Financial management of the European Union

A progress report

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
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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.

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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.