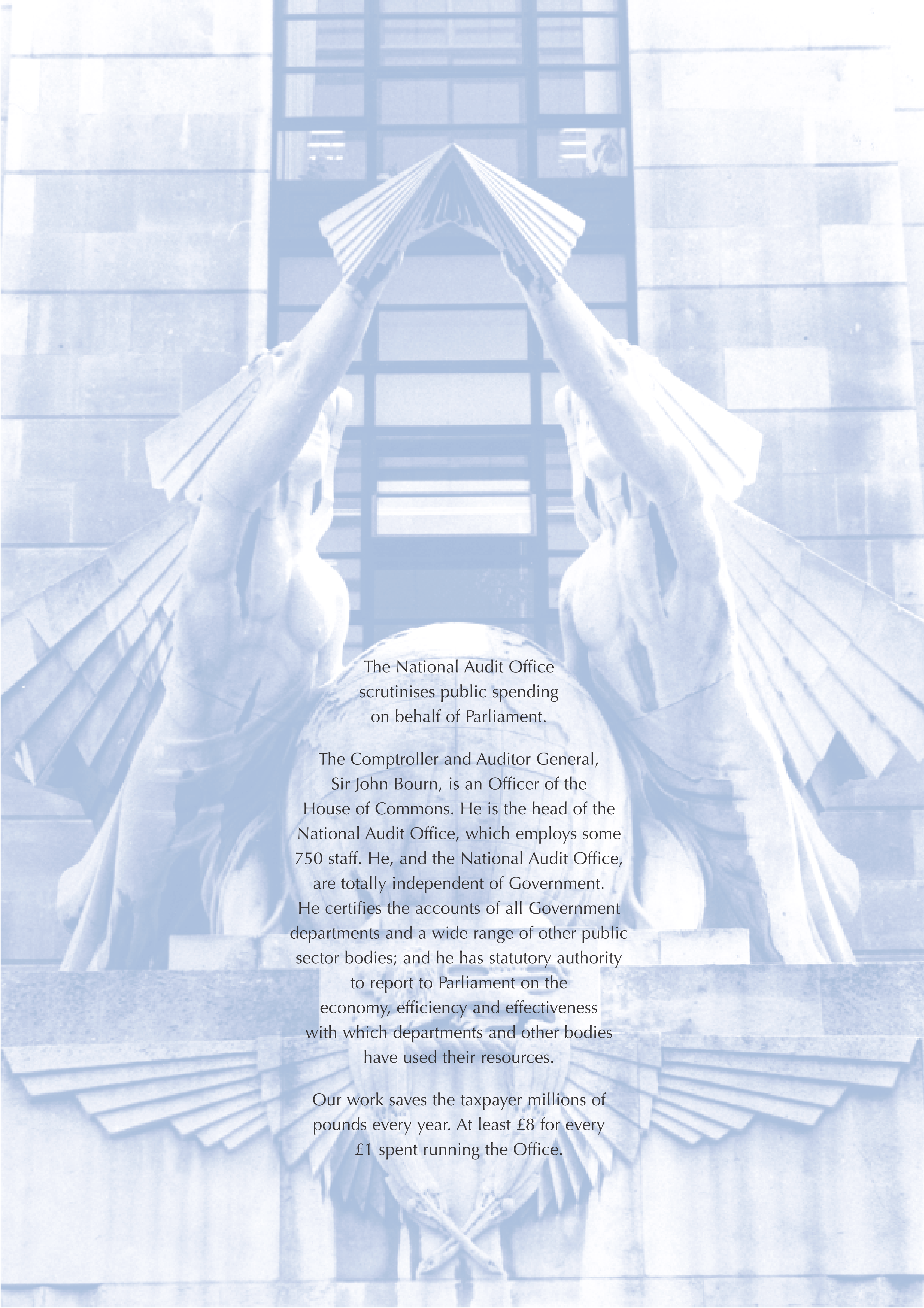
Financial management in the European Union

The European Court of Auditors report for the year 2001

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 701 Session 2002-2003: 12 June 2003



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John Bourn
Comptroller and Auditor General

National Audit Office
4 June 2003

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executive summary

1 This report summarises the findings of the European Court of Auditors (the Court) for the year 2001 and reviews information provided by the European Commission on key developments to strengthen financial management and control of the General Budget of the European Community[1]. It also summarises reported rates of fraud and irregularity, compiled by the European Anti-Fraud Office, and considers some aspects of financial control associated with the forthcoming enlargement of the European Union. This report complements a number of earlier National Audit Office reports on specific aspects of the revenue due and expenditure funded from the Community General Budget in the United Kingdom. The reports published since 1998-1999 are listed in Appendix 1. Recent reports covered issues such as agricultural fraud, the Sheep Annual Premium Scheme and the Arable Area Payments Scheme.

2 The European Court of Auditors is required to provide the European Parliament and the Council of Ministers 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 2001, the Court drew similar conclusions to previous years and for the eighth year in succession qualified its opinion on the reliability of the Community's accounts. The Court's opinion on the financial statements again emphasised the persistent and on-going weaknesses in the Commission's accounting systems, particularly the lack of reliable information on the completeness of assets held, and recommended that urgent action be taken to address these problems.

3 The Court was able to provide assurance on the legality and regularity of the transactions underlying revenue and commitments. It was also able to provide the same assurance on administrative expenditure in the accounts, but not to give assurance on the legality and regularity of other types of expenditure, for example, that incurred under the Common Agricultural Policy or structural measures. Such payments accounted for the great majority of budgetary expenditure (some 94 per cent). The problems identified by the Court in regard to the transactions underlying the accounts were similar to those it had

1 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 three European Communities in a political Union, and introducing the term European Community to refer to them.

observed in previous years and were most prevalent at the level of final recipients of European funding, for example, individual farmers and businesses or national, regional and local authorities and other public bodies.

4 The Court reviewed the Commission's progress in implementing its strategy of financial management reforms, initiated in March 2000 in the wake of the resignation of the previous Commission in March 1999. The Court noted some progress. In particular, it welcomed the introduction of individual declarations by the heads of the main administrative units within the Commission on the reliability of the financial controls in their areas, which the Court considered offered 'an unprecedented degree of openness as regards accountability for management'. The Court also noted that this was the first year that the Commission had used this approach and there were weaknesses which needed to be addressed in order to improve the consistency and reliability of the declarations.

5 In June 2002, the Commission secured approval from the Council for a new Financial Regulation[2], allowing for greater delegation of financial controls to operational units. Most of its provisions came into force on 1 January 2003, although a provision to establish full accruals accounting is not scheduled to be implemented until January 2005. The main outstanding problems relating to the accounting system are:

- the Commission currently produces financial statements that include some accrual elements: its balance sheet contains fixed assets, creditors and debtors, but it has not yet set out a comprehensive accounting framework; and
- the Commission does not have a single integrated computerised accounting system which can generate all the figures for the annual financial statements. It has a centralised system dealing with cash transactions - SINCOM 2 - but information on accruals items cannot be automatically derived from this system and must be compiled from a variety of local management records.

6 The number and value of cases of suspected fraud or other irregularity detected and reported by Member States to the Commission in 2001[3] was substantially lower than in 2000 with the overall reported number of cases falling from 6,634 to 5,455 and the estimated value falling from €1.1 billion (£678 million) to €0.6 billion (£323 million)[4]. No firm conclusions on trends can be drawn from this because cases of fraud and irregularity tend to be identified unevenly within programmes and reported levels can fluctuate considerably from year to year. By their nature, the reported statistics include only identified fraud and irregularity and cannot take account of other frauds which might exist but which have not been identified. The extent to which the figures reported by the Commission equate to actual levels of fraud against the General Budget is therefore unclear.

7 Different practices remain between Member States in reporting fraud and irregularity to the Commission. The European Anti-Fraud Office, commonly known by its French acronym OLAF[5], has been working with Member States to attempt to resolve this situation but progress remains limited.

2 Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the General Budget of the European Communities. Official Journal L248, 16 September 2002.

3 Source: Protection of the Financial Interests of the Communities and Fight Against Fraud - Annual Report 2001, 26 June 2002, COM (2002) 348.

4 A conversion rate of €1 = £0.6085 (the exchange rate as at 31 December 2001) has been used in this report.

5 Office Européen de Lutte Anti-Fraude (OLAF).

8 Ten new Member States are expected to accede to the European Union on 1 May 2004, the largest single enlargement in the history of the Union. Each year since 1997, to inform the accession negotiation process, the Commission has produced an assessment of each Candidate Country outlining their progress against agreed political, economic and administrative criteria. This has included an assessment of the financial control arrangements in each Candidate Country and by October 2002, all the Candidate Countries had provisionally concluded this aspect of their accession negotiations with the Commission. However, the Commission noted that most needed to continue strengthening and implementing new financial control structures in the run up to enlargement in order to meet fully the accepted Community standards[6].

Conclusions

- It remains a matter of concern that for the eighth year in succession, the Court qualified its opinion on the reliability of the accounts and was also unable to provide positive assurance on the legality and regularity of the transactions underlying the great majority of Community expenditure. The Court highlighted persistent weaknesses in the Commission's accounting system which it considered was not adequately designed to provide assurance that all components of the Community assets were recorded. We endorse the Court's view that the Commission needs to take urgent in-depth action to address these problems.
- The declarations made by each Director General in the Annual Activity Reports offer a significant opportunity to improve accountability in the European Union. The Commission has attached great importance to this work and we support the active approach it has taken towards identifying lessons for improving the content and consistency of the Annual Activity Reports in future years. We agree with the Court's view that to maximise their usefulness, Annual Activity Reports should be made available as soon as possible after the end of the year to which they relate, so that the Court can evaluate them as part of its own audit process and the Commission now intends to do this.
- We welcome the new Financial Regulation approved in June 2002. We note the Commission's intention to introduce full accruals accounting by 1 January 2005, supported by a comprehensive, integrated information technology system. While we are supportive of the Commission's intention, we consider this is a very challenging task for the time available. We recommend that United Kingdom departments and other agencies involved in the administration of European funds play an active role in the technical discussions which will be necessary to agree appropriate accruals accounting treatment for Community activities.
- Different practices continue to exist between Member States in reporting fraud and irregularity to the Commission. We urge the United Kingdom Government to continue to play a full role in influencing other Member States to adopt a pragmatic reporting framework.
- The enlargement of the European Union represents a challenge to both the new Member States and the European Institutions. We recommend that the United Kingdom Government use its influence to ensure that financial management issues continue to be given a high priority in Candidate Countries and the remaining improvements planned for key areas are fully implemented.

6 *Source: information in the latest Regular Reports on Progress Towards Accession, published individually for each Candidate Country, by the Commission in October 2002.*

Part 1

Introduction

1.1 Each year the Comptroller and Auditor General reports to Parliament on the Annual Report of the European Court of Auditors (the Court) which sets out the results of its audit of the consolidated accounts of the General Budget of the European Community (the Budget). This report summarises the findings in the Court's Annual Report for 2001[7]. It also outlines the key developments in strengthening financial management and control arrangements at the European Commission (the Commission), summarises rates of irregularities and fraud reported by Member States, and considers the implications of the forthcoming enlargement of the Union for financial control of the Budget.

1.2 The activities and finances of the European Union are governed by European legislation and overseen by the five Community Institutions **(Figure 1)**. Under the Treaty Establishing the European Community, the European Commission is responsible for producing the consolidated accounts of the Community, which comprise the revenue and expenditure account and balance sheet[8].

1.3 The Commission has overall responsibility for implementing the Budget, although over 80 per cent of Community funds are managed by national, regional and local authorities within the Member States of the European Union and in countries outside the Union. Under the Treaty Establishing the European Community, Member States are required to take the same measures to counter fraud affecting the financial interests of the Community as they take to counter fraud affecting their own financial interests[9].

Budget for the year 2001

1.4 The total Budget available for payments in 2001 was €94.3 billion (£57.4 billion). The breakdown of revenue and expenditure is illustrated in **Figure 2**. The procedures for setting, controlling and accounting for the Budget are set out in Appendix 2, and Figure 9 summarises the main processes in the budgetary cycle.

Budget surplus

1.5 For the second year running, there was a significant surplus of revenue over expenditure. For 2001, this amounted to €15 billion (£9.1 billion), some 16 per cent of the Budget, compared to €11.6 billion (£7.2 billion), 14 per cent of the Budget for 2000. The 2001 surplus resulted mainly from low take-up of monies for structural measures and the Court noted that nearly one third of funds available for expenditure in this area were not needed.

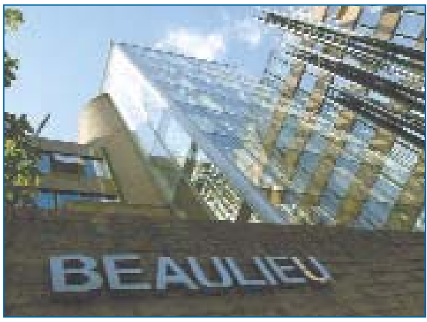
1.6 The Commission relied on forecasts by Member States to set the budget for structural measures and these forecasts proved to be overly optimistic about the level of funding Member States could spend in the period. The Court considered that Member States' and the Commission's past experience of spending programmes should have enabled them to make more realistic budget estimates in these areas. The Court also noted that, as the extent of the underspend became clear during 2001, the Commission should have used mechanisms available under Supplementary and Amending Budget procedures to adapt the Budget to more realistic expectations of financial needs. If such amendments had been made the Court calculated that financial demands on Member States for GNP resources could have been reduced by between 30 and 40 per cent.

7 Published in the Official Journal of the European Communities, C295 on 28 November 2002.
8 Article 275 of the Treaty Establishing the European Community.
9 Article 280 of the Treaty Establishing the European Community.

1 The European Institutions

Council of Ministers
15 Ministers, one from each Member State. Senior legislative body of the Community.
Administrative spend: €0.4bn (£0.3bn)

European Parliament
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.
Administrative spend: €1bn (£0.6bn)

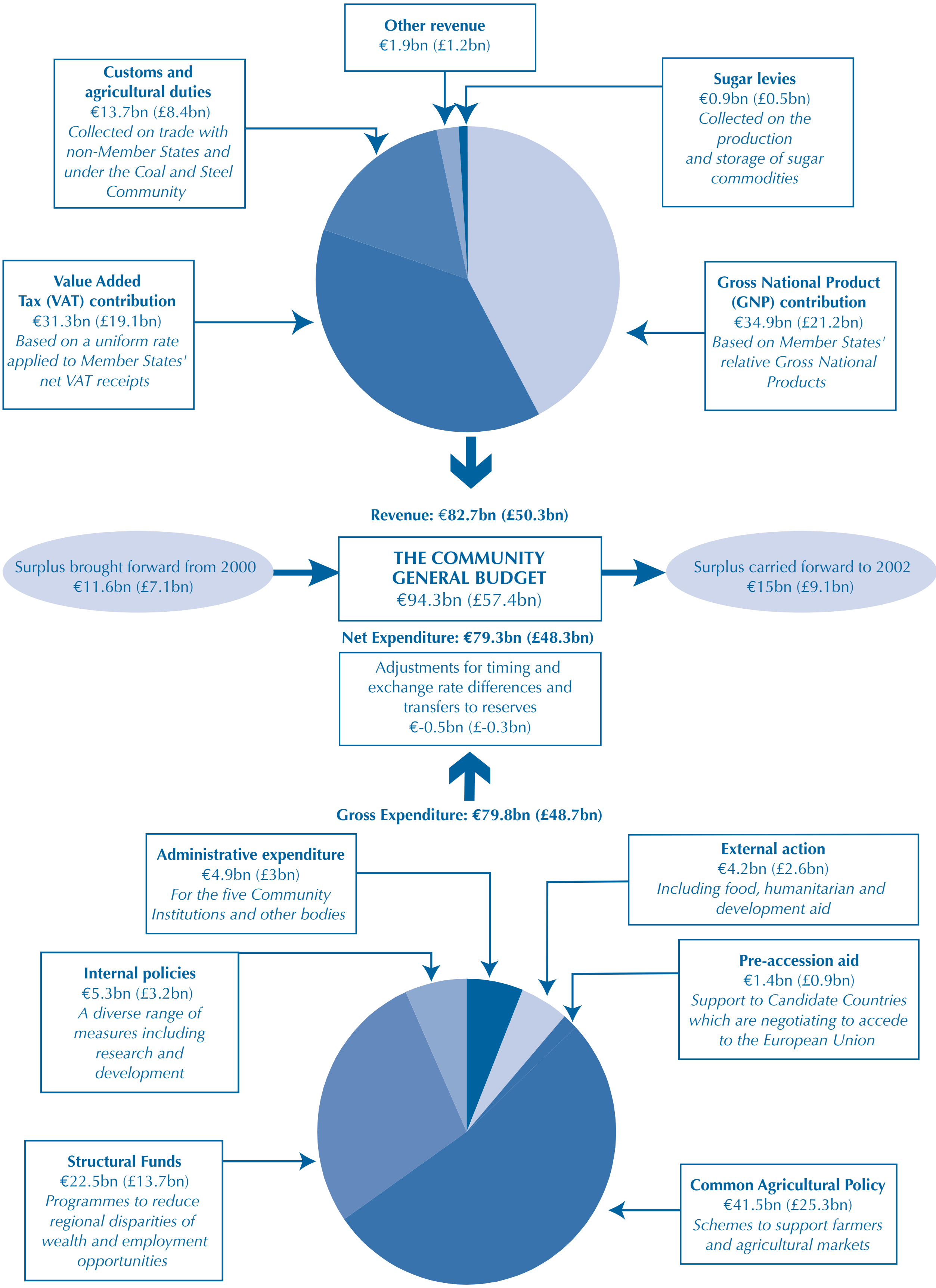


European Commission
20 Commissioners and some 20,000 staff. Proposes and executes Community policies and ensures Member States meet their Treaty obligations. Answerable to Parliament for the use of the Community Budget.
Administrative spend: €3bn (£1.9bn)

European Court of Justice
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.
Administrative spend: €0.1bn (£0.06bn)

European Court of Auditors
15 Members and 550 staff. External auditor of the accounts of all revenue and expenditure of the Community.
Administrative spend: €0.07bn (£0.04bn)

2 Revenue and expenditure in 2001



Source: Data from the Annual Report of the European Court of Auditors 2001, and the Financial Statements of the European Community 2001

The European Court of Auditors' Annual Report

1.7 The European Court of Auditors is the external auditor of the European Union. In accordance with the Treaty Establishing the European Community[10], the Court examines the accounts of all revenue and expenditure of the Community. The Court provides 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. It examines whether all revenue has been received and all expenditure incurred in a lawful and regular manner and whether the financial management has been sound. The Court publishes its Statement of Assurance in its Annual Report. In addition, in 2002, the Court published the results of audits of specific topics in seven Special Reports, which are listed in Appendix 3 to this Report.

1.8 The Court carries out its examination in accordance with international audit and accounting standards, modified as appropriate to the Community context. The work of the Court covers the Commission and other Community Institutions, and extends to the final recipients of Community funds. The Court's Statement of Assurance is not intended to provide conclusions on the financial management in particular Member States.

Discharge of the 2001 Community General Budget

1.9 In March 2003, the Council, having examined the annual accounts prepared by the Commission, recommended to the European Parliament that the Commission should be granted discharge for the 2001 Budget. Following its own examination, which drew on the European Court of Auditors' work and the Council's recommendation, as well as additional information supplied by the Commission, the European Parliament formally granted the Commission discharge for the Budget for 2001 on 8 April 2003 (this process is set out in more detail in Appendix 2).

The United Kingdom Parliament's scrutiny of European matters

1.10 The House of Commons Committee of Public Accounts considers my reports on the Court's work. The Committee published its last report on European matters in July 1999[11] following a fact-finding visit to the European Institutions responsible for the management and oversight of the General Budget. Two other Parliamentary Committees - the House of Commons European Scrutiny Committee and the House of Lords European Union Committee - are responsible for examining European Community documents and proposals for legislation, and may also carry out inquiries into other matters relating to the European Union.

1.11 The House of Commons European Scrutiny Committee usually debates the Court's Annual Report. The Annual Report for 2001 was debated on 26 February 2003, together with the Commission's 'Fight Against Fraud' Annual Report 2001[12].

Scope of the National Audit Office examination

1.12 This report considers the progress made since my last report on the management of European funds for the year 2000[13] and in particular:

- summarises the Court's Statement of Assurance on the accounts of the Community for the year 2001 and its other significant findings on the management of the Community General Budget (Part 2); and
- outlines the key developments in financial management and control arrangements at the Commission, summarises reported rates of fraud and irregularity, and considers the key financial control issues associated with enlargement (Part 3).

In preparing this report, the National Audit Office reviewed information published by the Court and the Commission and visited both institutions to discuss matters of interest with officials. We also discussed the Court's findings relevant to the United Kingdom with HM Treasury and other interested government departments.

10 *Article 248 of the Treaty Establishing the European Community.*
11 *Financial management and control in the European Union, Committee of Public Accounts Twenty-ninth Report (HC 690, 1998-99).*
12 *See Footnote 3.*
13 *Financial management of the European Union (HC 859, 2001-02, 30 May 2002).*

Part 2

The European Court of Auditors' Statement of Assurance and other findings

2.1 This part of the report notes the Court's main findings in its Annual Report, including its Statement of Assurance work on the accounts of the European Community and its other reports during the year.

Statement of Assurance for the year 2001

2.2 For its Statement of Assurance on the year 2001, the Court examined some 450 transactions to evaluate the Commission's monitoring and control systems. This work involved testing within Member States as well as within Community Institutions to allow the Court to evaluate how controls were operating across the spectrum of Community operations. The Court also examined further samples of transactions in different sectors to test specific control systems. The Court told us that approximately ten per cent of its overall audit effort related to the United Kingdom, which is commensurate with the level of expenditure relating to the United Kingdom.

Reliability of the accounts

2.3 The first part of the Court's opinion concerned the reliability of the accounts. Although the Court concluded that the accounts for the year 2001 faithfully reflected the revenue and expenditure of the Community for the year and the financial position at the end of the year, its opinion was subject to a number of qualifications relating to the financial position at the end of the year. In particular, the Court noted:

- provisions for depreciation paid to Member States in respect of agricultural intervention stocks were overstated by €148.7 million (£90.5 million);
- €980 million (£596.3 million) relating to cash transfers in third countries had been entered under sundry debtors without adequate justification;
- the bases for a provision of €564 million (£343.1 million) relating to the cost of dismantling the Joint Research Centre's nuclear installations were doubtful; and
- outstanding commitments were overstated by €1.3 billion (£0.8 billion).

Appendix 4 provides more detailed information on the observations made by the Court.

2.4 For several years, the Court has highlighted inadequate accounting practices and the failure by the Commission to introduce an effective framework of accounting policies, based on the principles of accruals accounting. It noted on-going weaknesses in its Statement of Assurance on the 2001 Budget and urged the Commission to take urgent action to rectify the problems. The Court commented that most of the weaknesses it had identified over several years stemmed 'from the Community accounting system which was not designed to provide an assurance that the various components of the Community assets have all been recorded'. The Commission has acknowledged shortcomings and recognised that improvements are needed to enable it to produce reliable, accurate and complete financial statements on an accruals basis.

2.5 In its reports on the accounts for 1999 and 2000, the Court had also highlighted problems in the Commission's main financial accounting system, SINCOM 2. In particular, it had noted difficulties in reconciling the information from different sub-systems and identified security weaknesses in the SINCOM 2 system. The Court did not specifically repeat these observations in its 2001 report but it noted that many of its reservations arose from on-going weaknesses in the Commission's accounting system. The Commission had begun to implement an extensive action plan to address the problems raised by the Court's 1999 report and continued this work in 2001 and 2002. In December 2002, the Commission told us that it considered it had addressed all the Court's detailed recommendations and believed its systems for recording and accounting for cash transactions were relatively strong, and that it could account for its use of the cash budget. The Court, however, told us in December 2002, that it was still concerned about how fully shortcomings in SINCOM 2 had been addressed.

2.6 During 2002 a senior official, responsible for preparing the consolidated financial statements and taking forward the accounting reform process, made a series of allegations concerning the integrity of the Commission's accounting systems and records and their potential vulnerability to fraud. Vice-President Neil Kinnock, the Commissioner with overall responsibility for administration and reform in the Commission, provided evidence to the European Parliament's Committee on Budgetary Control on this matter in September 2002. While acknowledging that the Commission's accounting system was still not perfect, he noted that the official's views represented a disagreement over policy rather than the reporting of possible wrong-doing by the Commission. He also noted that the Commission was already aware of all the issues raised by the official and that improvements to the accounting system were in the process of being implemented following recommendations made by the European Court of Auditors, prior to the official's allegations.

Legality and regularity of the underlying transactions

2.7 The second part of the Statement of Assurance gives the Court's findings on the legality and regularity of the transactions underlying the financial statements. As in previous years, most of the errors identified by the Court's testing concerned the two largest areas of expenditure, the Common Agricultural Policy and structural measures. This is as might be expected, since testing relates to the level of expenditure incurred, and these areas represent nearly 80 per cent of the Budget. The Court's main findings by sectoral area are set out in **Figure 3**.

Issues relating to the United Kingdom

Statement of Assurance

2.8 The Court examined 26 payment transactions in the United Kingdom for its Statement of Assurance work. This was part of the Court's sample to inform its overall opinion on the accounts prepared by the Commission and was not intended to provide an opinion on the United Kingdom's management of European funds. The Court identified nine errors with monetary impact in the United Kingdom which were similar to the level and types of error it identified in other Member States.

2.9 Errors found by the Court in the United Kingdom included low value errors in relation to the Common Agricultural Policy. For example, the over-declaration of the size of a field by a farmer resulting in a monetary error of £96.17 and the failure by another farmer to declare that some animals in his herd had been replaced by others which made them ineligible for support under Community regulations and resulted in a monetary error of £572.02.

2.10 In relation to the structural measures, the Court identified what it considered to be larger scale errors in projects administered by the United Kingdom. For example, it identified an error of some £2.5 million, relating to a redevelopment project partly funded by the European Regional Development Fund. The Court considered that the project did not create enough jobs to meet the funding eligibility requirements. It therefore argued that all the support paid by the Community to the project was ineligible.

3 The Court's findings on the underlying transactions by sectoral area

Own resources

- Own resources is the term given to the income of the European Community. The main elements are VAT and GNP contributions from Member States, as illustrated in Figure 2
- Income: €82.7 billion (£50.3 billion)
- No material financial error identified
- The Court noted that VAT and GNP contributions (which amounted to 80 per cent of the Community's income in 2001) were calculated using macro-economic statistics from Member States. As in previous years, it noted that the scope of its audit was limited as it could not test the underlying data directly

Agriculture

- Comprising programmes under the Common Agriculture Policy to support the production of crops and animals
- Expenditure: €41.5 billion (£25.3 billion), 52 per cent of gross expenditure
- The Court examined: 156 transactions; control systems for specific agricultural payment schemes; and the results of checks carried out by Member States
- The Court found no evidence of significant improvement in level and type of errors as compared to previous years. Most errors were at the level of the farmer or company receiving subsidy. Particular risks and weaknesses were noted in relation to expenditure on rural development and subsidies paid on the basis of the quantity of production
- The Court was unable to provide positive assurance

3 The Court's findings on the underlying transactions by sectoral area (continued)

Structural measures

- The four Structural Funds aim to promote economic and social cohesion, mainly by providing financial assistance to the less developed regions of the European Union. The two largest funds are the European Regional Development Fund and the European Social Fund
- Expenditure: €22.5 billion (£13.7 billion), 28 per cent of gross expenditure
- The Court examined: 146 payments and 304 commitments
- The Court found similar types of financial error to previous years, including claims for ineligible activities, claims based on estimates, failure to declare revenue raised and non-compliance with grant conditions
- The Court was unable to provide positive assurance

Internal policies

- Internal policies focus on the implementation and development of the single market through activities in areas such as technological research and development
- Expenditure: €5.3 billion (£3.2 billion), seven per cent of gross expenditure
- The Court examined the Commission's support for Trans-European transport networks - key strategic transport links within and between Member States. The Court found inadequate definitions of work and eligibility criteria and a failure by the Commission fully to apply its official procedures manual
- The Court also reviewed research activities and found costs in all 19 contracts it examined, were either overstated by the beneficiary or the beneficiary was unable to justify the costs claimed
- The Court was unable to provide positive assurance

External action

- External action largely comprises humanitarian aid and support for development projects
- Expenditure: €4.2 billion (£2.6 billion), five per cent of gross expenditure
- The Court found controls were generally satisfactory at the Commission level but unreliable locally, for example, where the Commission was working with Non-Government Organisations in developing countries
- The Court was unable to provide positive assurance

Pre-accession aid

- Pre-accession aid was provided to the Candidate Countries to assist them in meeting the requirements for membership of the European Union
- Expenditure: €1.4 billion (£0.9 billion), two per cent of gross expenditure
- Expenditure was some €0.7 billion (£0.4 billion) under budget
- The Court found implementation delays in new pre-accession programmes were due to the need to establish decentralised paying agencies and other management structures in Candidate Countries and the long lead time required to develop some large infrastructure projects
- The Court was unable to provide positive assurance

Administrative expenditure

- Administrative expenditure is mainly incurred by the five Community Institutions, with the principal areas of expenditure being staff costs, procurement and costs relating to fixed assets
- Expenditure: €4.9 billion (£3 billion), six per cent of gross expenditure
- The Court provided positive assurance on this area of expenditure

2.11 The United Kingdom authorities strongly contested the Court's finding on the grounds that the project had been established in a previous programming round under different eligibility criteria which it fully met. They argued that the project had been carried forward from the 1994-96 to the 1997-99 Programme, bringing with it ring-fenced funding. The United Kingdom authorities had obtained formal ratification from the Commission for this course of action, and in its response to the Court's audit findings, the Commission strongly supported the United Kingdom's position. Both the Court and the United Kingdom authorities agreed that this was a unique case and was not symptomatic of any systematic weaknesses in the United Kingdom's management of European Structural Funds.

United Kingdom abatement

2.12 Community revenue and expenditure by Member State in 2001 is shown in **Figure 4**. The United Kingdom was the fifth largest net contributor to the Budget, providing a net contribution of €1.8 billion (£1.1 billion) after a rebate of €7.3 billion (£4.4 billion) was taken into account.

2.13 The Court examined the calculation of the abatement and the distribution of its financing among the other Member States. It noted that the calculation was complex and suggested that the Commission put forward proposals to simplify it. The complexity of the calculation is partly the result of the United Kingdom's agreement that it would not benefit from the so-called windfall that would otherwise have accrued from successive changes to how the Budget is financed. The United Kingdom receives a rebate in recognition of the fact that, without it, its net contribution would be unacceptably high given its relative prosperity. The imbalance between the United Kingdom's gross and net position is primarily the result of the relatively low level of receipts which it gets from the General Budget.

Duties on seized goods

2.14 The Court identified a systematic problem in the United Kingdom regarding customs duties on seized goods. If goods entering the United Kingdom from countries outside the European Union are seized by HM Customs and Excise, and subsequently sold, then duties should be brought to account and made available to the Community as part of its Own Resources revenue. However, the Court found that HM Customs and Excise was not doing this and was unable to quantify the amount of duties involved. The Court recommended that the Commission take appropriate action to rectify this situation. Following subsequent investigation HM Customs and Excise identified that £250 in duty had not been accounted for on vehicle disposals. HM Customs and Excise consider that it would require disproportionate cost to quantify the liability arising on the remaining disposals and are therefore seeking to agree a formula for these liabilities with the Commission. Using average duty rates, the liability is unlikely to exceed £40,000. HM Customs and Excise have issued amended guidance to ensure that revenue is brought to account on sales of seized goods in future.

VAT fraud

2.15 The Court noted that an unknown amount of VAT receipts are lost through 'carousel fraud' across the European Union. This is a particular form of the practice known in the United Kingdom as 'missing trader fraud'. This type of VAT fraud involves obtaining a VAT registration number for the purposes of purchasing goods free from VAT in another Member State, selling them at a VAT inclusive price and then going missing without paying the tax due to the tax authorities. Missing trader fraud is a problem across all Member States and the Court recommended closer working procedures between Member States, facilitated by the Commission, to combat it.

2.16 HM Customs and Excise have been pro-active in assessing the impact of missing trader fraud in the United Kingdom and reported similar findings to those of the Court in their November 2002 Pre-Budget Report paper 'Protecting Indirect Tax Revenues,' and their November 2001 paper 'Tackling Indirect Tax Fraud'[14]. The 2002 paper estimated that the impact on the United Kingdom of missing trader fraud was between £1.7 and £2.75 billion in 2001-02.

Sheep Annual Premium Scheme

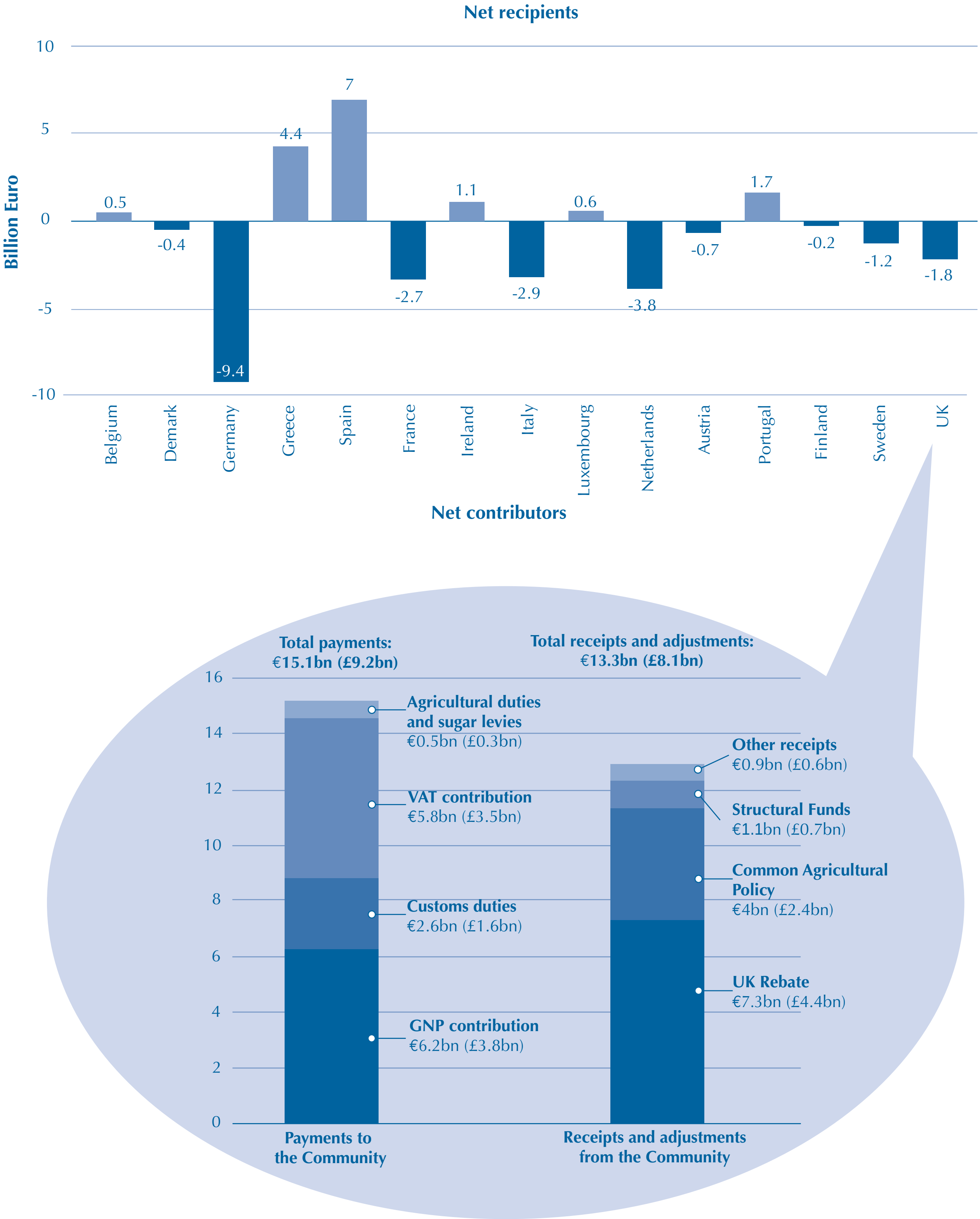
2.17 The Court noted that the outbreak of Foot and Mouth Disease in 2001 meant that most of the physical inspections of animals required under European regulations could not take place in the United Kingdom and alternative arrangements for cross-checking the claims made by farmers were instituted. The Court reported that the authorities in Northern Ireland had found discrepancies, before payment was made, between the numbers of animals the authorities had culled and the numbers included in farmers' premium claims.

2.18 Issues relevant to this were addressed in a report by the Comptroller and Auditor General for Northern Ireland[15] on the operation of the Sheep Annual Premium Scheme (SAPS), administered in Northern Ireland by the Department of Agriculture and Rural Development. In 2001, the Department had paid £16 million in subsidy, to some 9,700 applicants. The report assessed the level and quality of the Department's on-farm inspection programme, the adequacy of payments controls and the extent of fraud, penalties and subsequent prosecution.

14 Protecting indirect tax revenues - HM Customs & Excise (November 2002), Tackling Indirect Tax Fraud - HM Customs & Excise (November 2001).

15 Sheep Annual Premium Scheme (HC 330, 2002-03; NIA 75/2002), 6 February 2003.

4 **Contributions to and receipts from the European Budget by Member State for the year 2001**



Source: Report by the European Commission, 'Allocation of 2001 EU operating expenditure by Member State', September 2002

The report made a number of recommendations for strengthening the Department's checking and control procedures, including the planning, conduct and reporting of on-farm inspections; enforcement of European Union requirements on flock records and marking of animals; and the referral, investigation and prosecution of suspected fraud cases.

2.19 The Comptroller and Auditor General for Northern Ireland considered that while the discrepancies identified by the Department during the cull might not have been typical of Northern Ireland as a whole, the contrast between the numbers of sheep claimed and the numbers actually found in the two cull areas involved was striking. This brought into question whether the results of the normal SAPS inspection procedures, carried out each year, accurately reflected the actual levels of error and fraud that were present. In reporting the outcome of its investigation into the discrepancies to the European Commission, the Department said that it believed the problems in the two areas did not reflect an on-going level of fraud which it had previously failed to detect, either in those areas or more generally.

Structural measures

2.20 The Court noted, in its 2001 Annual Report, that delays were occurring in starting up new programmes, partly due to a lack of clarity in the division of responsibilities between the Commission and the Member States and also to the absence of a precise pre-established programming framework. The Court also noted that the complexity of the regulations governing structural measures was a source of difficulties. For several years, the Court has noted that the Commission and Member States have had difficulties in fully and accurately processing final payments in order to close programmes.

2.21 In June 2002, the Auditor General for Wales reported on Structural Fund programmes in the 2000 to 2006 cycle, administered through the Welsh European Funding Office (WEFO)[16]. European funds available to Wales during this period are some £1.4 billion, a major increase on previous periods, due to areas in West Wales and the Valleys qualifying for additional support. The report considered how WEFO and its partners were managing the key risks associated with delivering the programmes. It found that WEFO had experienced difficulties in setting up and resourcing systems to administer the programmes, but that these problems were being overcome. In particular, WEFO was working to improve management information and the appraisal of grant applications. It had established procedures to ensure that payment claims were processed reliably and quickly while meeting the financial control requirements of the Commission, although there remained a backlog of inspection visits from the previous programming round. These inspections and other audit work had identified significant problems in the eligibility, recording and accuracy of expenditure claimed by final recipients. Overall the Auditor General for Wales concluded that WEFO had been keenly alert to the challenge of striking an appropriate balance between approving new projects rapidly and ensuring robust systems were in place to manage funds appropriately.

Conclusions

2.22 Our main conclusions based on the Court's audit work on the 2001 year were:

- it remains a matter of concern that for the eighth year in succession, the Court qualified its opinion on the reliability of the accounts and was also unable to provide positive assurance on the legality and regularity of the transactions underlying the great majority of Community expenditure; and
- the Court highlighted persistent weaknesses in the Commission's accounting system which it considered was not adequately designed to provide assurance that all components of the Community assets were recorded. We endorse the Court's view that the Commission needs to take urgent in-depth action to address these problems.

16 *'European Union Structural Funds: maximising the benefits for Wales', (LD1456, 13 June 2002).*

Part 3

Other financial management issues

3.1 This part of the report deals with other major financial management issues facing the Community. The topics addressed are:

- key developments to strengthen financial management and control;
- reported irregularity and fraud; and
- issues relating to enlargement.

Strengthening financial management and control arrangements

3.2 In March 1999 all 20 European Commissioners resigned following a period of rising concern about the Commission's financial management. Subsequently, the new Commission, acting on recommendations made by the European Parliament and independent outside experts, issued a White Paper on Reform in March 2000[17]. The Commission's strategy for reform and modernisation was supported by an action plan which it intended to implement by the second half of 2002. The Comptroller and Auditor General's last three reports published in April 2000[18], April 2001[19] and May 2002[20] have outlined the Commission's reform proposals and progress made against the action plan. The Court reviewed the Commission's progress towards reform and published its findings in its Annual Report on the year 2001, and this section of the report draws on the Court's work. The Court's review focused on the audit, financial management and control aspects of the Commission's reform process. The Court noted that the timetable originally envisaged in the Commission's action plan had not been achieved for some of the reforms. It described the original timetable as being unrealistic and found that:

- there had been delays in recruiting skilled staff to new departments such as the Internal Audit Service, audit capabilities in individual Directorates General and the Central Finance Service[21] which resulted in some departments not being fully operational by the end of 2001 as had been planned;
- the deadlines for introducing certain internal control standards, for example standards on staff competence, staff performance and risk assessment and management, which were originally fixed for the end of 2001, were extended to dates ranging between March and December 2002; and
- the deadline for introducing more effective management of the recovery of improperly paid funds, originally set for July 2000, was deferred until June 2002.

3.3 The Court noted that the delays in making the Internal Audit Service and separate audit capabilities in the Directorates General fully operational had contributed to the Central Financial Service's difficulties in overseeing the implementation of the Commission's minimum internal control standards. Directorates General provide descriptions of their management and financial control systems to the Central Finance Service and the Internal Audit Service and auditors in individual Directorates General provide reports on the operation of these systems. The Court found that in-depth audits on the introduction of internal control standards had not been performed by the end of 2001 and that the Central Finance Service had not been able to discharge fully its duties of supervising the application of the minimum standards.

17 *Reforming the Commission - a White Paper (March 2000).*
18 *Financial management of the European Union (HC 437, 1999-2000).*
19 *Financial management of the European Union (HC 402, 2000-2001).*
20 *Financial management of the European Union (HC 859, 2001-2002).*
21 *The Internal Audit Service reports directly to a Vice President of the Commission and has a mission to audit the internal control systems in the Commission to assess their effectivenesss. Separate internal audit capabilities report to individual Directors General on the operation of internal controls in their service. The Central Finance Service provides guidance and training on financial controls and also sets minimum internal control standards which Directorates General are expected to meet.*

Annual Activity Reports

3.4 The Commission made a major change in its financial management arrangements in respect of 2001. Each Director General prepared an Annual Activity Report incorporating a declaration as to whether he or she had reasonable assurance that resources had been used for the intended purpose and that control procedures guaranteed the legality and regularity of the underlying transactions. These declarations have similarities with the Statement of Internal Control Accounting Officers in the United Kingdom have been required to sign since 2001-02 and the Statement on Internal Financial Control, required since 1998-99. This change is in line with a recommendation made by the Committee of Public Accounts in 1999, endorsing the Prime Minister's call that individuals in the Commission holding positions of responsibility be fully accountable for their budgets[22]. **Figure 5** compares the main features of the United Kingdom's Statements of Internal Control with the declarations by Directors General.

3.5 The Commission considers the declarations made by each Director General are a cornerstone of its reform policy and represent a fundamental cultural change in the way it conducts its business. The declarations require Directors General to take responsibility for the resources allocated to them. The Commission thus considers that they support one of the main objectives of the reform process - to provide better accountability and responsibility for funds expended by the Commission. The Court welcomed the introduction of the declarations in its Annual Report, noting that they 'constitute an unprecedented degree of openness as regards accountability for management of resources'.

3.6 For 2001, the 36 Directors General all confirmed that they had reasonable assurance that control procedures in place gave the necessary guarantees over the legality and regularity of the underlying transactions. However, many of the declarations were qualified by either reservations - which pointed out risks not sufficiently under control or not sufficiently managed which could endanger the sound functioning of the Directorate General; or observations - which commented on specific issues of management Directors General wished to highlight but were not so serious as to qualify the assurance given.

3.7 The Commission noted a lack of understanding and consistency between Directorates General as to what constituted a reservation as opposed to an observation. The Commission undertook an extensive review of the results of the Annual Activity Reports and drew up a synthesis report which it submitted to the budgetary authorities - the European Parliament and the Council - in July 2002[23]. This report noted that 27 of the 36 Directors General had qualified their declarations of assurance by including reservations, either in the declaration itself or by reference to material elsewhere in their Annual Activity Reports. The Commission went on to add on the effects of observations in the declarations and noted that overall 31 Directors General had made a total of 135 qualifications of one sort or another, leaving only five services with no qualifications.

3.8 The types of reservations and observations reported by Directors General included a lack of reliable financial and management information and a lack of assurance about how controls were operating in areas where significant expenditure was managed by Member State administrations rather than directly by the Commission. The fact that these qualifications were made, however, does indicate that the Directors General gave due consideration to how control systems were operating and were willing to be open about the risks that existed.

3.9 The Commission's Internal Audit Service also carried out an extensive review of the process of preparing the reports in order to advise Directors General on good practice and to maximise the value of the reports. The Commission actively sought to learn from the first year's experience and identified an eighteen-point action plan to improve the way Annual Activity Reports were prepared in the future. Key actions which it intended to undertake included disseminating improved guidance, closer co-ordination between departments, the improvement of financial management and accounting systems and clarification of responsibilities where several Directorates General cover similar areas of activity. In January 2003, the Commission issued a paper clarifying the methodology for completing Annual Activity Reports and the associated declarations by Directors General[24].

22 *Twenty-ninth Report of the Committee of Public Accounts: Financial Management and Control in the European Union, HC 690 Session 1998-99.*

23 *Communication from the Commission to the European Parliament and the Council: Synthesis of the Annual Activity Reports and declarations of the Directors General and Heads of Service COM (2002) 426.*

24 *The 2002 review of the implementation of activity-based management in the Commission, including clarification of the methodology for the establishment of Annual Activity Reports COM (2003) 28, 21 January 2003.*

3.10 The Court carried out its own review building on the work of the Internal Audit Service to assess what, if any, reliance it might place on the declarations in carrying out its own audit work. It drew similar conclusions about the content of the reports. In addition, it expressed concerns about the timing of the Annual Activity Reports. For the year 2001, the Annual Activity Reports were not all issued until the end of May 2002, too late for the Court to evaluate fully or place reliance on them in reaching its own audit opinion on the annual financial statements.

New Financial Regulation

3.11 In June 2002 the Commission's new Financial Regulation - the secondary legislation which sets the framework for the financial management of the General Budget - was approved by the Council of Ministers. Most of the provisions of the new Financial Regulation came into effect on 1 January 2003, although some, such as full accruals accounting, are not scheduled to be implemented until January 2005.

5 Comparison of Commission and United Kingdom statements

Commission	United Kingdom
Requirements A long form report detailing activities of the Directorate during the year, accompanied by a declaration signed by the Director General (DG): ■ Affirming that the information contained in the report gives a true view ■ Stating that the DG has reasonable assurance that resources were used for the intended purpose, in accordance with principles of sound management, and that control procedures give guarantees of legality and regularity of underlying transactions ■ Confirming that the DG is not aware of any matter which could harm the interests of the institution ■ Expressing any reservations on quality and explaining limitations and impact of problems ■ Commenting on control failures, their implications and quantification	**Requirements** A signed statement by the Accounting Officer: ■ Stating the responsibility of the Accounting Officer to maintain a sound system of internal control ■ Stating that the Accounting Officer is responsible for reviewing the system ■ Detailing the components of the system and the sources informing the review
Coverage Each DG completes a declaration for their Directorate. Declarations are combined into a Commission-wide statement for publication	**Coverage** Covers an individual government body, or in some cases a department and the associated bodies consolidated with it. No combined statement for the whole of Government
Audit requirement No formal requirement for Court to report on the declarations	**Audit requirement** The Comptroller and Auditor General is required to report by exception on areas where the statement does not agree with his other knowledge of the entity or the account or does not meet HM Treasury requirements
Purpose To provide assurance about the reliability and quality of systems and to identify areas where there were reservations about the functioning of controls	**Purpose** Intended to ensure that Accounting Officers satisfy their responsibility to ensure that effective management systems, including financial management and control systems have been put in place Not intended to provide a commentary on the adequacy of the systems or their correct functioning
Sources of assurance Internal controls, self-assessment based on Commission-wide scoring system, internal audit and external audit	**Sources of assurance** Internal control systems, reporting mechanisms, internal audit and external audit
Publication Individual declarations are for internal assurance and are not published. Overall findings are combined into a single document which is publicly available	**Publication** Published with the annual financial statements and covered by the accompanying audit certificate

3.12 The main changes established by the new Financial Regulation are:

- the abolition, from January 2003, of the Commission's centralised Financial Control Directorate General, which previously checked and approved requests for commitment and payment before expenditure could be incurred, and the transfer of these responsibilities to staff in individual Directorates General;
- the strengthening of internal audit within the Commission - with audit capabilities in each Directorate General and a new Internal Audit Service able to undertake cross-cutting horizontal audits;
- provision for the introduction of full accruals accounting; and
- requirements to comply with the principle of sound financial management and to develop a system of evaluation using specific, measurable, achievable, relevant and timed objectives.

These changes make the Commission's system of financial control more similar to that found in the United Kingdom, where responsibility is allocated to individual operational bodies, Accounting Officers are personally accountable for the resources under their control and an accruals accounting approach is used. The introduction of a requirement to comply with the principle of sound financial management is in line with the particular priority which the United Kingdom has given to this issue. In 1999, the Committee of Public Accounts called for the United Kingdom Government to use its influence in Council to move towards sound and efficient management practices and to ensure that clear and measurable objectives were set for all new programmes[25]. The Government responded positively to this recommendation and ensured that appropriate measures were incorporated in the new Financial Regulation.

3.13 In December 2002, the Commission approved an action plan to further reform its accounting system by 1 January 2005. The two main outstanding problems which the plan sought to address are:

- the Commission currently issues financial statements that include some accrued elements, particularly balance sheet items such as fixed assets, creditors and debtors. However, the Commission has not developed a comprehensive framework of accounting policies establishing how to deal with all items which need to be accrued, for example pension liabilities. It therefore needs to develop such a comprehensive accruals accounting framework; and
- the Commission does not have a single integrated computerised accounting system which can provide all the figures it needs to disclose in the annual financial statements. It has a centralised system dealing with cash transactions - SINCOM 2 - but information on accruals items cannot be automatically derived from this system and must be compiled from a variety of local records. Ideally it needs a fully integrated information system which can automatically provide reliable data on both cash and accruals for its financial statements.

3.14 In the United Kingdom the introduction of full accruals accounting took some seven years from 1994, when a Green Paper[26] first introduced the concept, to 2001-02 when the parallel running of cash-based appropriation accounts was finally discontinued. We recognise that the Commission already uses a form of modified accruals accounting, including a balance sheet, which the United Kingdom did not, but nevertheless there are many issues it needs to address, requiring consultation with a range of parties, including Member State administrations. For example, if the Commission is to distinguish fully between payments held by intermediaries and those made to final recipients, more detailed and frequent reporting may be required from Member State administrations.

3.15 We also consider that the difficulties, and potential costs, of introducing an integrated computerised accounting system should not be underestimated. The National Audit Office has reported on many information technology projects in the United Kingdom which have exceeded planned time scales and budgets. In December 2002 the Commission announced that it intended to commission an external study to review options for improving its information systems to support accruals accounting. Whatever approach the Commission decides to adopt, it faces a very tight timetable to successfully introduce the required improvements, fully test them and train staff by 1 January 2005.

Reported fraud and irregularity

3.16 The Commission and the Member States are jointly responsible for the fight against fraud[27]. The European Anti Fraud Office (OLAF) was established in June 1999, as part of the reform process and plays a co-ordinating and enabling role in fighting fraud within the Community. Member States are obliged to report cases of suspected fraud or irregularity valued at more than €10,000 (£6,100) in the revenue sector, and €4,000 (£2,400) in Common Agriculture Policy and structural measures expenditure.

25 *See 22 above.*

26 *Better Accounting for the Taxpayers' Money: Resource Accounting and Budgeting in Government, Cm 2626, July 1994.*

27 *Article 280 of the Treaty Establishing the European Community, states that 'Member States shall 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'.*

3.17 Irregularity, including fraud, generally results in a loss to the Community General Budget and the European Union taxpayer. The broad distinction between fraud and irregularity is that fraud is an intentional act and a criminal offence, whereas irregularity is any failure to comply with Community regulations resulting from an act or omission. The European Commission noted in its Annual Report 2001[28] that, as in previous years, Member States were not consistent in how they interpreted and reported cases of fraud and irregularity.

3.18 Through the Advisory Committee for the Co-ordination of Fraud Prevention, OLAF has continued to work towards mutually acceptable definitions of fraud and irregularity and has been helped by the coming into force of the Convention on Protection of the European Communities' Financial Interests (the 'Fraud' Convention) on 17 October 2002[29]. This includes a common definition of fraud but a particular difficulty is that some Member States consider fraud cannot be recognised until a conviction has been obtained through the legal system. The Commission is exploring the possibility of reporting suspected fraud cases based on the balance of probabilities rather than actual convictions.

3.19 Each year OLAF publishes information about the frauds and irregularities reported to it by Member States. In total, Member States notified the Commission of 5,455 cases of fraud and irregularity in 2001, with an estimated value of some €0.6 billion (£0.4 billion). The cases concerned Community revenue, Common Agricultural Policy and structural measures expenditure. **Figure 6** provides a breakdown by Budget category.

6 Cases of fraud and irregularity notified by Member States in 2001

Area of the Budget	Number of cases	Amounts involved (€ million)
Revenue from customs and agricultural duties, and sugar levies	1,846	256
Common Agricultural Policy expenditure	2,415	141
Structural Funds expenditure	1,194	202
Total	**5,455**	**599**

Source: data from Protection of the Communities' Financial Interests and the Fight Against Fraud, Annual Report 2001

3.20 The type and scale of fraud and other irregularity can vary considerably. On the revenue side, OLAF noted the types of fraud committed were becoming more complex, with common examples being large-scale cigarette and alcohol smuggling and carousel fraud with organised criminal gangs often being involved. In such cases, while European co-operation is important, the main victims of the fraud are tax authorities at national level and national taxpayers. In relation to agriculture, common types of fraud involved the manipulation of quota systems or set-aside programmes. In relation to structural measures, cases of fraud often involved the use of false invoices and false declarations by project beneficiaries.

3.21 The figures for 2001 represented a substantial fall on the number of cases which Member States had reported in 2000 (6,634) and also the value of cases in 2000 (€1.1 billion, £0.6 billion). In 2001, the United Kingdom notified OLAF of 499 cases of suspected fraud and irregularity involving some €76 million (£46.2 million). This represented a major fall in the number and value of cases reported in the previous year (968 cases valued at €381 million, £231.8 million). Many of the irregularities previously detected and reported by the United Kingdom, related to the import of milk products from New Zealand, and these cases were settled during 2002. Overall in 2001, the United Kingdom reported the third highest value of cases of suspected fraud and irregularity, and the fourth highest number of cases of all Member States.

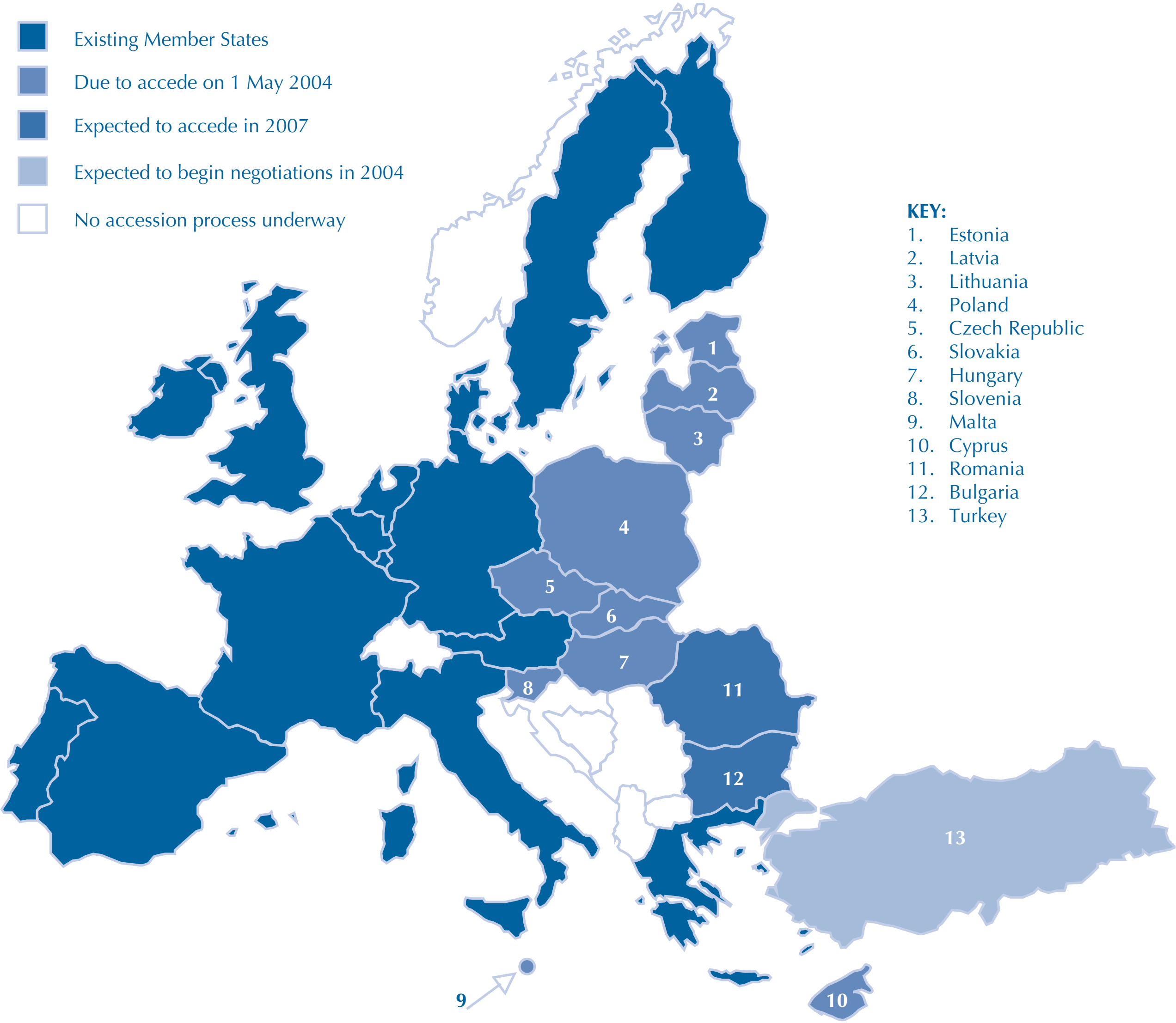
3.22 No conclusion regarding long-term trends can be drawn from the statistics published by OLAF. Cases of fraud and irregularity tend to be identified unevenly within programmes and reported levels can fluctuate considerably from one year to another. By their nature, the reported statistics include only identified fraud and irregularity and cannot take account of other frauds which might exist but which have not been identified. From the figures available, it is not possible to draw conclusions on the actual levels of fraud against the General Budget.

Enlargement

3.23 The Copenhagen European Council on 12 and 13 December 2002 concluded accession negotiations with ten Candidate Countries which are due to become new Member States of the European Union on 1 May 2004 - Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, the Czech Republic, and Slovenia. This is the largest single enlargement in the history of the Union. **Figure 7** outlines the main steps in the enlargement timetable.

28 *Protection of the Financial Interests of the Communities and the Fight Against Fraud, Annual Report 2001, COM (2001) 348, June 2002.*
29 *Protection of the European Communities' Financial Interests, OJ C316, November 1995.*

7 The enlargement process



1998	**October:**	**Accession negotiations started with Bulgaria, Latvia, Lithuania, Malta, Romania and Slovakia.**
1999	**March:**	**Accession negotiations started with Cyprus, Czech Republic, Estonia, Hungary, Poland and Slovenia.**
2000	**November:**	**First regular progress report on accession criteria published.**
	December:	**'Accession partnership' with Turkey established.**
2001	**March:**	**Nice Treaty establishes new national representation quotas for the European Institutions and provides for expansion and reform.**
	June:	**Ireland rejects Nice Treaty.**
2002	**October:**	**Irish referendum approves Nice Treaty.**
	December:	**Copenhagen Summit concludes negotiations with ten new Member States, and sets provisional accession dates for Bulgaria and Romania and a provisional date for beginning negotiations with Turkey.**
2003	**April:**	**Signature of Accession Treaty.**
	June:	**Convention on the Future of Europe reports.**
2004	**By Spring:**	**Ratification of the Accession Treaty by the Member States and Candidate Countries.**
	1 May:	**Date of Accession.**

Source: National Audit Office

8 Analysis of financial management preparedness in the Candidate Countries

	External audit	EDIS	PIFC
Satisfactory arrangements in place or only minor improvements required for effective implementation by accession	All Candidate Countires	Cyprus, Malta	Cyprus, Estonia, Malta, Slovenia
Legislative changes or moderate administrative strengthening required for effective implementation by accession	None	Hungary, Slovenia	Latvia, Lithuania, Slovakia
Accelerated action or significant administrative strengthening required for effective implementation by accession	None	Czech Republic, Estonia, Latvia, Lithuania, Poland, Slovakia	Czech Republic, Hungary, Poland

Source: National Audit Office analysis of findings reported by the Commission in its October 2002 Regular Reports on the progress towards accession of each of the Candidate Countries

Readiness of Candidate Countries in the field of financial control

3.24 Each year since 1997 the Commission has produced an assessment of each Candidate Country outlining their progress towards accession. These reports form the basis of the Commission's recommendations on their readiness to accede. The reports include a review of financial control arrangements, in particular:

- external audit;
- the Extended Decentralisation Implementation System (EDIS) which relates to Candidate Countries taking direct management responsibilities for certain European Union funds; and
- the Public Internal Financial Control (PIFC) system, which addresses how public funds are managed by individual ministries, including internal audit arrangements.

3.25 In **Figure 8,** the National Audit Office analyses the results reported by the Commission, under three broad categories of preparedness.

3.26 The Commission considered all Candidate Countries had a satisfactory legal framework for external audit and noted only minor operational areas requiring improvement.

3.27 The Extended Decentralisation Implementation System (EDIS) is the Commission's method for passing the responsibility for managing certain European funds[30] to Candidate Countries once they have adequate systems to manage such funding in a legal and regular manner. In order to gain EDIS accreditation from the Commission, Candidate Countries must undertake a gap analysis to assess weaknesses in their existing procedures; develop an action plan to bridge these gaps; and submit an application for accreditation to the Commission. The Commission then evaluates the system in place and makes a decision.

3.28 The Commission expects all the Candidate Countries to submit applications in the first half of 2003, to allow accreditation in the second half of 2003. By December 2002, all Candidate Countries had commenced the gap analysis exercise but only two - Malta and Cyprus - had submitted applications to the Commission. The Commission noted that six countries needed to reinforce and accelerate their efforts to meet the accreditation timetable.

3.29 In respect of the systems of Public Internal Financial Control (PIFC), the Commission reported significant weaknesses in the arrangements in three Candidate Countries. In Hungary, the Commission found that PIFC arrangements were not compatible with international norms and sustained efforts were required to re-define and up-grade the internal audit function. In Poland, it considered further substantial efforts were needed to bring legislation into line with European requirements and ensure the necessary administrative capacity was in place. In the Czech Republic, the Commission noted that significant efforts were needed to complete institution building, in particular, to establish functionally independent internal audit units.

3.30 The Commission will continue monitoring the progress of Candidate Countries in the run up to enlargement and will produce another monitoring report in October 2003. If the Commission judges that Candidate Countries have not made adequate progress, it can append specific safeguard clauses to the Accession Treaty which would require the country concerned to take remedial action to address the area of weakness for three years after accession. The Commission can also offer additional support to build up administrative capacity in the new Member States. However, negotiations on Financial Control have been provisionally concluded with all ten Candidate Countries and none currently foresees the need for additional support following accession.

30 *Prior to accession, the Instrument for the Structural Policies for Pre-Accession (ISPA) funds, and after accession, the Structural Funds.*

The European Institutions

3.31 The Treaty of Nice negotiated at the Inter-Governmental Conference of December 2000 provided for changes to the post-enlargement composition of the governing bodies of the European Institutions. Both the Commission and the Court will have a member from each Member State, resulting in an increase in the membership of each body to twenty-five.

3.32 The details of which responsibilities will be allocated to individual Commissioners or Members of the Court has yet to be decided. In the Commission's case there is an added complication, in that the Copenhagen Summit in December 2002 agreed that Commissioners from the ten new Member States would join the Commission from the date of accession on 1 May 2004, even though the existing twenty Commissioners' term of office is not due to expire until the end of October 2004.

3.33 The twenty-five Members of the Court post-enlargement will represent a very high ratio of management to staff in what is a relatively small organisation. In the context of the Convention on the Future of Europe, the United Kingdom Government submitted a proposal in May 2003 on the reform of the Court to maintain its effectiveness in an enlarged European Union. A report issued by the House of Lords in April 2001[31] also included observations on the Court's management procedures and called for reforms to improve their efficiency.

3.34 The Commission submitted a paper on administrative arrangements for enlargement to the European Parliament in July 2001[32], and the Court produced a similar document in September 2001[33]. The preparations of both Institutions cover a wide range of administrative issues for example staff numbers and recruitment procedures and translation and interpretation requirements.

Conclusions

3.35 The European Community is currently addressing a range of important financial management and control issues, in particular:

- the declarations made by each Director General in the Annual Activity Reports offer a significant opportunity to improve accountability in the European Union. The Commission has attached great importance to this work and we support the active approach it has taken towards identifying lessons for improving the content and consistency of the Annual Activity Reports in future years. We agree with the Court's view that to maximise their usefulness, Annual Activity Reports should be made available as soon as possible after the end of the year to which they relate, so that the Court can evaluate them as part of its own audit process and the Commission now intends to do this.
- we welcome the new Financial Regulation approved in June 2002. We note the Commission's intention to introduce full accruals accounting by 1 January 2005, supported by a comprehensive, information technology system. While we are supportive of the Commission's intention, we consider this is a very challenging task for the time available. We recommend that the United Kingdom departments and other agencies involved in the administration of European funds play an active role in the technical discussions which will be necessary to agree appropriate accruals accounting treatment for Community activities.
- different practices continue to exist between Member States in reporting fraud and irregularity to the Commission. We urge the United Kingdom authorities to continue to play a full role in influencing other Member States to adopt a pragmatic reporting framework.
- the enlargement of the European Union represents a challenge to both the new Member States and the European Institutions. We recommend that the United Kingdom Government use its influence to ensure that financial management issues continue to be given a high priority in Candidate Countries and outstanding improvements in key areas are fully implemented.

31 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).
32 Administrative preparations for enlargement: Objectives and practical arrangements, European Commission working document, July 2001.
33 Financial implications of enlargement for the European Court of Auditors 2002-2005 (IBU165039EN01-00PP-NU/dm).

Appendix 1 Reports by the Comptroller and Auditor General which relate to European matters since 1998-99

House of Commons number	Title
Cm 5671, 2002-2003	NAO Standard Report (published with HM Customs and Excise Account)
HC 939, 2001-2002	The 2001 outbreak of Foot and Mouth Disease
HC 859, 2001-2002	Financial management of the European Union: Annual Report of the European Court of Auditors for the year 2000
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

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 9.

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.

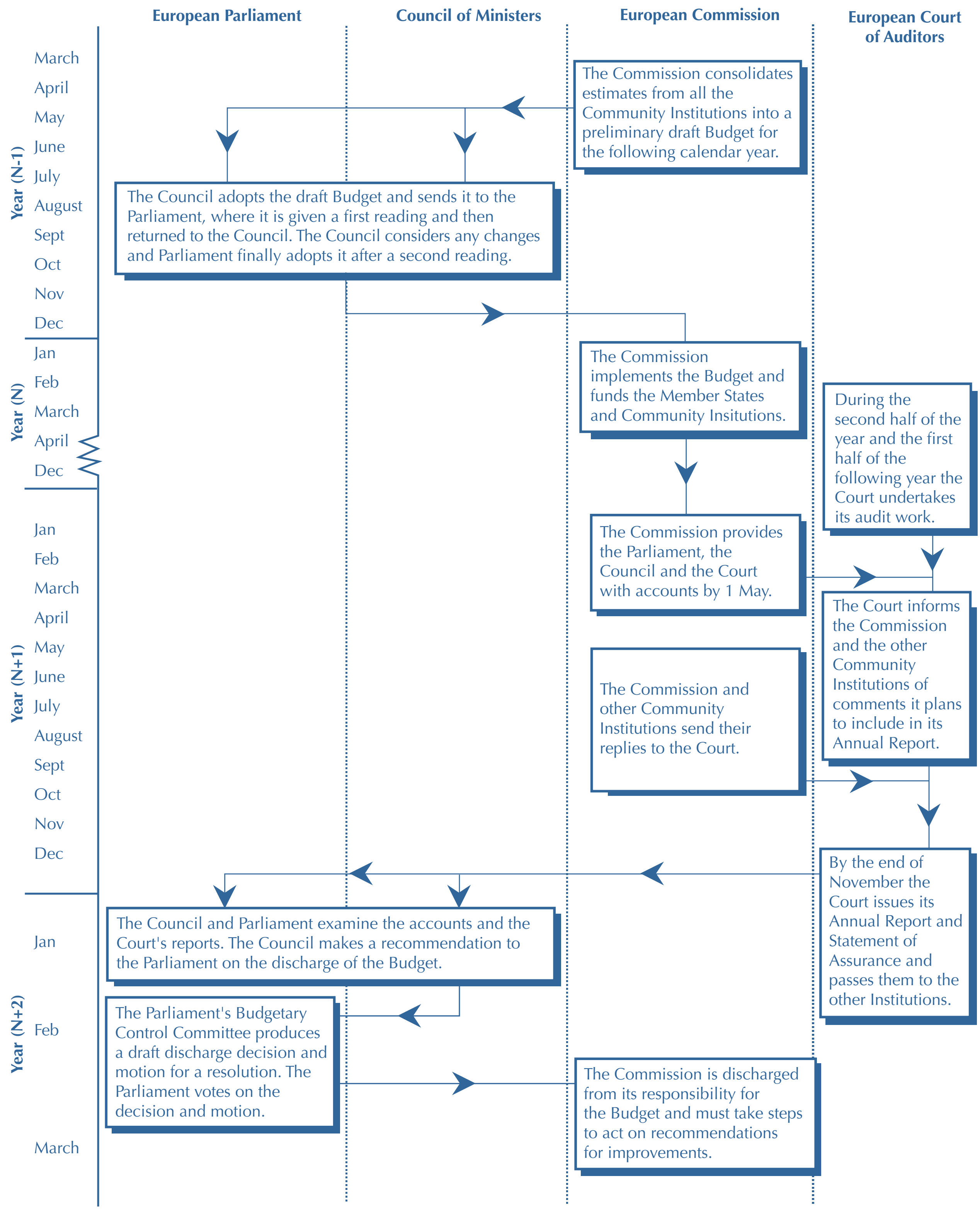
5 The Council and the Parliament monitor the implementation of the Budget during the year. This is done through the 'Notenboom procedure' whereby the Commission is invited to comment on the level of implementation of individual appropriations in the autumn of each year. Following a resolution by the 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 for the previous financial year. 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 or defer it 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.

9 Control of the Community General Budget



Appendix 3 Special Reports published by the European Court of Auditors during 2002

Special Report	Title
1/2002	Macro-financial assistance to third countries and structural adjustment facilities in the Mediterranean countries
2/2002	The Socrates and Youth for Europe Community action programmes
3/2002	The Community Initiative Employment - Integra
4/2002	Local Actions for Employment
5/2002	Extensification premium and payment schemes in the common market organisation for beef and veal
6/2002	The Commission's management of the EU oilseeds support scheme
7/2002	The sound financial management of the common organisation of markets in the banana sector

Appendix 4 The European Court of Auditors' main findings on the reliability of the accounts of the Community for 2001

Problem	Effect
Accounting system and governance	
Weaknesses exist in the accounting system which mean that the accurate recording of Commission assets cannot be guaranteed. There were also low levels of awareness of accounting controls and records. Plans of action to improve controls and implement accruals accounting by 2005 have yet to be implemented	Not quantified
Limitation of scope	
The Court was unable to express an opinion on €1,230m (£748m) of Own Resource income from Member States due to problems with the Member States' systems	Not quantified
Negative expenditure	
Negative expenditure was recorded relating to agriculture. This should have been classified as revenue	Expenditure and revenue both understated by €2,804m (£1,706m)
Commitments	
The Commission entered into legal obligations which exceeded available appropriations for 2001 in relation to international fisheries agreements and External Actions. They were disclosed as off-balance sheet liabilities.	Understatement of €610m (£371m) for fisheries agreements and €239m (£145m) for External Actions
The figure for commitments included amounts outstanding from before 2000, which had not been subject to any payment during 2000 or 2001. In some cases, the Court considered there was no longer an obligation to make payments	Estimated overstatement of €1,318m (£802m)
Fixed assets	
The Court found examples where the additional controls to ensure recording of all Commission assets recommended in 2000 had not been implemented	Not quantified
Loans and joint ventures	
The Commission could not substantiate figures relating to the European Community Investment Partners, a financial instrument to support investment in developing countries. This covered valuation of participating interest in joint ventures, loans made and loan repayments collected	€22.9m (£13.9m) valuation of joint ventures and €67.6m (£41.1m) of loans could not be substantiated
Amounts receivable	
The figure recorded under sundry debtors was incomplete as the Commission had to derive this value from non-accounting records	Not quantified