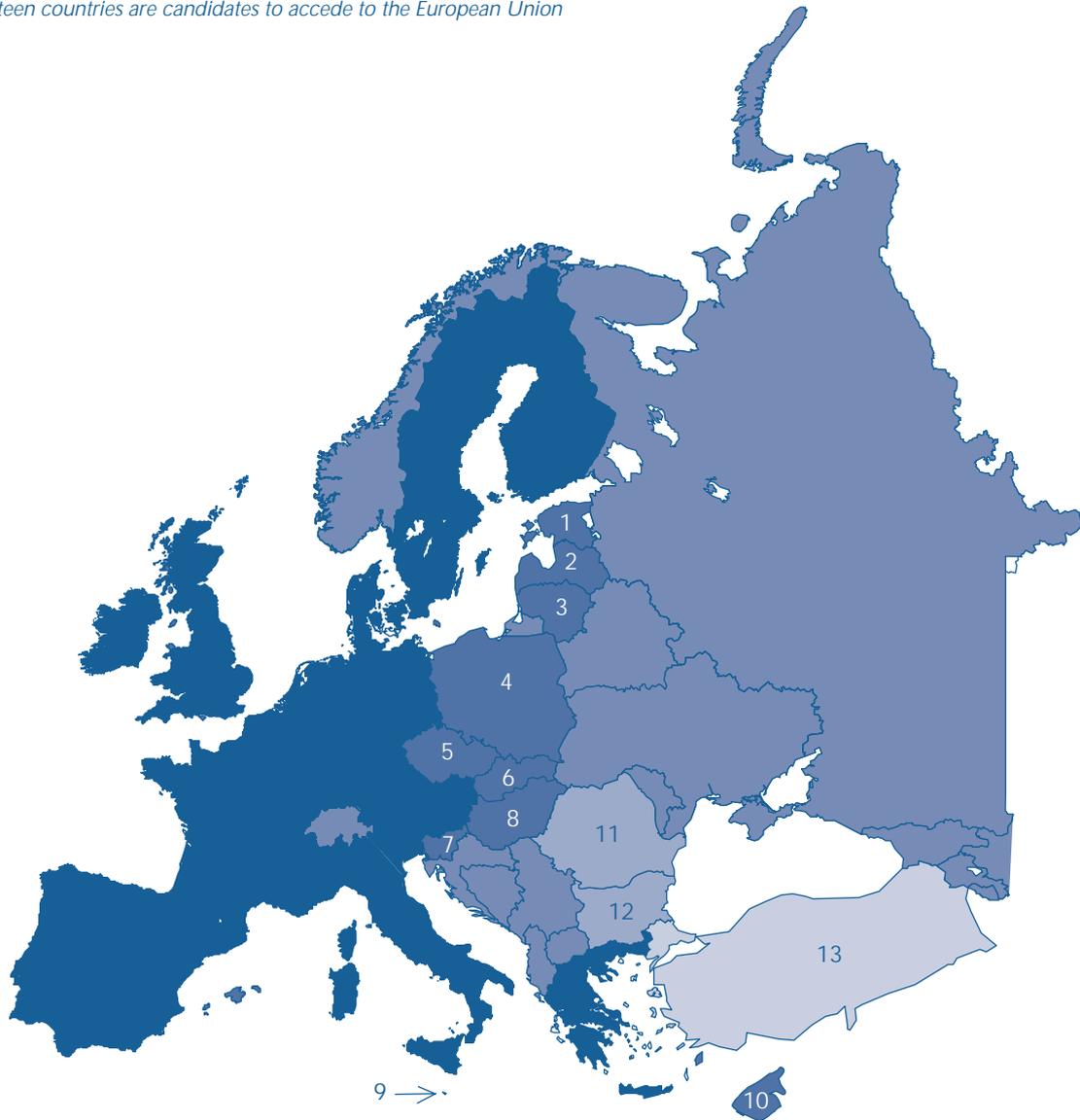
44 Article 280 of the Treaty establishing the European Community, as amended by the Amsterdam Treaty states that, 'The Council ..... shall adopt the necessary measures in the fields of the prevention of and the fight against fraud affecting the financial interests of the Community with a view to affording effective and equivalent protection in the Member States. These measures shall not concern the application of national criminal law or the national administration of justice.'

45 The 'road map' for Candidate Countries outlines a timetable for negotiations to take place on accession issues. This concept was originally endorsed by the European Council at Nice in December 2000.

46 European Governance, a White Paper, COM/2001/0428, OJ C287, 12/10/2001.

4 Enlargement of the European Union

Thirteen countries are candidates to accede to the European Union



Key:		
Negotiations completed by end 2002	Negotiations continuing after 2002	Negotiations not yet commenced
1. Estonia	6. Slovak Republic	11. Romania
2. Latvia	7. Slovenia	12. Bulgaria
3. Lithuania	8. Hungary	13. Turkey
4. Poland	9. Malta	
5. Czech Republic	10. Cyprus	

Source: data from the Annual Report of the European Court of Auditors 2000, and the Financial Statements of the European Community 2000

4.54 The United Kingdom, has been or is currently involved in some 20 twinning projects in the fields of public finance and public administration in all ten of the Candidate Countries eligible for Phare projects<sup>47</sup>. The

National Audit Office has been very active in this area, and since 1998 has been selected to lead projects with the Supreme Audit Institutions of Hungary, Slovenia, Romania, Bulgaria, Latvia and Lithuania.

47 See Footnote 18 also. Countries eligible for Phare funding are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

## Conclusions

4.55 The European Community is currently addressing a range of issues of significance to good financial management and control. We recognise that the United Kingdom Government has been supportive of these moves and we note that:

- good progress has been made in implementing the changes set out in the Reform Strategy, broadly within the original timetable, although progress on the reform of human resources policy has been slower than envisaged. The two critical, and potentially most difficult, areas where reforms remain to be completed are recasting of the Financial Regulation and the Staff Regulations, both of which require approval from the Council of Ministers. The United Kingdom Government, through the Council and its other links with the Community, should continue to support the Commission in its efforts to implement the reforms and ensure that the momentum is maintained;
- the improved financial accountability and management which the Commission is seeking to achieve as part of its Reform Strategy, require changes in culture, as well as organisational structures, and that the Commission and the Court consider it is too early to judge whether the reforms have been a success. Nevertheless it is important to identify any tangible improvements achieved by the reform process;
- different practices continue to exist between Member States in reporting fraud and irregularity to the Commission. We agree with the Court that robust working definitions, agreed and understood by all parties, need to be established, in order to ensure suspected fraud and irregularity are reported on a common basis and allow more meaningful comparisons and trend analysis to be undertaken. We welcome OLAF's efforts to take this forward and urge the United Kingdom departments to play a full role; and
- the enlargement of the European Union in the next few years will have an impact on the operation of all the European Institutions. The United Kingdom Government should seek to ensure that financial management issues are given appropriate priority during the Convention on the future of Europe and in other bodies dealing with the enlargement process.

# Appendix 1

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

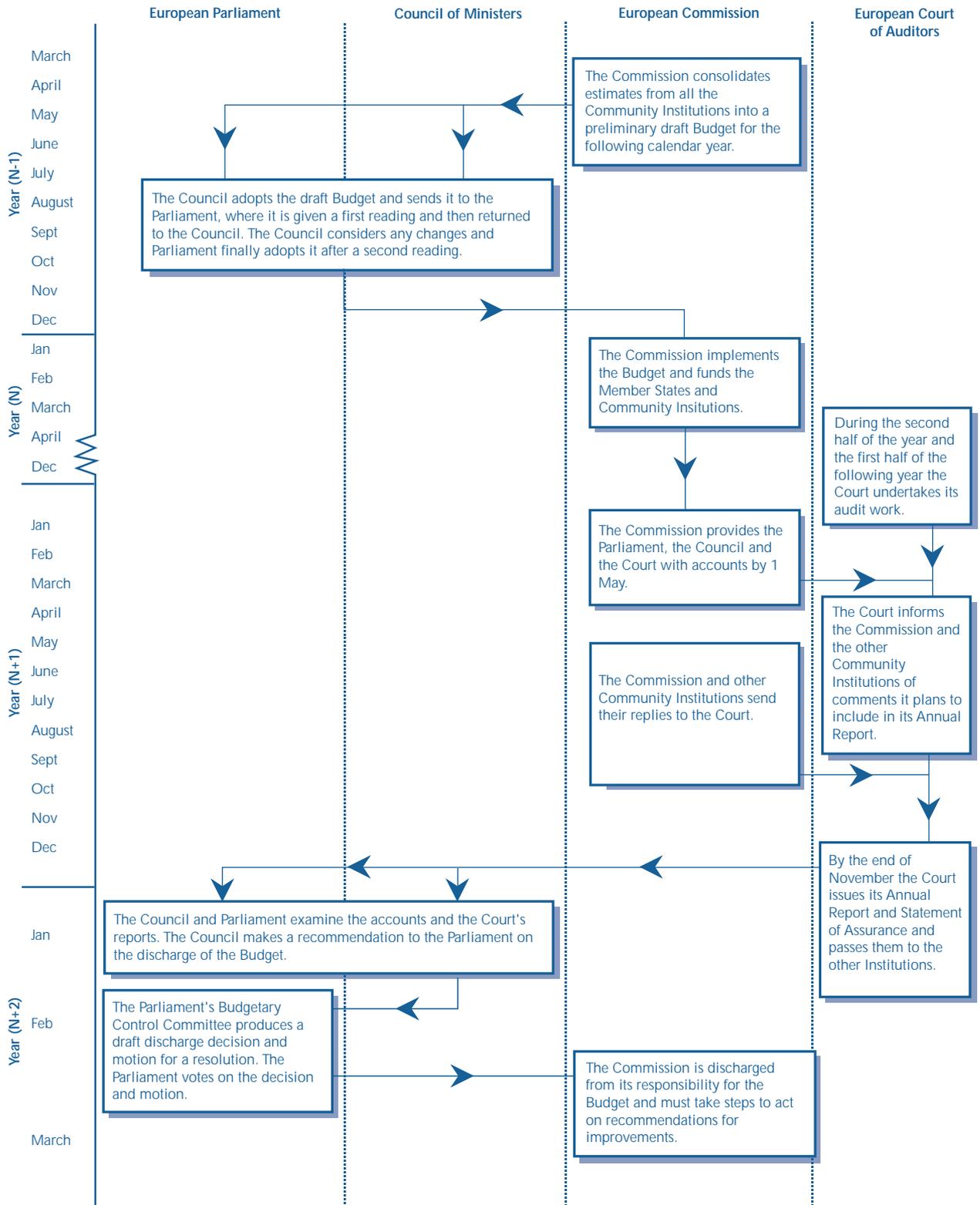
House of Commons number	Title
HC 615, 2001-2002	Agricultural fraud: the case of Joseph Bowden
HC 402, 2000-2001	Financial Management of the European Union
HC 131, 2000-2001	Regulating Freight Imports from Outside the European Community
HC 437, 1999-2000	Financial Management of the European Union
HC 273, 1999-2000	The Sheep Annual Premium Scheme in England
HC 279, 1998-99	Audit of the General Budget of the European Union for 1997 and related developments
HC 223, 1998-99	Arable Area Payments Scheme
HC 853, 1997-98	BSE: the cost of a crisis
HC 697, 1997-98	The Annual Report of the European Court of Auditors for 1996
HC 566, 1997-98	Reform of customs transit in the European Community
HC 276, 1997-98	Exchange of information on direct taxation within the European Union
HC 251-XIII, 1997-98	Appropriation Accounts 1996-97 (Class XIII, Vote 2): European Social Fund (Scotland)
HC 251-III, 1997-98	Appropriation Accounts 1996-97 (Class III, Vote 1): Intervention Board Executive Agency
HC 120, 1997-98	Protecting environmentally sensitive areas

# Appendix 2

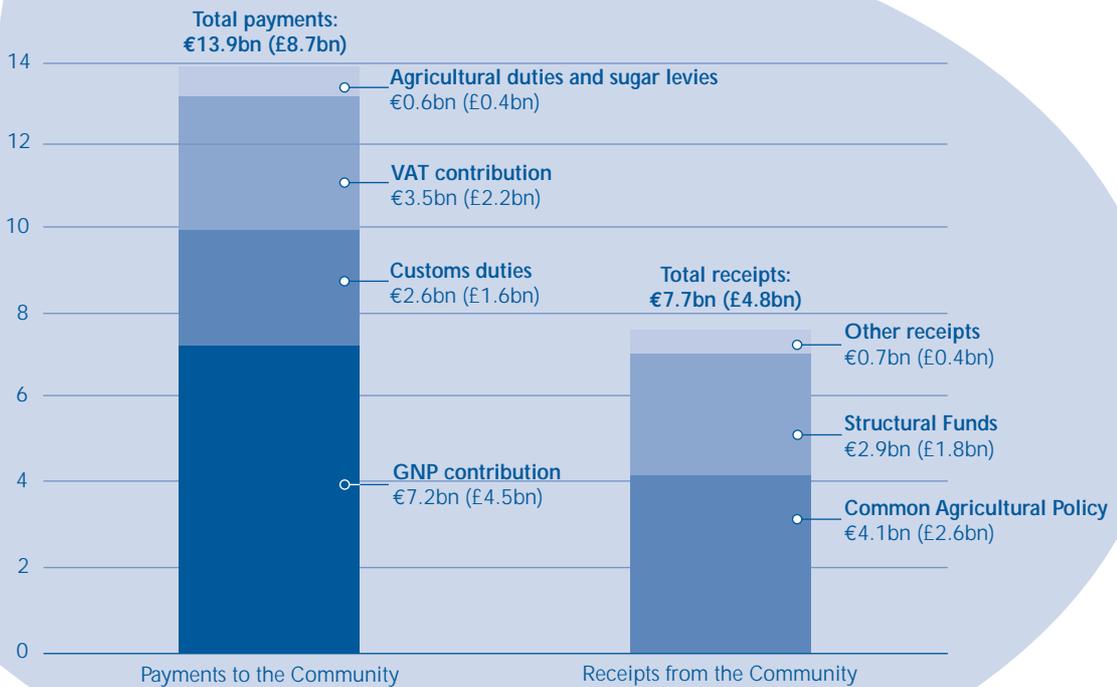
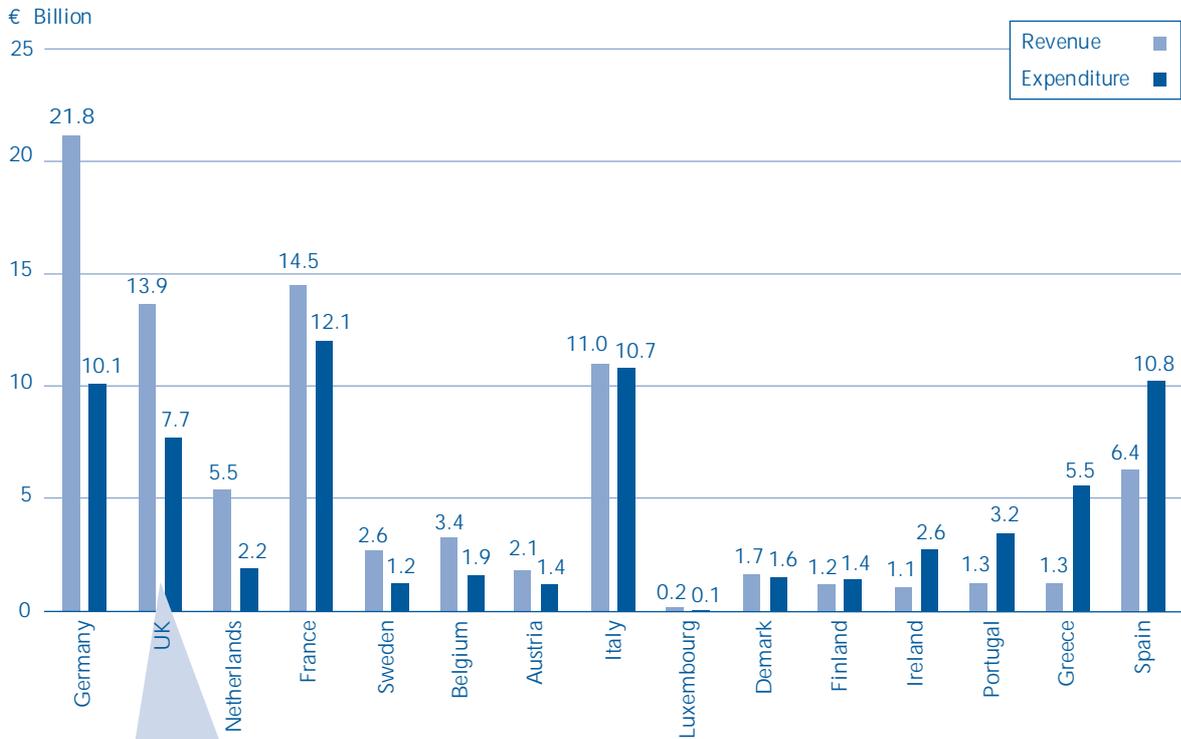
## The procedure for setting, controlling and accounting for the Community General Budget

1. The National Audit Office's report on the Annual Report of the European Court of Auditors and the Statement of Assurance for 1995 (HC 332, 1996-97) described in detail the roles of the different Community Institutions in setting, controlling and accounting for the Community General Budget. This appendix provides a summary of that procedure, which is shown in [Figure 5](#).
2. Annual budgetary decisions are taken in the context of the European Union's financial perspectives, the Own Resources Decision and relevant programme specific legislation. The financial perspectives are multi-annual spending plans for broad categories of expenditure from the Community Budget. The current financial perspective, agreed following the Berlin European Council in 1999, covers the years 2000 to 2006. The Own Resources Decision, a legal text agreed by Member States and ratified by national parliaments, sets out the basis on which revenue is contributed to the Community Budget. Specific Community legislation sets out the objectives and detailed arrangements for individual expenditure programmes and policies.
3. 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 has powers of amendment, although these are limited in respect of 'compulsory' expenditure (including expenditure on the Common Agricultural Policy).
4. The Commission implements the expenditure set out in the Budget under its own authority, in accordance with financial regulations approved by the Council and as provided in relevant specific European Union legislation. These regulations are intended to secure sound financial management and control of expenditure both within the Commission and in Member States, which administer around 80 per cent of the expenditure.
5. The Council and the Parliament monitor 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 the autumn of each year. Following a resolution by the Parliament, the 'Notenboom transfer' may be 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. The Commission also provides 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 allow the Commission to provide assurance to the Council and the Parliament that their wishes are being adhered to, or to explain why variances have occurred.
6. 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 for the Statement of Assurance. The results of this and other work by the Court on the revenue and expenditure programmes of the Community, are brought together in the Court's Annual Report published in November.
7. 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. This requires the Council and the Parliament to examine the annual accounts prepared by the Commission, and provides for the Parliament to decide, by the end of the following April, on a recommendation by the Council, whether formally to discharge the Commission from any further responsibility for the Budget. Discharge 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 may refuse to grant discharge if it is dissatisfied with 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 may also postpone discharge until the Commission has taken action on key weaknesses identified by the Court of Auditors.

5 Control of the Community General Budget



# Appendix 3 Community revenue and expenditure in 2000 by Member State



# Appendix 4

## Special Reports published by the European Court of Auditors during 2001

Special report	Title
20/2000	Management of the Common Organisation of the Market for Sugar
21/2000	The management of the Commission's external aid programmes (in particular on country programming, project preparation and the role of Delegations)
22/2000	Evaluation of the reformed clearance of accounts procedure
23/2000	Valuation of imported goods for customs purposes (customs valuation)
1/2001	URBAN Community initiative
2/2001	Management of emergency humanitarian aid for the victims of the Kosovo crisis (ECHO)
3/2001	The Commission's management of the International Fisheries Agreements
4/2001	The audit of the EAGGF - Guarantee - the implementation of the Integrated Administration and Control System (IACS)
5/2001	Counterpart funds from structural adjustment support earmarked for budget aid (seventh and eighth EDFs)
6/2001	Milk quotas
7/2001	Export refunds - destination and placing on the market
8/2001	Refunds for the production of potato and cereal starch and potato starch aid
9/2001	The training and mobility of Researchers' Programme
10/2001	The financial control of the Structural Funds, Commission Regulations (EC) No 2064/97 and (EC) No 1681/94
11/2001	The Tacis Cross Border Co-operation Programme
12/2001	Certain structural measures to improve the employment situation - the impact of ERDF aid on employment - ESF measures to combat long-term unemployment
13/2001	The management of the Common Foreign and Security Policy
14/2001	The follow up on the Court's Special Report No 19/1998 on BSE

# Appendix 5

## The European Court of Auditors' main findings on the reliability of the accounts of the Community for 2000

Problem	Effect
<b>Disclosure of fixed assets</b>	
<p>The figure for fixed assets was both understated because it did not take sufficient account of buildings being rented with an option to buy, by the Economic and Social Council (ESC) and the Committee of the Regions (CoR); and overstated because it did not take account of depreciation on the Council's building.</p>	<p>Understatement of €225 million (£140.4 million) and overstatement of €81 million (£50.5 million), amounting to a net overstatement of €144 million (£89.9 million)</p>
<b>Amounts receivable and potential assets</b>	
<p>The Commission was unable to explain how it had calculated amounts of sundry debt to be written off as irrecoverable in the figure for sundry debtors. No specific rules had been laid down for this.</p>	<p>Not quantified</p>
<p>The figure recorded under sundry debtors was incomplete as the Commission had to derive this value from non-accounting records.</p>	<p>Not quantified</p>
<p>The Commission's methodology for calculating a figure for potential recovery of funds from fraud and irregularity cases was flawed, with data not being drawn up on the same date, and the possibility of duplicate entries existing.</p>	<p>Not quantified</p>
<b>Advances and payments on account</b>	
<p>For a second year, the Commission made a significant effort to record in the balance sheet amounts transferred to intermediate bodies but not paid over to final recipients. However, the Commission was unable to produce complete and reliable information distinguishing between advance and final payments. Thus there was a lack of clarity on the extent to which funds had been paid over to final beneficiaries or were being held by intermediaries.</p>	<p>Not quantified</p>

Problem	Effect
<b>Commitments and potential liabilities</b>	
<p>The figure for commitments included amounts outstanding from before 1999, which had not been subject to any payment during 1999 or 2000. In some cases, the Court considered there was no longer an obligation to make payments.</p>	<p>Estimated overstatement of some €1680 million (£1048 million)</p>
<p>The Commission entered into multi-annual legal obligations which exceeded available appropriations for 2000, in relation to international fisheries agreements and External Actions. These were, however, disclosed as potential liabilities.</p>	<p>Understatement of €39 million (£24.3 million) in relation to international fisheries agreements, and €174 million (£108.6 million) in relation to External Actions. Total understatement of €213 million (£132.9 million).</p>
<b>Economic result</b>	
<p>The economic result was calculated for the first time in 2000 and is intended to link the budgetary cash based accounts with the published financial statements, providing a broader picture of the Institutions' performance. However, due to weaknesses in the financial accounting information available to the Commission, for example the lack of a figure for debtors, the result only partially reflects the true situation.</p>	<p>Not quantified</p>