NATIONAL AUDIT OFFICE

Financial management of the European Union

A progress report

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 529 Session 2003-2004: 6 May 2004

The National Audit Office scrutinises public spending on behalf of Parliament.

The Comptroller and Auditor General, Sir John Bourn, is an Officer of the House of Commons. He is the head of the National Audit Office, which employs some 800 staff. He, and the National Audit Office, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources.

Our work saves the taxpayer millions of pounds every year. At least £8 for every £1 spent running the Office.

Financial management of the European Union
A progress report

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 529 Session 2003-2004: 6 May 2004

LONDON: The Stationery Office
£8.25

Ordered by the
House of Commons
to be printed on 4 May 2004

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
30 April 2004

The National Audit Office study team consisted of:

Julie Lynn, Bryan Ingleby, and Richard Douglas, under the direction of Frank Grogan.

This report can be found on the National Audit Office web site at www.nao.org.uk

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

Contents

Acknowledgement: Cover image reproduced courtesy of the European Commission

executive summary

1 Since 1997 we have reported each year on developments in the financial management of the European Union. The aim of this work has been to contribute to Parliamentary scrutiny of European Union issues by providing an annual update on matters arising from the audit of the Budget of the European Community, and on the progress of work to strengthen the financial management and control of the Community General Budget.

2 The subject of financial management in the European Union has now taken on a new and significant dimension, with the enlargement of the Union to 25 countries, embracing 450 million people. The National Audit Office remains committed to working closely with the European Court of Auditors and its counterparts in the other 24 Member States to respond to these challenges.

3 To put our current work in context, for its 2004 financial year the European Union is budgeting for expenditure of €94.6 billion[1] (£59.5 billion), with the net contribution of the United Kingdom forecast to be some €6.5 billion (£4.1 billion).[2] For 2002, the year for which the most recent audited figures are available, the United Kingdom contributed gross revenue of €15.1 billion (£9.5 billion) to the European Union's budget. After allowing for the money which the United Kingdom received from the European Union - principally through the Common Agricultural Policy and the Structural Funds programmes, and also the United Kingdom's rebate, which for 2002 was €4.9 billion - the United Kingdom made a net contribution of €4.2 billion (£2.6 billion). This meant that for 2002 the United Kingdom was, after Germany, the second largest net contributor to European Union funds.

4 In line with our established practice, this report summarises the findings of the European Court of Auditors (the Court) for the year 2002.[3] It draws on information provided by the European Commission to set out developments in strengthening financial management and control. It also summarises the rates of irregularities and suspected frauds reported by Member States to the European Anti-Fraud office. Finally it considers aspects of financial control associated with the enlargement of the European Union.

The Annual Report of the European Court of Auditors

5 The Court is required by the Treaty establishing the European Community 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 ninth year in succession the Court qualified its opinion on each element.

1 Published in 'Introduction and Financing of the General Budget', the Official Journal of the European Union, 23 February 2004 (L 053).

2 Published in 'European Community Finances: Statement on the 2004 EC Budget and measures to counter fraud and financial mismanagement' (Cm 6134), by HM Treasury, 23 April 2004.

3 The Annual Report of the European Court of Auditors concerning the financial year 2002 was published in the Official Journal of the European Union, 28 November 2003 (c286 volume 46).

6 The basis of the Court's qualification in regard to the reliability of the accounts lay with ongoing weaknesses in the Community accounting system. The current system is cash based and was not designed to ensure that assets and liabilities are fully recorded. The Court noted several significant problems relating to the disclosure and valuation of assets and liabilities. For example, it found that €240 million (£151 million) of the Commission's commitment of £520 million (£327 million) to the capital of the Galileo[4] undertaking was shown as an advance instead of as an investment in the balance sheet.

7 As for the legality and regularity of the underlying transactions, the Court provided a clear opinion in respect of revenue and commitments. However, the Court qualified its opinion on over 90 per cent of expenditure because it identified a material level of errors in the underlying transactions with a financial impact. Against this, the Court was able to give a clear opinion on administrative expenditure and, for the first time, on expenditure for pre-accession aid to the countries in the process of joining the European Union.

8 The Court also made an important innovation in its annual report for the 2002 financial year. In relation to agricultural expenditure, the Court provided for the first time its assessment of the varying levels of risk attaching to different types of expenditure. It found that expenditure subject to the Integrated Administration and Control System (IACS)[5] - that is, those subsidies paid to farmers for arable crops based on the area cultivated and premiums paid for the numbers of eligible animals held during the relevant retention periods - had a lower risk of error than other categories of agricultural expenditure. Arable crop subsidies were the element of agricultural expenditure least exposed to the risk of error. The Court considered that categories of agricultural expenditure outside IACS, for example, subsidies paid for crops such as olive oil and cotton on the basis of quantities produced, posed greater risks and were subject to less effective control systems.

Other financial management issues

Reform of the accounting system

9 In March 2000, following the resignation of the previous Commission in March 1999, the European Commission initiated a substantial reform programme to improve financial management and accountability.[6] One of the key elements of this process which is still to be completed is reform of the Commission's accounting system, to allow it to produce accruals based accounts. The Commission is working towards complying by 2005 with the International Public Sector Accounting Standards (IPSAS), established by the International Federation of Accountants (IFAC). It is also in the process of upgrading its IT platform, so that this can systematically generate the figures required for the financial statements. Until these improvements are made, particularly in regard to the IT systems, it is likely that the Court will continue to have to qualify its audit opinion on the reliability of the Community's annual accounts.

4 The Galileo project is an initiative launched by the European Union and the European Space Agency. Its purpose is to develop a satellite radio navigation system to enable any position to be accurately determined to within one metre accuracy. It is based on a collection of 30 satellites and ground stations.

5 The Integrated Administration and Control System (IACS) is a database of all claims and supporting information which enables paying agencies in Member States to conduct administrative and on-the-spot checks on European Union funding claims.

6 The resignation of the Commission in 1999, and the setting up of the Commission's reform programme in 2000, are covered in detail in our 2000 report on Financial Management of the European Union (HC 437, 1999-00). We have commented on the progress of the Commission's reform programme in our reports in 2001, 2002, and 2003.

10 The project to move to a full accruals based accounting system is a major undertaking. The Commission is buying in expert advice through two major consultancy contracts it awarded in 2003. PricewaterhouseCoopers are providing assistance in project planning and management, and in the development of accounting standards and procedures; IBM are assisting in the planning and development of the IT functions. During 2003 the Commission recruited 12 extra staff to work on the project, and expects to recruit a further 14 in 2004. A substantial training programme is being launched in 2004 to support the transition to new accounting procedures.

11 In its 2002 Report, the Court reviewed progress made by the Commission in its reform programme, and described its timetable as 'over-ambitious'. The Court considered there was a risk that the Commission would be forced to make gradual changes to the current systems in order to meet deadlines rather than implementing a fully reformed system. The Commission, meanwhile, has stated that its priority is to introduce the accruals based accounting framework by 1 January 2005, but has acknowledged that the full integration of its central IT systems and the local IT systems used by each Commission Directorate might take place over a longer time.

Reported irregularity and suspected fraud

12 Member States notified the European Anti-Fraud Office (OLAF) of just over ten thousand cases of irregularity and suspected fraud in 2002, with a value of €1.1 billion (£0.7 billion).[7] The number of cases was some 84 per cent higher, and the value of cases some 96 per cent higher, than in 2001. Much of this increase was due to a sharp rise in the number of reported cases in the Structural Funds. In the Commission's view, this is due to projects for the period 1994-1999 coming to a close and final expenditure claims now being audited in detail. The scheme most affected is the European Regional Development Fund. Some 2,716 cases have been reported. These have a total value of around €400 million (£250 million).

13 Although the Commission and Member States have agreed a common definition of fraud, the Commission has noted that Member States are still not reporting cases of suspected fraud on a consistent basis. The major difficulty is that some Member States consider that fraud cannot be recognised until a conviction has been obtained through their national legal system. The Commission is continuing to explore the possibility of reporting suspected fraud cases based on the balance of probabilities rather than actual convictions.

Enlargement

14 Ten new Member States joined the Union on 1 May 2004 - Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia. Since 1997 the Commission has prepared annual reports assessing the state of preparedness of new Member States to join the Union, and has continued to assess their readiness up to the date of accession.

7 Detailed in OLAF's annual 'Fight Against Fraud' report for 2002 (Commission Report 'Protection of the Financial Interests of the Communities and Fight Against Fraud' Annual Report 2002; COM(2003), 23 July 2003).

15 In the field of financial control, the Commission has not identified any outstanding issues of serious concern in any of the new Member States, although it did identify some areas where more effort was needed before accession.[8]

- In relation to public internal financial control (the system to ensure sound management and control of public resources, including internal audit), Cyprus, the Czech Republic, Hungary and Poland still needed to implement legislation on financial control, and to improve their administrative capacity.
- In relation to the protection of European Union financial interests (the incorporation and implementation of EU directives in national legislation and administrative and control processes), Estonia, Hungary, Latvia and Poland required enhanced efforts in order to complete their preparations for accession.

Scrutiny at the level of individual Member States

16 With new developments in the European Union, such as the enlargement to 25 countries, and the renewal of debate over a future European Constitution, it is likely that public interest in the Institutions of the European Union, and in the resources available to the EU and the use made of these resources, will only increase. As an illustration of this, the United Kingdom has recently set out proposals for enhancing UK Parliamentary scrutiny of European Union issues.[9]

17 Enhancing the audit of European Union revenue and expenditure and improving accountability for the financial management and use of European Union resources will remain key areas of concern. The National Audit Office intends playing a full role in the development of this process:

- We will continue to produce each year a report on financial management in the European Union. We will also provide any other support that Parliament may require to enhance its scrutiny of European Union matters.
- We will continue to work closely with the European Court of Auditors and the audit offices of the other 24 Members of the European Union to help ensure that all the revenues and expenditures of the European Union are audited to International Accounting Standards.
- We will also work closely with the audit offices of other Member States to build on the work started by the Netherlands Court of Audit to develop indicators that will help assess progress in improving the financial management of the European Union.[10]

8 European Commission's Comprehensive Monitoring Reports on the state of preparedness for EU membership of each of the new Member States, published September 2003.

9 Announced in a statement to the House of Commons by the Secretary of State for Foreign and Commonwealth Affairs on 11 February 2004.

10 Algemene Rekenkamer, EU Trend Report 2003.

Conclusions

Our main conclusions within this report are:

- We welcome the changes that the Court has made to the format of its Annual Report. These give increased clarity to the assessment of budgetary management. We particularly welcome the greater analysis provided by the Court of the varying levels of risk in different types of Community expenditure. We consider this to be helpful in focusing management attention on areas of greatest risk.
- We are concerned that for the ninth year in succession - since the procedure was first established - the Court has qualified its opinion on the reliability of the accounts. It is disappointing that the Court was again unable to provide positive assurance on the legality and regularity of the transactions underlying the great majority of Community expenditure, in particular that managed by the Member States. However, we are pleased to note that some progress has been made by the Commission, in that the Court was able to give positive assurance in the area of Pre-Accession Aid for the first time.
- We share the Court's view that the root of its qualification of the Community's accounts lies in the weaknesses in the Commission's accounting system. This situation is unlikely to improve until the Commission has completed the development of a comprehensive framework of accounting policies and has upgraded its IT platform. We support the work the Commission is undertaking to remedy these weaknesses. While an early resolution of these matters is clearly desirable, it is at least as important that the changes made are robust and work in practice.
- Inconsistencies continue to exist in how Member States report cases of irregularity and suspected fraud. We look to the United Kingdom authorities to continue to influence Member States towards adopting an improved reporting of irregularities, and an enhanced reporting of fraud as far as this is practical.
- The enlargement of the European Union to 25 countries will bring with it a more intense scrutiny of the EU's revenues and expenditures. The National Audit Office is prepared to play a full part in Parliamentary scrutiny of the European Union, and also in working with the European Court of Auditors and the audit offices of the other 24 member countries to ensure that the revenues and expenditures of the European Union are audited to International Accounting Standards.

Part 1

Introduction

1.1 Each year the National Audit Office 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 2002.[11] It also outlines the key developments in the process of reforming financial management and control arrangements at the European Commission (the Commission); summarises rates of fraud and irregularities reported by Member States (as set out in the annual 'Fight Against Fraud' report published by the European Commission); and considers the implications of the forthcoming enlargement of the Union for financial control of the Budget, based on the European Commission's latest annual reports on the preparedness of new Member States.[12]

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 Commission is responsible for submitting to the Council and the European Parliament accounts showing the implementation of the Budget, together with a financial statement of the assets and liabilities of the Community.[13] In December 2003 the Community's consolidated accounts were for the first time, in accordance with the Commission's new Financial Regulation, published together with the Court's Statement of Assurance.[14]

1.3 The Commission has overall responsibility for implementing the Budget, although over 80 per cent of Community funds are administered through shared management arrangements with national, regional and local authorities within the Member States.

Budget for the year 2002

1.4 The total Budget in 2002 - that is, the total amount of money that was available for expenditure - was €95.4 billion (£60.0 billion).[15] The breakdown of revenue and expenditure is illustrated in **Figure 2**. The procedures for setting, controlling, accounting for and discharging the Budget are set out in Appendix 2. Figure 9 summarises the main processes in the budgetary cycle.

Budget surplus

1.5 For the third year running, there was a significant surplus of revenue over expenditure. For 2002, this amounted to €7.4 billion (£4.7 billion), some 8 per cent of the Budget.[16] This follows a surplus of €15 billion (£9.4 billion), or 16 per cent of the Budget, for 2001.

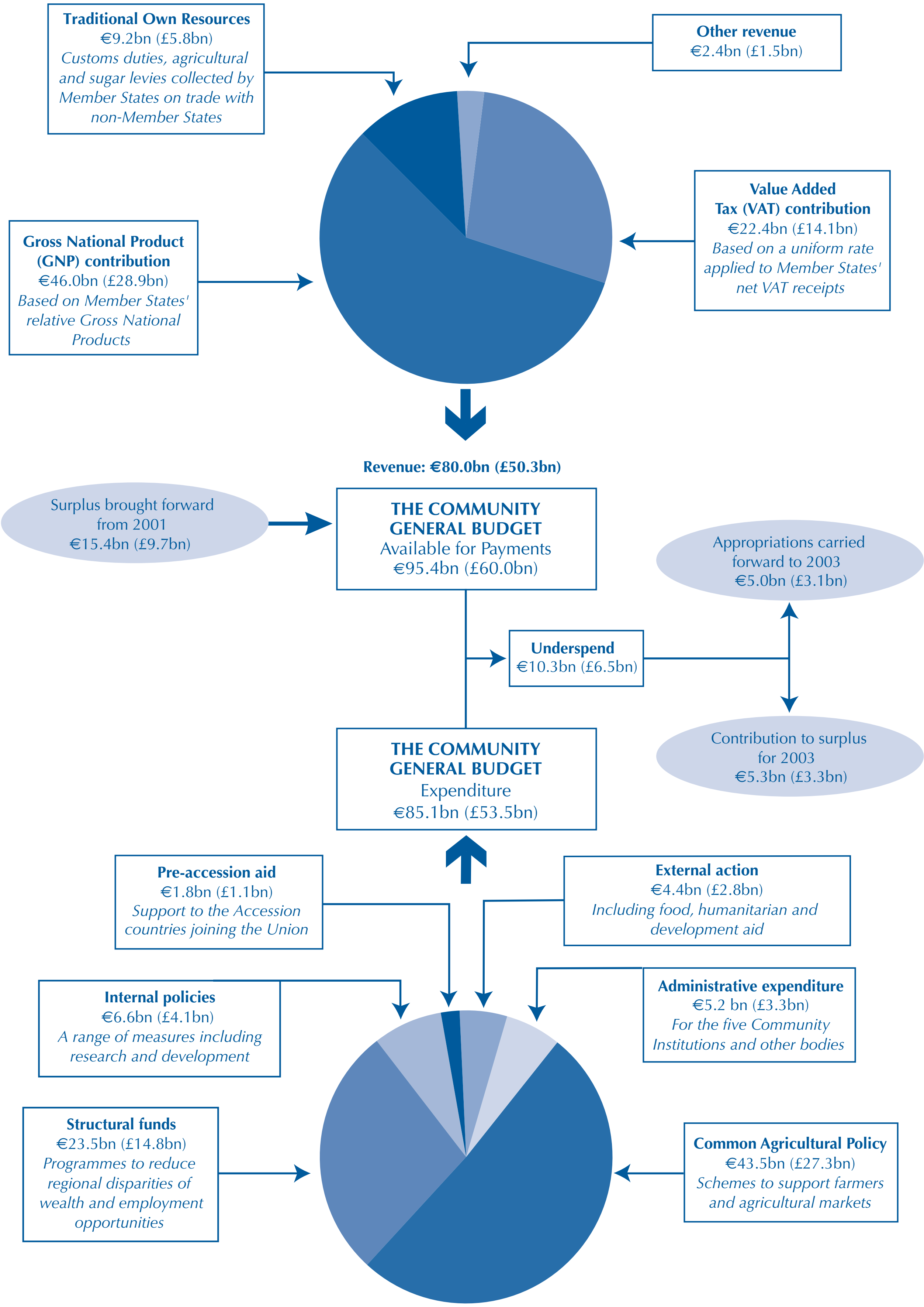
11 *Published in the Official Journal of the European Communities, C286, 28 November 2003.*
12 *European Commission's 2003 Comprehensive Monitoring Reports.*
13 *Article 275 of the Treaty Establishing the European Community (published in the Official Journal of the European Communities, C325 on 24 December 2002).*
14 *Published in the Official Journal of the European Communities, C316, 29 December 2003.*
15 *Amounts in Euros are converted to sterling using the published Bank of England average annual rate for 2002, £1 = €1.5909. All figures are rounded to the nearest €0.1bn or £0.1bn.*
16 *In the text we follow the Court's Annual Report Concerning the Financial Year 2002 in stating the amounts of underspend and surplus. These figures differ from those which appear in, and would be derived from, our Figure 2. The Court's figures reflect the difference between what was budgeted to be spent and what actually was spent; in other words the stated surplus of €7.4 billion is a budget surplus. Figure 2 meanwhile reflects the difference between the money that in practice was available to be spent and what actually was spent; in other words the surplus that would be derived from it is a cash surplus. By following this path, our report uses the same figures which are to be found in Chapter 2 of the Court's Report and, additionally, provides a breakdown of revenue and expenditure which may also prove useful.*

1 The European Community Institutions

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

Source: Data from the Annual Report of the European Court of Auditors 2002, and the Financial Statements of the European Community 2002

2 Revenue and expenditure in 2002



Source: Data from the Annual Report of the European Court of Auditors 2002, and the Financial Statements of the European Community 2002

1.6 The total underspend of the budget in 2002 was €13.4 billion (£8.4 billion). As in previous years, the underspend resulted mainly from low take up of monies for structural measures; the Court noted that €8.1 billion (£5.1 billion) available for expenditure in this area was not spent. Of the total underspend on structural measures, €5 billion (£3.1 billion) was carried over to 2003, reducing the reported budget surplus by the same amount. Within the amount carried forward is €3.3 billion (£2.1 billion) to cover final payments from the Structural Funds arising from the closure of projects from the 1994 - 1999 programming period. Under the new Financial Regulation the Commission is required to use all of the payment appropriations of the current year before those brought forward.[17] The deadline for the final receipt of claims was March 2003, and as a result the Court noted the strong possibility that the carried over appropriations will not be used because of the risk of delays in processing the closure claims.

1.7 The Commission relies on forecasts by Member States on their expected use of funds to set the budget for structural measures. As in previous years these forecasts proved to be overly optimistic about the level of funding Member States could spend in the period. The Court noted that the average overestimate for 2002 was 73 per cent, up from 38 per cent for 2001. The Commission acknowledged the problem, and has liaised with Member States to enhance the accuracy of the forecasts, but considers that expenditure forecasts from Member States remain the best available information for budgeting purposes. Nevertheless, the United Kingdom considers that the Commission could do more to work with Member States to improve the accuracy of forecasts and has suggested that the starting point should be an examination of best practice.

1.8 The Treaty establishing the Community does not allow the European Union budget to be in deficit, so a small surplus is to be expected. However, as in 2001, the Court considered that the Commission should have used mechanisms available under Supplementary and Amending Budget procedures to manage its financial needs more effectively. It noted that in the absence of such a procedure, up to €7.4 billion (£4.7 billion) of the GNP own resource called up from Member States was in excess of that needed to cover expenditure. The Court also considered that the process of carrying appropriations forward used by the Commission was not a fully transparent procedure. The Court recommended that this practice should cease, and that Supplementary and Amending Budget procedures should be used instead.

1.9 In its reply to the Court's findings, the Commission stated that it did not have the power to adjust own resources called up without a decision by the Budgetary Authority (the Council and the Parliament). It further stated that it did not share the Court's view regarding carry forwards, believing that this process offered faster and simpler funding arrangements.

The European Court of Auditors' Role

1.10 The European Court of Auditors is the external auditor of the European Union. In accordance with the Treaty Establishing the European Community,[18] the Court examines the accounts of all revenue and expenditure of the Community and bodies set up by the Community. The Treaty requires the Court to provide the other Institutions with an Annual Report, reporting on whether revenue received and expenditure commitments and payments made have been carried out in a lawful and regular manner, and whether financial management has been sound. The Court is further required to provide the European Parliament and the Council with a Statement of Assurance as to the reliability of the accounts prepared by the Commission, and to the legality and regularity of the underlying transactions. This statement, which is based on specific assessments for each major area of Community activity, forms the central part of the Court's Annual Report. Following the new Financial Regulation, approved by the Council of Ministers in June 2002, the Commission is now required to publish the Court's Statement of Assurance alongside the Community's consolidated accounts. The Community consolidated accounts for 2002 were the first to be published under the new Regulation. The Treaty also permits the Court to undertake specific investigations into certain topics, publishing its findings in Special Reports. In 2003 the Court published 13 Special Reports, with a further report published in February 2004. Details of these reports are listed in Appendix 3.

1.11 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.

17 Financial Regulation Article 9(3), Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002.
18 Article 248 of the Treaty establishing the European Community.

Discharge of the 2002 Community General Budget

1.12 On 10 March 2004 the Council, having examined the annual accounts prepared by the Commission, recommended to the European Parliament that the Commission should be declared to have carried out its budget responsibilities satisfactorily. Following its own examination, which drew on the Court's 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 2002 Budget on 21 April 2004 (this process is set out in more detail in Appendix 2).

The United Kingdom Parliament's scrutiny of European matters

1.13 The House of Commons Committee of Public Accounts may consider those aspects of reports prepared by the National Audit Office that touch on issues relating to European Union matters. 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.

1.14 Each year the House of Commons European Standing Committee B considers the Court's Annual Report. At its meeting on 23 February 2004, Members acknowledged the usefulness of the report produced each year by the National Audit Office to complement the Court's work. Members also raised the issue of how the National Audit Office could contribute further to the process of enhancing Parliamentary scrutiny of European financial matters.

Scope of the National Audit Office examination

1.15 This report considers the progress made since the last report by the National Audit Office on the management of European funds for the year 2001[19] and in particular:

- based on work carried out by the European Court of Auditors, summarises the Court's Statement of Assurance on the accounts of the Community for the year 2002 and its other significant findings on the management of the Community General Budget (Part 2); and
- based on a variety of published materials available from the European Commission and the Court, examines the key developments in the process of reforming financial management and control arrangements at the Commission, summarises rates of fraud and irregularities reported by Member States, and considers the implications of the forthcoming enlargement of the Union for financial control of the Budget. (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. Finally, for the first time, the National Audit Office was able to draw on a comprehensive survey of developments in the financial management of European Union funds published in 2003 by the Netherlands Court of Audit.[20]

19 *Financial management of the European Union (HC 701, 2002-03), published 12 June 2003.*
20 *Algemene Rekenkamer, EU Trend Report 2003.*

Part 2

The European Court of Auditors' Statement of Assurance for 2002 and other findings

2.1 This part of the report notes the Court's audit approach for the financial year 2002 and the 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.

The Court's methodology

2.2 The Treaty of Nice enables the Court to supplement its Statement of Assurance with specific assessments of each major area of Community expenditure (i.e., agriculture, the structural funds, internal policies, external action, pre-accession aid and administrative expenditure). For the financial year 2002, the Court wished to consolidate the basis of its Statement of Assurance by relying more systematically on an examination of the operation of the supervisory systems and controls set up by the Commission in each area.

2.3 The four main strands of the Court's audit methodology on the 2002 financial statements were:

- the identification, testing and evaluation of the supervisory systems and controls set up both in Community Institutions and in Member States and third countries;
- an examination of a sample of transactions for each major area involving audit checks down to final beneficiary level to confirm or negate the conclusions drawn from the evaluation of the control systems;
- an analysis of the declarations of the Directors-General of the Commission as to the operation of control systems; and
- an examination of the work of other auditors independent of Community management procedures, where relevant work had been conducted and the Court and the auditors concerned had agreed to cooperate.

This development in the Court's audit approach takes into consideration the Commission's ongoing reform process and in particular the reorganisation of its internal control system. Progress on the reform process, drawing on the Court's findings, is examined at Part 3 of this report.

2.4 The Court made a number of changes to the format of its Annual Report for 2002:

- the Statement of Assurance was presented as the first chapter of the Report;
- information on budgetary management was collected into a single chapter; and
- monitoring elements were introduced for each major expenditure area, highlighting the Commission's response to key weaknesses identified by the Court.

2.5 The changes made by the Court have added extra value to the Statement of Assurance by relating work done to the overall opinion given. The Court's conclusions on budgetary management have gained clarity by being presented in a separate chapter. The introduction of monitoring elements reflects the evolution of the Court's audit approach and, over a period of years, is intended to provide an indication of whether the Commission is successfully implementing the Court's recommendations.

Statement of Assurance for the year 2002

2.6 This year, as for the preceding eight years since the procedure was established, the Court has qualified its opinion on the consolidated accounts of the European Community. On the reliability of the accounts, the basis of qualification lay with weaknesses in the Community accounting system. On the legality and regularity of the underlying transactions, the qualification lay in material errors, in four of the six major expenditure areas - agriculture, structural measures, internal polices and external action - which together accounted for over 90 per cent of expenditure.

Reliability of the accounts

2.7 The first part of the Court's opinion concerned the reliability of the accounts. Although the Court concluded that the accounts for the year 2002 faithfully reflected the revenue and expenditure of the Community for the year and the financial position at the year end, its opinion was subject to a number of qualifications. In particular, the Court noted:

- legal commitments amounting to €820 million (£515 million) were off balance sheet;
- €240 million (£151 million) of the Commission's commitment of €520 million (£327 million) to the capital of the Galileo undertaking was shown as an advance instead of as an investment in the balance sheet;
- amounts of €91.1 million (£57.3 million) and €714.9 million (£449.4 million) included as liabilities in transitional accounts should have been reclassified to other balance sheet or revenue and expenditure headings; and
- the absence of effective internal controls meant that the Court was unable to conclude that sundry debtors were fully and accurately recorded.

2.8 As in previous years, the Court noted that the root of its qualifications lay in the Community's accounting system, which is cash based and was not designed to ensure that assets are fully recorded. At the end of 2002 the Commission adopted an action plan for the modernisation of the accounting system. The two key elements of the plan are an accruals based accounting system, and the full integration of IT systems across the European Institutions and Bodies. The Commission's timetable for full implementation of the new system is January 2005. The Court has concluded that this timetable appeared over-ambitious. More details on the accounting systems and proposed reforms are given in Part 3.

Legality and regularity of the underlying transactions

2.9 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. The Court gave the opinion that the underlying transactions were legal and regular in respect of revenue, commitments, administrative expenditure and pre-accession aid.

2.10 However, regarding other payments the court noted that:

- for the Common Agricultural Policy payments were, again, materially affected by errors;
- for the Structural Funds the same types of error occurred at Member State level with the same frequency as in previous years;
- for internal policies the transactions were still affected by significant errors; and
- for external actions, irregularities noted in the past were persisting at local levels.

2.11 However, the Court did note some improvements in 2002, in particular, for the first time, it did not qualify its opinion on the legality and regularity of the underlying transactions relating to pre-accession aid, which accounted for some €1.8 billion (£1.1 billion) or two per cent of gross expenditure. The Court noted that there was scope to strengthen supervisory systems and controls in this area, but felt able to conclude that the underlying transactions were legal and regular.

2.12 Also in relation to agricultural expenditure, the Court provided its assessment of the levels of risk attaching to different types of expenditure for the first time. The Court found that expenditure subject to the Integrated Administration and Control System (IACS)[21] had a lower risk of error than other categories of agricultural expenditure. In 2002, some 58 per cent (€25.4 billion or £16 billion) of agricultural expenditure was covered by IACS. Under IACS, subsidies are paid to farmers for arable crops, based on the area being cultivated. Premiums are paid for eligible animals, held during the relevant retention periods, subject to certain quotas and limits. The Court found that the arable crop subsidies were the element of agricultural support least exposed to the risk of error.

2.13 The Court considered that categories of agricultural expenditure outside IACS posed greater risks, and were subject to less effective control systems. The types of expenditure involved are set out in **Figure 3**.

3 Categories of agricultural expenditure posing greater risks

Expenditure by type	Expenditure as percentage of fund	Expenditure in € (£)
Subsidies paid for crops (e.g., olive oil and cotton) on the basis of quantities produced	12 per cent of Common Agriculture Policy expenditure	€5.3 billion (£3.3 billion)
Rural development schemes	10 per cent of agricultural expenditure	€4.3 billion (£2.7 billion)
Other expenditure, including intervention measures to support agricultural markets	20 per cent of Common Agriculture Policy expenditure	€8.5 billion (£5.3 billion)

Source: European Court of Auditors Annual Report 2002

21 *The Integrated Administration and Control System (IACS) is a mechanism whereby paying agencies in Member States conduct administrative and on the spot checks on claims for European Union funding. It also comprises a database of all claims and supporting information.*

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

Own resources

- Own resources is the term for European Community revenue. The main elements are VAT and GNP contributions from, and customs duties collected by, Member States.
- Revenue in 2002: €95.4 billion (£60.0 billion) including the 2001 surplus of €15.4 billion (£9.7 billion) brought forward.
- The Court reported satisfactory results for the reliability of the accounts used for recording own resources, and for the legality and regularity of transactions. No material errors were identified.
- The Court noted that VAT and GNP contributions (71 per cent of the Community's income in 2002) are based on macroeconomic statistics in Member States which cannot be tested directly. It found that VAT and GNP resources were being correctly calculated by the Commission and entered in the Community accounts. However, it noted problems with VAT collection, which cast some doubt on the accuracy and reliability of the VAT statements produced by Member States, and recommended that the Commission increase its VAT control activities.

Agriculture

- This heading comprises programmes to support the production of crops and animals in Member States.
- Expenditure in 2002: €43.5 billion (£27.3 billion), 51 per cent of gross expenditure.
- The Court examined a sample of 232 payments drawn from 25 paying agencies, responsible for 70% of CAP expenditure. It also examined the performance of the Integrated Administration and Control System (IACS) which each Member State is required to have in place.
- The Court noted that CAP expenditure was materially affected by error, with the highest risk areas being those outside the IACS scheme, for examples intervention measures to support agricultural markets. It was unable to provide positive assurance.
- In relation to IACS expenditure, the Court noted that support for producing arable crops had a lower risk profile than animal payment premiums. It noted that the risk analyses that inform the IACS checks could be improved to target the higher risk payments.

Structural measures

- The 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 in 2002: €22.5 billion (£14.1 billion), 28 per cent of gross expenditure.
- The Court examined the supervisory and control systems both at the Commission and in Member States. It also conducted substantive testing on payments at both levels.
- 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 incorrect contribution rates used. The Court was unable to provide positive assurance.
- The Court noted that systems internal to the Commission had improved. However, it also noted that there were weaknesses at Member State level regarding the implementation of Commission Regulation 438/01 concerning controls and checks over payments.[22]

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 in 2002: €6.6 billion (£4.1 billion), eight per cent of gross expenditure.
- The Court examined the Commission's systems and controls and followed up its 2001 investigation of the Trans-European transport networks (TEN-T) - key strategic transport links within and between Member States.
- Regarding systems and controls the Court noted the persistence of significant errors, particularly in the case of the research framework programmes which accounted for more than half this budget. It also reported systems weaknesses over payments and works associated with TEN-T projects. The Court was unable to provide positive assurance.

22 *Commission Regulation 438/01 was adopted on 2 March 2001, and covers the requirements for Member States' management control systems in the Structural Funds. It requires Member States to issue adequate guidance to the managing and paying authorities involved in managing Structural Funds expenditure, to set up a body to verify the systems of those authorities and test a minimum five per cent of transactions, and to report to the Commission by 30 June each year the outcome of those checks.*

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

External action

- External action largely comprises humanitarian aid and support for development projects.
- Expenditure in 2002: €4.4 billion (£2.8 billion), five per cent of gross expenditure.
- The Court reported that irregularities were found at local levels as in previous years. The Commission's supervisory systems did not provide assurance over payments at the level of bodies responsible for implementing projects. The Court was unable to provide positive assurance.

Pre-accession aid

- Pre-accession aid is financial assistance to the Candidate Countries to assist them with preparations for membership of the European Union.
- Expenditure in 2002: €1.8 billion (£1.1 billion), two per cent of gross expenditure.
- The Court's audit comprised an examination of the systems and controls over payments supported by detailed transaction testing.
- The audit did not reveal material errors and, for the first time, the Court provided positive assurance, although it noted that the supervisory systems and controls needed to be reinforced.

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 in 2002: €5.2 billion (£3.3 billion), six per cent of gross expenditure.
- The Court's audit comprised an examination of systems and controls supported by detailed transaction testing. It found no material errors and was able to provide positive assurance.
- However, the Court commented on secretarial allowance payments relating to the employment of assistants by the Members of the European Parliament. It recommended that procedure be applied rigorously to prevent this allowance being used inappropriately.
- The Court also followed up its 1999 report on the European Parliament's pension scheme and noted that the Parliament had not yet acted to establish a sufficient legal framework for the scheme as the Court had previously recommended.

How the Court's findings relate to the United Kingdom

Statement of Assurance

2.14 The Court's audit approach is planned in order to allow it to reach a Statement of Assurance opinion across the European Budget as a whole, and is not intended to lead to an assessment of the financial management of individual Member States. However, the Court has indicated that its findings in the United Kingdom were similar to those identified across the European Union generally.

Own Resources

2.15 The Court was able to provide positive assurance in respect of the revenue due to the European budget, and did not identify a material level of error in this area across the European Union as a whole. Where the Court cited weaknesses in procedures in the United Kingdom in its Annual Report, these irregularities were minor in nature and the United Kingdom authorities have indicated that action is being taken to implement improvements.

Common Agricultural Policy

United Kingdom CAP accounts

2.16 Agriculture expenditure in the United Kingdom is administered by six Paying Agencies.[23] Each Paying Agency is required to prepare annual accounts for the Common Agricultural Policy (CAP) financial year, which runs from 16 October to the following 15 October. These accounts must be audited by a Certifying Body (in the United Kingdom, the Comptroller and Auditor General) and submitted to the European Commission. The Commission may then examine the payments made and can 'disallow' expenditure if irregular payments are found to have been made or the Paying Agency's financial control systems were weak. Disallowed expenditure is borne by the Member State rather than the European Budget.

2.17 The National Assembly for Wales was unable to produce its accounts for the year ending 15 October 2002 in time for the National Audit Office to certify them and submit them to the European Commission by the statutory deadline of 10 February 2003. This situation was caused by problems associated with the introduction of a new

23 *Rural Payments Agency (RPA), Scottish Executive Environment and Rural Affairs Department (SEERAD), National Assembly for Wales, Department for Agriculture and Rural Development Northern Ireland (DARDNI), the Forestry Commission (FC) and the Countryside Council for Wales (CCW).*

computer system by the Assembly. Although the National Audit Office ultimately certified the accounts on 5 March 2003, the Commission decoupled the expenditure managed by the Assembly from its decision on the rest of CAP expenditure in the United Kingdom.

2.18 In November 2003, the Auditor General for Wales presented a report to the National Assembly, *Late Payments to Farmers in Wales,*[24] which looked at the wider consequences of the problems associated with the introduction of the new computer system. It found that the two main contributing factors that delayed the introduction of the new system were the outbreak of Foot and Mouth disease in 2001, which diverted staff resources away from the project; and the need to incorporate new and complex European regulations into the system, which increased the time required to develop and test new software. The report acknowledged that the National Assembly for Wales had put extensive remedial project management arrangements in place to try and ameliorate the payment delays associated with the project, but concluded that the Assembly had not met the overall standard of service that farmers had a right to expect. For the future, the report noted that the system appeared to be functioning well for the CAP year beginning in October 2003.

United Kingdom CAP expenditure

2.19 Most CAP expenditure in the United Kingdom is administered under the Integrated Administrative Control System and relates to either aid schemes for arable crops or premiums for animals. The Court reported that across the European Union, agricultural expenditure administered under IACS carried a lower risk of error than other types of support, with arable aid schemes having the lowest overall level of risk. However, as in previous years the Court continued to find numerous, generally low value errors in the sample of transactions it audited.

Arable aid schemes

2.20 Most of the errors identified by the Court involved discrepancies between the area of land declared by farmers as being eligible for support and the area found when the same fields were measured in the presence of the auditors. The Court reported that nearly half of the discrepancies it identified were of less than 3 per cent of the area declared by farmers, while in a similar number of cases there were discrepancies of over 3 per cent but not more than 20 per cent.[25] The overall discrepancy rate (in the 14 Member States which have implemented IACS - not Greece) was small - 1.2 per cent, down from 2.4 per cent in 2001.

Animal premium schemes

2.21 The Court found that typical errors in respect of animal premium schemes involved over-declarations of livestock and shortcomings in the accuracy and timeliness of data maintained in animal registers. The Court attributed the higher risk of error for animal premiums as compared to arable aid schemes to the complex eligibility conditions for animal premiums and the need to record frequent animal movements. The Court's report also noted the results of IACS inspections for animal premium claims carried out by Member State authorities and reported to the European Commission. Ten Member States, including the United Kingdom, reported error rates of less than two per cent.

2.22 The National Audit Office report *Identifying and Tracking Livestock in England*[26] examined the progress made by the Department for the Environment, Food and Rural Affairs (DEFRA) in implementing livestock identification and tracking in England for the most commercially important livestock species - cattle, sheep and pigs. All cattle must be individually identified and keepers must report animals' births, movements and deaths for recording on the Cattle Tracing System. All sheep born from 2003 must also be individually identified, but pigs need not be. Sheep and pig movements must be reported to the Animal Movements Licensing System, which also draws on information on cattle movements from the Cattle Tracing System. The objectives of these identification and tracking systems are to safeguard human and animal health, assist control of farming subsidies and improve the industry's commercial performance. They contribute to DEFRA's Animal Health and Welfare Strategy, a key part of the United Kingdom Government's response to the independent inquiries following the foot and mouth outbreak in 2001.

2.23 The Cattle Tracing System was not originally intended to be used to check claims for European Union Common Agricultural Policy subsidies, but since January 2000 the European Union has required Member States to use their national cattle databases for this purpose. The United Kingdom was not able to undertake full cross-checks of cattle subsidy claims for the year 2000, partly because the Cattle Tracing System did not cover cattle born before 1996. As a result, the European Commission imposed on the UK a penalty of £14 million (representing around 7 per cent of the value of bovine scheme payments in 2000-01).

24 *Late Payments to Farmers in Wales, Report by the Auditor General for Wales, presented to the National Assembly on 20 November 2003.*

25 *Under IACS rules, errors of less than 3 per cent of the declared area are corrected but not penalised. Errors of between 3 and 20 per cent are corrected and a penalty is imposed. Errors exceeding 20 per cent of the area declared lead to a refusal of the entire claim.*

26 *National Audit Office report Identifying and Tracking Livestock in England (HC 1144, 2002-03).*

2.24 The report found that the initial objectives of the Cattle Tracing system have been met and that the identification and tracking of sheep and pigs has improved, but that there is more that could be done. DEFRA is implementing the required changes under a 'Livestock Identification and Tracing Programme'. This will result in a single Livestock Register. The programme also provides scope to introduce electronic methods of identifying animals if this is justified by business benefits or required by European Union legislation.

Structural Funds

2.25 The Court evaluated the management and control systems for structural measures in several Member States, including the United Kingdom, and identified numerous weaknesses in these systems. Typical problem areas were:

- a lack of adequate guidance to the managing and paying authorities;
- breaks in the audit trail;
- an insufficient level of checks on payments made.

The Court considered that the systems it examined in the United Kingdom were subject to these types of problems.

2.26 The Court also tested a sample of transactions in Member States to corroborate the results of its system evaluations. It identified a large number of errors across Member States which it attributed to the weaknesses it had identified in their management and control systems. The types of error which the Court identified were similar to those it had found in previous years, for example:

- the inclusion of ineligible activities or persons in claims for support;
- the failure to take account of revenue generated or other income when calculating the net cost of projects;
- the same expenditure being declared more than once; and
- expenditure being paid without documentary evidence to support it.

The Court found errors such as these in the transactions it examined in the United Kingdom.

2.27 The National Audit Office views these shortcomings with concern and is currently undertaking a parallel audit with several other European national audit institutions to review how structural funds are managed in each country. The aim of this audit is to identify those controls within the regulatory structure which need to be improved and to highlight best practice in complying with European regulations. The audit will focus in particular on the conduct of checks and the maintenance of an audit trail. We intend to include information on the outcome of this work in our report next year.

United Kingdom's net contribution

2.28 Community revenue and expenditure by Member State in 2002 is shown in **Figure 5**. The United Kingdom was the second largest net contributor to the Budget behind Germany, providing a net contribution of €4.2 billion (£2.6 billion), after a rebate of €4.9 billion (£3.1 billion) was taken into account.

Other matters raised by the Court

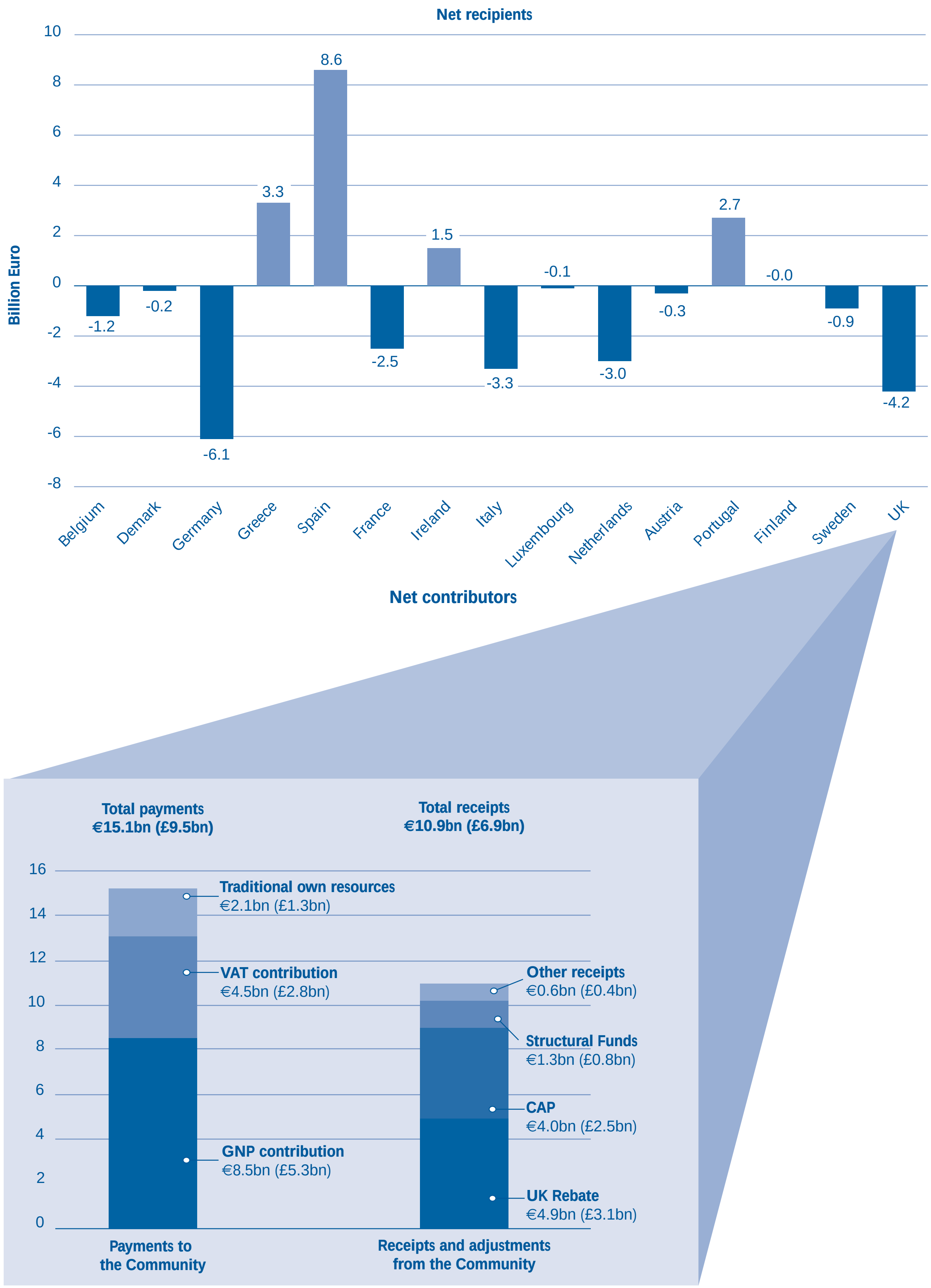
Expenses of Members of the European Parliament

2.29 The Court commented on 'secretarial allowance' payments made to Members of the European Parliament for the employment of assistants. The Court noted that €175,000 of such payments were not adequately supported by documentation to show that the funds had been used for their intended purpose. In a Special Report that it issued in 1998[27] the Court had recommended a tightening of the procedures surrounding the secretarial payments to ensure that funds were not misused. Rules were amended accordingly in April 2000. The Court stated that its findings showed that if the new rules were not adhered to, the risk of inappropriate use of the secretarial allowance remained.

2.30 In its reply to the Court, the Parliament stated that verification checks carried out prior to payment had been strengthened. The Parliament commented that payment to an assistant is only permitted where the contract and application are accompanied by evidence of the assistant's membership of a social security scheme, where the salary noted on the contract agrees with that on the application, and where expense payments are fully supported by documentation such as hotel bills and train tickets.

27 *European Court of Auditors Special Report No. 10/98 concerning the expenses and allowances of the Members of the European Parliament together with the replies of the European Parliament.*

5 **Contributions to and receipts from the European Budget by Member State for the year 2002**



Source: European Court of Auditors Annual Report 2002

2.31 The Court also raised concerns regarding the additional pension fund set up for the benefit of Members and former Members of the European Parliament. The Court had previously examined this scheme in 1999 and raised questions about the adequacy of the legal framework underlying the scheme. In its 2002 Annual Report, the Court noted that the European Parliament had not yet taken any action to address its concerns and reiterated its doubts regarding the pension fund's legal framework. The Court also noted that as at 31 December 2002, the asset value of the fund amounted to some €117 million (£73.5 million), but its liabilities amounted to some €158 million (£99.3 million), leaving a negative balance of some €41 million (£25.8 million). The Court repeated its opinion that clear rules should be established to define the liabilities and responsibilities of the European Parliament and of the members of the scheme in the case of a deficit.

Conclusions

2.32 Our main conclusions based on the Court's audit work on the 2002 year were:

- We welcome the changes that the Court has made to the format of its Annual Report which give increased clarity to the assessment of budgetary management. We particularly welcome the greater analysis provided by the Court of the varying levels of risk in different types of Community expenditure. We consider this is helpful in focusing management attention on areas of greatest risk;
- However, it remains a matter of concern that for the ninth year in succession, the Court qualified its opinion on the reliability of the accounts. We are also disappointed that the Court was again unable to provide positive assurance on the legality and regularity of the transactions underlying the great majority of Community expenditure. However, we are pleased to note that some progress has been made by the Commission as the Court was able to give positive assurance in the area of Pre-Accession Aid for the first time.

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 and progress on the Commission's reform programme;
- reported rates of irregularity and fraud by Member States; 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.[28] One of the main areas of reform addressed in the White Paper was improved financial management, accountability and control. Provisions included:

- the establishment and application of internal control standards;
- the introduction of activity based management; and
- a new Financial Regulation for implementation of the above to come into effect from 1 January 2003.

As an evolution of this process, in December 2002, the Commission approved a further action plan to develop a fully accruals based accounting framework and to upgrade and integrate IT systems across the European Institutions and bodies.

3.3 The Commission's White Paper strategy for reform and modernisation was supported by an action plan which it intended to implement by the second half of 2002. Our last three reports published in April 2001, May 2002 and May 2003 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 for the year 2002, and this section of our report draws on the Court's work.

Improvements to the accounting systems

3.4 As in previous years, the Court's qualification of its opinion regarding the reliability of the Community's accounts for the year 2002 stemmed from weaknesses in the Commission's accounting system. The Court found that the Commission was unable to produce reliable, accurate and complete financial statements on an accruals basis. The Commission has acknowledged the shortcomings. On 17 December 2002 it published an action plan to modernise its accounting system,[29] designed to meet the requirements of the June 2002 Financial Regulation which required the introduction of full accruals based accounting. The main problems which the action plan sought to address were that:

- the Commission had not developed a framework of accounting policies establishing how to deal with all items which need to be accrued, such as pension liabilities;
- the Commission did not have a single integrated accounting system capable of providing all the figures it needed to disclose in the financial statements; and
- the existing system - SINCOM 2 - was a centralised cash based system, which meant that any accruals based data had to be compiled from a variety of local records. This system, as a transitional measure, needed to be improved to ensure the security and consistency of information from various sources across the Commission.

28 *White Paper on reforming the Commission - COM(2000) 200, 1 March 2000.*
29 *Communication by the Commission COM(2002) 755, on 17 December 2002.*

3.5 The action plan gave a deadline of 1 January 2005 for the full implementation of the accruals based accounting system. The project is led by the Commission's accounting officer and is being managed in three streams:

- accounting;
- IT architecture; and
- user requirements.

The Commission established two committees in the first quarter of 2003 to manage the project - a Project Oversight Board and an Advisory Committee for Accounting Standards. In 2003 the Commission recruited 12 extra staff to DG Budget to work directly on the project and it planned to recruit a further 14 in 2004. In addition, the Commission has estimated that some 100 man years of time will be required from staff in operational Directorates-General in order successfully to deliver the project. The Commission has also awarded two major contracts to outside consultants to assist it in developing and introducing its new systems. PricewaterhouseCoopers are providing accountancy advice in a contract with an estimated lifetime value of some €3.5 million (£2.2 million), while IBM are providing IT expertise in a contract with an estimated lifetime cost of some €11.5 million (£7.2 million). The number of consultant staff involved in the project varies, but is normally some 12 to 15 people at any one time.

3.6 The Commission has undertaken to provide the Budgetary Control Committee of the European Parliament with quarterly progress reports against the planned project timetable. On 3 February 2004 Michaele Schreyer, the Member of the Commission responsible for the Budget, sent a report on progress to the end of January 2004 to the Budgetary Control Committee, as well as the Council's Budget Committee and the Court of Auditors. Ms Schreyer concluded that the project was fully on track and keeping to the projected timetable.

3.7 The Commission intends that all its new accounting standards will follow the International Public Sector Accounting Standards (IPSAS) established by the International Federation of Accountants (IFAC). The Commissioner reported that the accounting standards had passed initial opinions on five accounting standards and that work on an additional five had begun. The Commissioner also reported that accounting manuals are being written and that a new chart of accounts is being prepared.

3.8 Regarding the update of IT systems, the Commissioner reported that an inventory of all local systems used by the Commission's Directorates-General had been completed, and that the Commission's accounting software was being examined to determine what additional functionality was required for the integration of those systems. The software had been upgraded, and a new security policy had been implemented and documented. Overall, the Commissioner reported that the deadline of 1 January 2005 appeared 'ambitious but realistic'.

3.9 In its Annual Report, the Court commented on the progress made by the Commission. It noted in particular that the Commission often became aware of events that would normally require an entry to be made in the accounts at a very late stage, due to the shared management arrangements with Member States. The Court recommended that the Commission define accounting events in a manner that would allow the Commission to retain control over the process of recording them. The Commission told us that it does not expect the changes in its accounting standards to have any impact on the level of reporting required from Member States. It intends to develop a statistical approach to establish the figures which should be recorded in the financial statements, rather than requiring Member States to report on every single transaction in real time.

3.10 The Court concluded that the timetable for implementation appeared 'over-ambitious', and considered that there was a risk that the Commission would be forced to make gradual changes to current systems in order to meet deadlines rather than fully implement the necessary reformed information systems. The Commission, in its replies, stated that its priority was to introduce the accruals based accounting framework by 1 January 2005, but that the integration of its central IT systems and those local IT systems used by its Directorates-General might take place over a longer time. Until the new systems are in place, the shortcomings which have required the Court to qualify its opinion on the Community accounts for 2002 will remain.

3.11 Our experiences of similar reforms in the United Kingdom suggest that the Commission's timetable is very ambitious. In the United Kingdom, a system of accruals accounting, known as resource accounting, took some seven years to introduce - from 1994, when a Green Paper first introduced the concept, to 2001-02, when parallel running of cash based appropriation accounts was finally discontinued. Neither can the difficulties of introducing an integrated computerised accounting system be underestimated. We have reported on many information technology projects in the United Kingdom which have exceeded planned time scales and budgets.

3.12 The Commission needs not only to introduce the new systems, but also to ensure they are fully tested and that staff are fully trained in their use before reform can truly be said to have taken place. The planned deadline of 1 January 2005 appears very challenging when placed in this context. We consider that it is at least as important that the changes are successful in practice, as that the original timetable is strictly adhered to.

Annual Activity Reports

3.13 As part of the reform process, each Director-General has been required, since 2001, to prepare 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. The Annual Activity Reports increase the accountability of the Directors-General and are 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.[30]

3.14 As in 2001, all thirty-six of the Directors-General stated in their declarations that they had reasonable assurance that control procedures in place gave the necessary guarantees over the legality and regularity of the underlying transactions in their area of responsibility. Directors-General are also required to highlight any internal control weaknesses or irregularities they have identified and, where these exist, to draw up an action plan to address the causes.

3.15 If a risk is so serious as to endanger the sound functioning of the Directorate-General, it is classified as a reservation. Following the first round of Activity Reports in 2001, the Commission issued guidance on the setting of a materiality base to assess whether an irregularity should be reported as a reservation. This materiality was expressed as a percentage of the budget for the relevant activity.

3.16 Twenty-two of the Directors-General made reservations in their 2002 declarations. As in 2001, the Budget Director-General made reservations over the Commission's accounting systems and the IT systems supporting the accounting function. The Court noted that the number of reservations as a whole that are due to risk exposure had increased in comparison to 2001, and that the precise nature of the reservation was often not clear enough to assess its impact.

3.17 Following the first declarations made in 2001, the Court made a number of recommendations relating to the procedure for preparing the Annual Activity Reports. The Court noted that in 2002 the declarations were prepared more consistently. In the future, the Court intends where possible to use these management representations as part of its statement of assurance. However, for 2002, the Court considered that the imprecise nature of the reservations meant that it was unable to place reliance on the declarations made by the Directors-General.

3.18 In its reply to the Court, the Commission stated that for the 2003 declarations, each of the Directors-General would be required to submit supporting evidence for any reservations made, and to explain the impact of the reservation on the Statement of Assurance. Both the Court and the Commission agree that the Annual Activity Reports could contribute an important element of the audit evidence required for the Court to reach its audit opinion. As we concluded in our 2003 report on *Financial Management in the European Union,* we share this view and support the Court's efforts in maximising the usefulness of these reports.

Implementation of Internal Control Standards

3.19 The White Paper on reform announced that 24 internal control standards were to be adopted as an integral part of the reform process. The internal control standards were adopted on 13 December 2000[31] and amended on 21 December 2001.[32] These were designed to cover all aspects of the Commission's management process, including:

- the control environment - covering administration and human resources issues;
- performance and risk management - covering objective setting, planning, performance monitoring and risk analysis;
- information and communication - covering management information and reporting;
- control activities - covering segregation of duties, documentation procedures, supervision and continuity; and
- audit and evaluation - covering internal audit, recording and correction of control weaknesses and the annual review of internal control.

30 Twenty ninth Report of the Committee of Public Accounts: Financial Management and Control in the European Union, HC 690 Session 1998-99.
31 Communication by the Commission SEC (2000) 2203 on 13 December 2000.
32 Communication by the Commission SEC (2001) 2037 on 21 December 2001.

3.20 In its examination of the reform process for the year 2002, the Court particularly considered what assurance the internal control system could provide regarding the legality and regularity of payment transactions, basing its review on information reported by Directors-General in their declarations.

3.21 Reviewing the implementation of internal control standards across the Commission as at 31 December 2002, the Court found that minimum standards on internal control had not been fully implemented. However, it recognised that full reform of the Commission's internal control systems would take time, and that reforms were just beginning to take effect. The Court concluded that substantial progress had been made despite the slippage in the original timetable.

Reported fraud and irregularity

3.22 The European Anti-Fraud Office (known by its French acronym, OLAF)[33] was set up in June 1999. OLAF's mission is to protect the financial interests of the European Union; to fight fraud, corruption and any other illegal activity that has a financial consequence, including misconduct within the European Institutions. It plays both a coordinating role between Member States and an enabling role by conducting internal and external investigations in the Community. The Treaty establishing the Community requires 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'.[34]

3.23 Member States must report to OLAF cases of irregularity or suspected fraud valued at over €10,000 (£6,300) in the revenue sector, and €4,000 (£2,500) in Common Agriculture Policy and Structural Measures expenditure. In collecting these statistics, OLAF plays a co-ordinating role to provide information to Member States and help them to cooperate in areas of mutual interest. The broad distinction between fraud and irregularity is that fraud is an intentional, criminal offence, whereas irregularity is any failure to comply with Community regulations resulting from an act or omission. Irregularities and frauds reported in the revenue sector impact on the finances of individual Member States rather than the Community General Budget. Any such shortfalls due to fraud and irregularity are made up by increased VAT/GNP contributions from Member States, with national budgets suffering a concomitant loss of income due from customs duties.

3.24 Each year OLAF publishes information about the irregularities and suspected frauds reported to it by Member States in the Commission's 'Fight Against Fraud' Annual Report.[35] In total, Member States notified the Commission of 10,060 cases of irregularity and suspected fraud in 2002, with an estimated value of some €1.1 billion (£0.7 billion). **Figure 6** gives a breakdown by sector and a comparison with reported rates in 2001.

6 Cases of fraud and irregularity notified by Member States in 2002

Area of the Budget	2002 Number of cases	2002 Amounts involved (€ million)	2001 Number of cases	2001 Amounts involved (€ million)	2001-2002 Change cases	2001-2002 Change amounts
Revenue from customs duties, agricultural and sugar levies	2,119	325	1,873	239	+13%	+36%
Common Agricultural Policy expenditure	3,285	198	2,415	140	+36%	+41%
Structural Funds expenditure	4,656	614	1,194	202	+290%	+204%
Total	**10,060**	**1,137**	**5,482**	**581**	**+84%**	**+96%**

Source: Data from Protection of the Communities' Financial Interests and the Fight Against Fraud, Annual Report 2002

33 *Office Européen de Lutte Anti-Fraude.*
34 *Article 280 of the Treaty establishing the European Community.*
35 *Commission Report 'Protection of the Financial Interests of the Communities and the Fight Against Fraud' Annual Report 2002; COM (2003) 0445, published 23 July 2003.*

3.25 The notifications by the Member States reflect only a partial picture. Cases of fraud and irregularity tend to be identified unevenly within programmes, and reported levels may fluctuate considerably from one year to another. By their nature, the reported statistics can only include identified cases, and cannot take account of other frauds which may exist but which have not been identified. From the statistics available for 2002, it is not possible to draw conclusions on the actual levels of fraud against the General Budget. These uncertainties also make it impossible to conclude whether the level of irregularity and fraud is improving or worsening year on year.

3.26 The statistics also depend on the quality of the information supplied by Member States. The Convention on Protection of the European Communities' Financial Interests (the 'Fraud' Convention) came into force in October 2002 and included a common definition of fraud.[36] However, in its 2002 'Fight Against Fraud' report, the Commission noted that Member States were still not reporting cases of suspected fraud on a consistent basis. The major difficulty is that some Member States consider fraud cannot be recognised until a conviction has been obtained through their national legal system. The Commission is continuing to explore the possibility of reporting suspected fraud cases based on the balance of probabilities rather than actual convictions. Given the lack of consistency in how Member States report irregularities and suspected fraud, the Commission published only aggregated figures in 2002, and will not be able to report accurately on the level of suspected fraud until consistent reporting by Member States can be achieved.

3.27 OLAF has sought to enhance communication by setting up an electronic system for reporting cases which should be easier for Member States to use and improve the consistency of statistics. However, take-up of this system to date has been slow, largely due to technical difficulties. The United Kingdom is currently using the electronic system to report agricultural cases, but not those arising from the Structural Funds.

3.28 The figures for 2002 represented a substantial increase on the number and value of cases reported by Member States for 2001. This increase derived mainly from a sharp rise in the reports relating to Structural Funds expenditure. The Commission concluded that this was due to projects for the period 1994-1999 coming to a close and final expenditure claims being audited in detail. Most affected was the European Regional Development Fund, with 2,716 cases reported valued at some €403 million (£253 million).

3.29 In 2002 the United Kingdom notified the Commission of 750 cases of suspected fraud or irregularity involving some €49 million (£31 million). Whilst this represented an increase in the number of cases from 2001 (499 cases) there was a significant decrease in the value of cases from 2001 (€76 million, or £48 million). This came on top of significant falls in the number and value of cases reported by the United Kingdom in 2001 when compared with 2000.

3.30 On the revenue side, OLAF noted that frauds involving the large scale smuggling of cigarettes and false declarations regarding the country of origin of bananas in order to take advantage of more favourable tariff rates, accounted for the largest share by both number and value of cases. OLAF also highlighted significant frauds involving the import of sugar and aluminium. In relation to agriculture, common types of fraud involved the manipulation of quota or set-aside schemes. In relation to structural measures, cases of fraud often involved the use of false invoices and false declarations by project beneficiaries.

Missing trader fraud

3.31 During 2003 the Comptroller and Auditor General carried out an examination into how HM Customs and Excise dealt with VAT fraud. This resulted in the report *Tackling VAT Fraud* (HC 357, Session 2003-04), published on 3 March 2004. One of the main issues this addressed was a type of VAT fraud known as 'missing trader fraud'. This is where bogus traders register for VAT, buy goods VAT-free from another European Union Member State, sell the goods on at VAT-inclusive prices and then disappear without paying the VAT to HM Customs and Excise. The more common lucrative variant is carousel fraud where, instead of being sold for consumption on the home market, goods are sold through a series of contrived transactions before being sold to a trader in another Member State, who then sells the goods back to the UK. This allows the trader to carry out the fraud repeatedly using the same goods. This is one of the most serious types of fraud confronting not only the United Kingdom but also other Member States. Where invited by the Member States concerned, OLAF helps to coordinate particular investigations.

36 *Protection of the European Communities' Financial Interests, OJ C316, November 1995.*

3.32 Our report found that HM Customs and Excise had done well to estimate the scale of losses on VAT, including VAT missing trader intra-Community fraud, and that they had introduced a range of measures to deal with it. Customs were working with partners in other European Union Member States and with OLAF to improve their administrative cooperation. In particular, they were working to strengthen the Commission's computerised system for automatically exchanging information about VAT registered taxpayers, the VAT Information Exchange System (VIES). Our report noted that HM Customs and Excise should continue working with the European Commission to strengthen VIES, as information on this system can be at least three months out of date.

3.33 The enlargement of the European Union in May 2004 could pose further risks to some countries in the EU from this type of fraud, particularly those with land borders with the new Members. Customs have been working with new Members - in particular Poland, the Czech Republic and Cyprus - to help them improve their systems. Customs have also been working with the European Commission and some Member States to produce a good practice guide on tackling missing trader fraud.

3.34 The European Commission is encouraging joint investigations between Member States into cases of suspected VAT missing trader fraud. The Commission considers that these types of investigations are an effective way of unravelling the complex relationships that fraudsters use between companies in a number of different States. It has funded an operational project carried out by UK Customs and the Danish and Dutch tax authorities of a VAT missing trader fraud carried out in a number of States, and lessons learnt from this project could assist in future joint investigations. Customs have also worked bilaterally with other Member States on investigations, such as with authorities in the Republic of Ireland, France, Spain, and Germany.

The Eurostat case

3.35 During 2003 concerns regarding financial management at Eurostat, the Commission's statistical office based in Luxembourg, were widely reported in the press. The two main issues concerned:

- the channelling of Community funds through unofficial bank accounts; and
- improper contracting processes whereby contracts were awarded without competition to companies in which senior Eurostat officials were alleged to have had an interest.

In July 2003 the Commission began internal disciplinary action against several senior officials at Eurostat. Investigations carried out by OLAF have led to dossiers being sent to the legal authorities in France and Luxembourg, as geographically Eurostat and the companies involved lie within their jurisdiction, and prosecutions may follow. The Commission's Internal Audit Service also carried out an investigation into Eurostat in 2003 and produced a confidential report which was submitted to the Commission and the Budgetary Control Committee of the European Parliament.

3.36 As a result of the Eurostat case, the Commission asked for and obtained assurances from all its other services and Directorates-General that there were no similar 'black accounts' or irregular contracts in their areas of responsibility. The Commission has sought to learn lessons from the case, and in particular has identified the need for better and speedier communication between OLAF and the Commission's senior management when such issues arise.

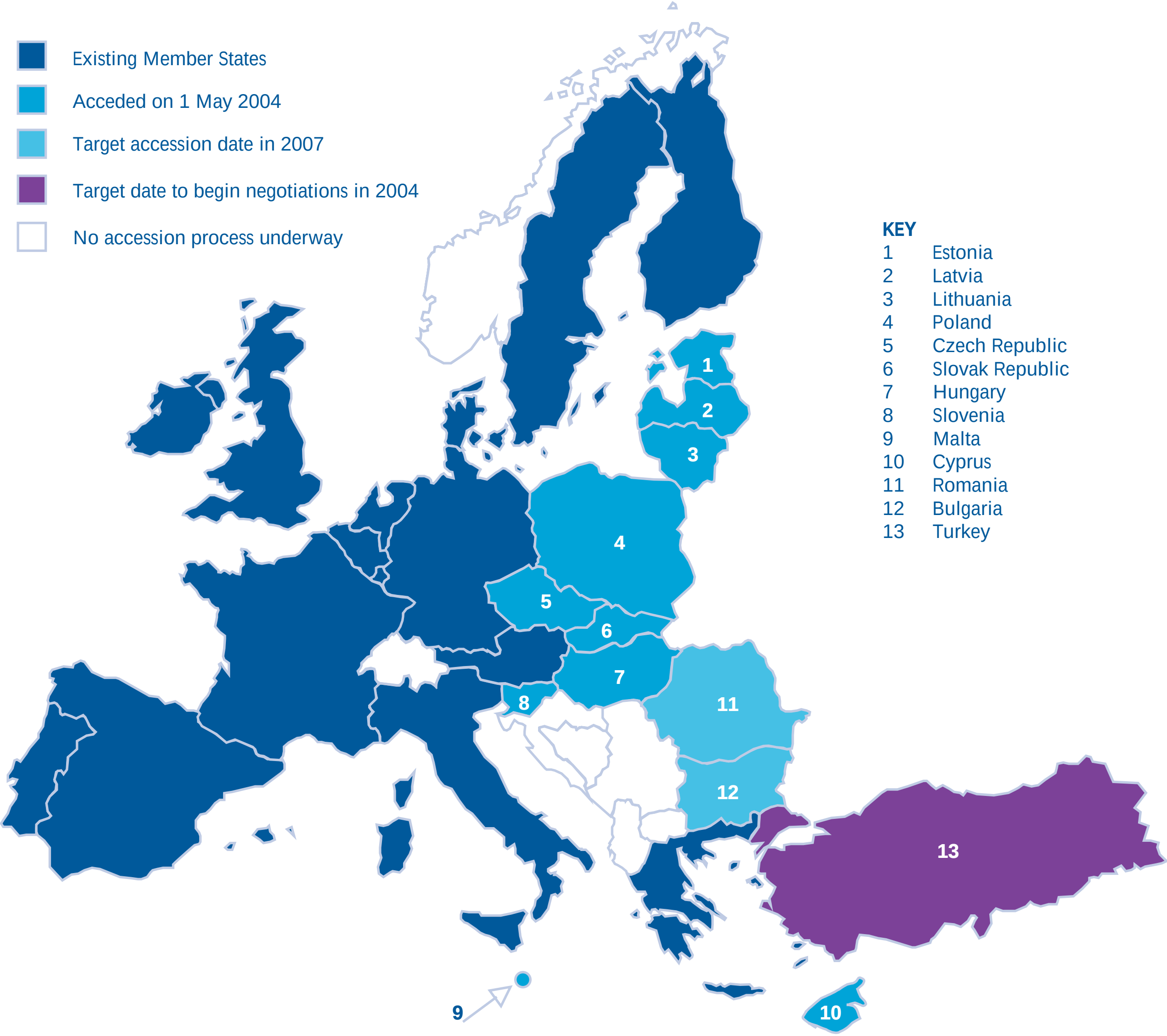
3.37 In February 2004 the Commission put forward proposals to strengthen the regulatory framework which governs OLAF's investigations. These proposals are aimed at enhancing OLAF's operational efficiency by enabling it to focus on its priorities and to accelerate its investigations. New provisions specify when and how OLAF is to keep institutions informed of investigations which concern them. The Commission states that this is required in order to allow institutions to take the necessary action to protect the EU's financial interests without harming the effectiveness of OLAF's investigations.[37] The United Kingdom will examine the implications of these proposals carefully to ensure that OLAF's operational independence is preserved.

Enlargement

3.38 The Copenhagen European Council on 12 and 13 December 2002 concluded accession negotiations with 10 Candidate Countries - Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia. A Treaty of Accession was signed in Athens on 16 April 2003, and these new Member States officially joined the Union on 1 May 2004.

37 *'Strengthening OLAF: Commission proposes improving information flows with the EU Institutions and reinforcing procedural guarantees', Commission press announcement, 9 February 2004.*

7 The enlargement process



1998	March:	Accession negotiations started with Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia.
2000	February: November: December:	Accession negotiations started with Bulgaria, Latvia, Lithuania, Malta, Romania and the Slovak Republic. First regular progress reports on accession criteria published. "Accession partnership" with Turkey established.
2001	March:	Nice Treaty establishes new national representation quotas for institutions and provides for expansion and reform.
2002	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	March: 16 April:	Commission on the Future of Europe reports. Signature of Accession Treaty.
2004	By Spring: 1 May:	Ratification of the Accession Treaty by the Member States and Candidate Countries. Date of Accession.

Source: National Audit Office

Readiness of the new Member States in the field of financial control

3.39 Each year since 1997 the Commission has produced an assessment of each Candidate Country outlining its progress towards accession. The Copenhagen Council requested that monitoring should continue up to May 2004. The Commission published a Comprehensive Monitoring Report in September 2003, presenting its findings on the countries' preparedness, identifying the remaining gaps and recommending policy options for closing those gaps.

3.40 In respect of financial control, the new Member States are required to have:

- an independent external audit function;
- adequate financial controls and functionally independent internal audit systems;
- financial control mechanisms for pre-accession funding and future structural actions; and
- arrangements to protect European Union financial interests, including an anti-fraud coordination service to cooperate with OLAF at an operational level.

3.41 **Figure 8**, summarises the Commission's views on the readiness of the new Member States in each area of financial control.

3.42 In relation to external audit, the Commission was satisfied that nine of the 10 new Member States were ready or that only minor issues remained. In Latvia, the Commission considered further progress was required to ensure the financial independence of the supreme audit institution and on its adoption of International Accounting Standards.

3.43 In relation to internal financial controls and internal audit arrangements, the Commission reported that enhanced efforts were required from Cyprus, the Czech Republic, Hungary and Poland to ensure that membership requirements were met. The Commission noted that legislation still needed to be implemented in these countries to facilitate financial control and that administrative capacity needed to be improved.

3.44 In relation to control over structural action expenditure, the Commission concluded that all 10 candidate countries had met the required membership standards.

3.45 In relation to the protection of European Union financial interests, the Commission reported that Estonia, Hungary, Latvia and Poland required enhanced efforts to meet the standards. In Estonia, Poland and Latvia the powers and role of the anti-fraud coordinating service needed to be clearly defined. In Hungary the Commission reported that the operational capacity of the service needed to be considerably reinforced.

3.46 The Commission concluded that significant progress had been made, but that certain important tasks still needed to be undertaken before May 2004.

Possible further enlargement

3.47 The enlargement process of the European Union is expected to continue beyond the current round. Negotiations are ongoing with Bulgaria and Romania with a view to gaining membership in 2007, and a strengthened pre-accession strategy for Turkey is being implemented. Croatia has also signalled its desire to join the Union.

8 Analysis of financial management preparedness in the new Member States

Commission category assigned to state of preparedness	External audit arrangements	Internal control and internal audit arrangements	Control over structural expenditure	Protection of EC financial interests
Country is ready or minor issues remain. Such issues will be resolved if the current pace of preparations is maintained	All except Latvia	Estonia, Latvia, Lithuania, Malta, Slovakia, Slovenia	All	Cyprus, Czech Republic, Lithuania, Malta, Slovakia, Slovenia
Some issues remain requiring enhanced efforts and an increased rate of progress to ensure they are resolved	Latvia	Cyprus, Czech Republic, Hungary, Poland	None	Estonia, Hungary, Latvia, Poland
Issues of serious concern exist where immediate and decisive action needs to be taken	None	None	None	None

Source: Commission's September 2003 Comprehensive Monitoring Reports on the progress towards accession of each of the new Member States

3.48 Accession negotiations with Bulgaria and Romania began in 2000 and will continue using the same principles that guided the negotiations with the ten countries that acceded on 10 May 2004. The Commission's 2003 monitoring reports showed that Bulgaria and Romania had continued to make significant progress in implementing the accession criteria. They continued to fulfil the political requirements for membership and were closer to fulfilling the economic and legislative criteria. The Union's stated objective is to welcome Bulgaria and Romania as members in 2007, providing that adequate progress has been made against all membership criteria.

3.49 The Commission reported that Turkey was making significant progress in preparing for membership. In line with a request from the Copenhagen European Council, the Commission will assess Turkey's progress towards meeting the accession criteria before the end of October 2004. The Commission will make a recommendation on whether Turkey fulfils the political criteria in order to allow the European Council to decide, at its meeting in December 2004, on the opening of accession negotiations with Turkey.

3.50 Croatia presented its application for accession to the European Union on 20 February 2003. At its meeting on 14 April 2003, the Council requested the Commission to prepare an opinion on this application for the Council. To this end the Commission transmitted a series of questions to the Croatian authorities in May 2003, receiving a reply in October 2003. On 20 April 2004 the Commission gave its opinion, recommending that the Council go ahead with membership negotiations.

Conclusions

3.51 Our main conclusions in this section are:

- We share the Court's view that the basis of its qualification of the Community's accounts lies in weaknesses in the Commission's accounting system. This situation is unlikely to improve until the Commission has completed the development of a comprehensive framework of accounting policies and upgraded its IT platform. We support the work the Commission is undertaking to remedy these weaknesses but consider that while an early resolution of these matters is clearly desirable, it is at least as important that the changes made are robust and actually work in practice; and
- Inconsistencies continue to exist in how Member States report cases of irregularity and suspected fraud. We look to the United Kingdom authorities to continue to influence Member States towards adopting an improved reporting of irregularities, and an enhanced reporting of fraud as far as this is practical.

Appendix 1

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

House of Commons number	Title
HC 357, 2003-2004	HM Customs & Excise: Tackling VAT fraud
HC 1144, 2002-03	Identifying and Tracking Livestock in England
HC 563, 2002-03	Fisheries Enforcement in England
Cm 5671, 2002-2003	NAO Standard Report (published with 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

Setting, controlling and accounting for the Community General Budget and the effects of the new Financial Regulation

1 Annual budgetary decisions are taken in the context of the European Union's financial perspectives, the Own Resources decision and relevant programme specific legislation. A summary for the procedure for setting, controlling and accounting for the European Community General Budget is shown at **Figure 9**.

- **Financial perspective** - since 1988 the annual budget has been set using a multi annual expenditure framework known as the financial perspective. This sets out expenditure ceilings for the seven broad expenditure headings which must be respected by the budgetary authority when it determines the budget. The current financial perspective, agreed following the Berlin European Council in 1999, covers the years 2000 to 2006;
- **Own Resources decision** - the Community is not permitted to fund a budget deficit and the budget must therefore be fully funded by contributions from Member States. The Own Resources decision sets out the arrangements by which contributions are derived. It sets a ceiling on the amount that can be raised from Member States in any one year, which is expressed as a percentage of overall Community Gross National Income;
- **Specific legislation** - this sets out the objectives and detailed arrangements for expenditure on individual programmes and policies. For example, in 2002 the Public Health Programme was started. This is to run from 2002 to 2006 and will enhance the European network infrastructure in areas such as the surveillance of communicable diseases. €312 million has been set aside for this programme.

2 The annual Community Budget is set by a procedure involving the Commission and the budgetary authority, comprising the European Council 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. This is then forwarded to the Parliament which has powers of amendment, although these are limited in respect of compulsory expenditure (expenditure relating to specific commitments referred to in Community legislation) such as expenditure on the Common Agricultural Policy.

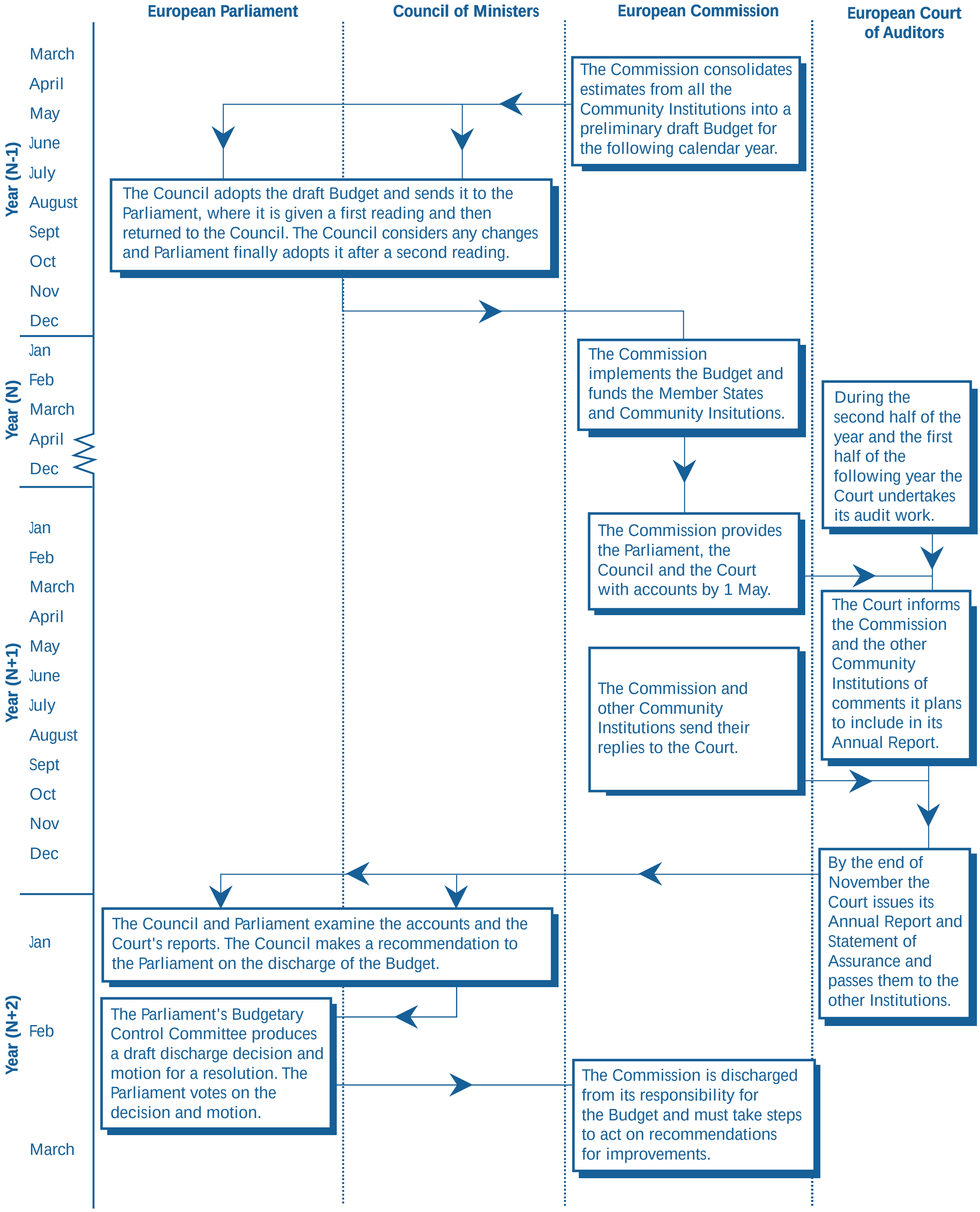
3 The budget is adopted by the European Parliament following its second reading. The Commission then implements the budget under its own authority in accordance with Financial Regulations approved by the Council and as provided in specific Community legislation. These regulations are intended to secure sound financial management and control of expenditure both within the Commission and the Member States, which administer over 80 per cent of expenditure. In exceptional circumstances, the Commission may propose during the year that the budget is amended it does this by submitting draft amending budgets. These are subject to the same procedural rules as the general budget.

4 The Council and 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 individual appropriations in the autumn of each year. Following a Parliament resolution, a 'Notenboom transfer' may be made, where the Commission adjusts the budget to maximise the effectiveness of appropriations. This procedure is also designed to inform 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 budgeted amount. These mechanisms allow the Commission to provide assurances that the budget is being implemented as designed, or to explain why variances have occurred.

5 By the beginning of May each year, the Commission is required to present to the Council, the Parliament and the Court the accounts of Community revenue and expenditure, and a statement of assets and liabilities for the previous financial year. The accounts form the basis of the Court's work for the Statement of Assurance. The results of this and other work by the Court on the Community's revenue and expenditure programmes are brought together in the Court's Annual Report published in November.

6 The Court's Annual Report and Statement of Assurance are the starting point for the discharge procedure that completes the cycle of accountability for the budget. This requires the Council and Parliament to examine the accounts prepared by the Commission and provides for the Parliament to decide, on a recommendation from the Council, whether to discharge the Commission from any further responsibility for the Budget. Discharge indicates

9 Control of the Community General Budget



that the Commission's stewardship has been sound, expenditure has been lawful and regular and that financial management has been effective. The granting of discharge formally ends the budgetary process for a given year.

7 Parliament may refuse to grant discharge if it is dissatisfied with the Commission's management of Community funds. Such refusal is one of the strongest rebukes which the Parliament can give and may precipitate a motion of censure. Discharge is normally given in April, but the Parliament may postpone discharge until the Commission has taken satisfactory action on key weaknesses identified by the Court of Auditors.

The new Financial Regulation

8 In June 2002 the Commission's new Financial Regulation - the secondary legislation which sets the framework for the financial management of the Budget - was approved by the Council of Ministers. The new Financial Regulation clarifies the budget setting and control procedure and specifies a more detailed timetable for the process. It also sets out the accounting and audit timetable and process in detail for 2003 onwards, although the timetable for the accruals based accounting framework will only come into operation from January 2005. The new timetable is detailed in **Figure 10.**

10 Arrangements under the new Financial Regulations

Budget setting procedures

- Each European body provides an estimate of revenue and expenditure to the Commission by 1 April in the year preceding implementation.
- The European Institutions shall send an estimate of their revenue and expenditure to the Commission by 1 July of that year.
- The Commission shall place a preliminary draft budget before the Council and the Parliament by 1 September, consolidating the estimates provided by the Institutions and bodies.
- The Commission may present amendments to the Council at least 30 days before the first reading by the Parliament.
- The Council will place the budget before the Parliament by 5 October, attaching an explanatory memorandum regarding changes to the preliminary draft budget.
- The President of the European Parliament will adopt the budget.

Budgetary Control

- The Commission will report twice a year to the Parliament and Council on budgetary guarantees and the corresponding risks.
- The Commission will send, on a monthly basis, actual figures of revenue received and expenditure incurred to the Council and the Parliament. These will be sent within 10 working days of the month end and include appropriations carried over.
- Three times a year, within 30 working days following 31 May, 31 August and 31 December, the Commission will send the Council and the Parliament a report on the implementation of the budget by chapter, article and item.

Accounting Procedures

- Accounts are to be prepared on an accruals basis.
- The accounting officers of the institutions and bodies will send to the Commission accounting officer their provisional accounts together with a report on budgetary and financial management by 1 March of the following year.
- The Commission accounting officer will consolidate the accounts and send the individual and consolidated accounts to the Court of Auditors by 31 March. The accounting officer will also send the reports on budgetary and financial management to the Parliament, the Council and the Court by the same date.
- The Court will make its observations on the draft accounts of each institution by 15 June.
- Each institution and body will prepare its final accounts by 1 July and send them to the Court and the Commission accounting officer.
- The Commission will then prepare the final Community consolidated accounts and transmit them to the Parliament, the Council and the Court by 31 July. The final consolidated accounts will be published in the Official Journal of the European Communities, together with the Court's Statement of Assurance, by 31 October.

Audit Arrangements

- The Court of Auditors will send to the Commission and the institutions concerned any observations which should appear in its Annual Report by 15 June.
- Each institution will address its response to those observations to the Court by 30 September.
- The Court will transmit its Annual Report to the authorities responsible for giving discharge to the Budget and other institutions by 31 October.
- The Commission will immediately inform individual Member States of details of the Annual Report which relate to management of the funds for which they were responsible. The Member States have 60 days in which to frame their reply to the Commission.
- The Commission will then send a summary of the replies to the Court, the Council and the Parliament by 15 February.

Appendix 3 Special Reports published by the European Court of Auditors during 2003

Special Report	Title
1/2003	The Prefinancing of Export Refunds
2/2003	Implementation of the Food Security Policy in developing countries financed by the general budget of the European Union
3/2003	Invalidity Pensions Scheme of the European Institutions
4/2003	Rural Development: support for less favoured areas
5/2003	Phare and ISPA Funding of Environmental Projects in the Candidate Countries
6/2003	Twinning as the main instrument to support Institution building in Candidate Countries
7/2003	The Implementation of assistance programming for the period 2000-2006 within the framework of the Structural Funds
8/2003	The execution of infrastructure work financed by the EDF
9/2003	The system for setting the rates of subsidy on exports of agricultural products (export refunds)
10/2003	The effectiveness of the Commission's management of development assistance to India in targeting the poor and ensuring sustainable benefits
11/2003	The Financial Instrument for the Environment (LIFE)
12/2003	The sound financial management of the common organisation of the market in dried fodder
13/2003	Production aid for cotton
14/2003	Measurement of farm incomes