NATIONAL AUDIT OFFICE

# Financial management of the European Union

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 289 Session 2004-2005 | 3 March 2005

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*John Bourn*
**Comptroller and Auditor General**
**National Audit Office**

**28 February 2005**

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# EXECUTIVE SUMMARY

**1** In 2003 the United Kingdom contributed some €10 billion (£7.0 billion) to the European Union budget, while some €6 billion (£4.2 billion) of European Union funds were spent in the United Kingdom. The United Kingdom Parliament has taken a considerable interest in the way European funds are managed and controlled. This report continues our practice in recent years of informing Parliament of the results of the examination of the European Union's accounts by the European Court of Auditors (the Court). Since we last reported in May 2004[1], the European Union has seen some significant developments:

- it has grown from 15 to 25 Member States;
- a Constitutional Treaty has been signed and is awaiting ratification;
- the European Parliament (the Parliament) has been enlarged and re-elected; and
- a new Commission took office.

**2** This report:

- summarises the findings in the Court's Annual Report for the financial year 2003 (which runs from January to December);
- describes key developments in the reform of financial management and control arrangements at the European Commission (the Commission);
- summarises the data on fraud and irregularities reported by the Member States, as set out in the Commission's annual *Fight Against Fraud* report; and
- describes issues arising on the management of European Union funds in the United Kingdom.

It is based on our review of the findings in the Court's report for the financial year 2003 and other material published by the Court and the Commission and discussions with relevant officials from the Court, the Commission, the European anti-fraud agency and the United Kingdom's HM Treasury.

## Financial reporting

**3** The main issues on **the European Union accounts and the Court's opinion** were:

- The Court's report for 2003 continues with the improvements we noted last year[1], such as the increased analysis of the different types of the Community's expenditure.
- Each year, the Court is required to provide the Parliament and the Council with a Statement of Assurance concerning the reliability of the accounts and the legality and regularity of the underlying transactions. For the tenth successive year the Court qualified its opinion in a number of important aspects.
  - Apart from one area (compared to four in 2002), the Court was able to give a positive opinion on the reliability of the accounts.

1 Financial Management of the European Union – a progress report (HC 529, Session 2003-04).

- The Court did not give a positive opinion on the legality and regularity of the transactions for the following expenditure headings: the Common Agricultural Policy; Structural Measures; internal policies; external actions; and pre-accession aid. The majority of these expenditure areas were administered by Member States. Last year, the Court gave a positive assurance in the area of pre-accession aid. For 2003, the Court concluded that shortcomings in candidate countries' internal control systems resulted in errors and greater risks affecting the legality and regularity of transactions in this area.

- For 2003, the Community's budget surplus (the difference between budgeted and actual expenditure) was €5.5 billion (£3.8 billion), the lowest amount since 2000. The Court attributed the reduction to specific measures taken by the Commission to improve forecasting, mainly the cancellation of €5.0 billion (£3.5 billion) payment appropriations for structural operations which the Commission realised could not be spent. The Court believed that there was scope for the Commission to reduce the budget surplus still further and contrasted the continued underspend with increases in the budget. For 2003, the difference between actual revenue and expenditure was €2.9 billion (£2.0 billion).

- The Court commented that the Commission's budgetary process should take a more realistic view of Member States' ability to spend the money they receive. The Court noted that when payments continued to fall short of the estimate outstanding financial commitments increased and amounted to €105 billion (£73.3 billion) at the end of 2003.

- The Court, as it had in previous years, referred to weaknesses in the Commission's accounting system. The Court noted that the Commission was planning to introduce a new accounting system from 1 January 2005 and commented that full implementation of the new system would require considerable effort by all those concerned. At the end of January 2005 the Commission reported that the transition to the new system had been successful.

4 **The Court's key findings on the Common Agricultural Policy and Structural Measures** were:

- The Court found the Commission's processes for the certification of Common Agriculture Policy (CAP) paying agencies worked satisfactorily and that there had been improvements in the Commission's internal controls for Structural Measures. However, the Court was unable to take assurance from the Annual Activity Reports of the Directors-General in either area.

- Inspection results from the Integrated Administration and Control Systems (IACS) implemented in Member States represent an important source of evidence of the legality and regularity of CAP transactions. However, the Court reported variations in the risks and error rates for different categories of expenditure within the CAP. For example, the Court reported that the majority of arable crop subsidy payments made under area aid schemes were free from error but categories of expenditure not covered by the IACS (such as export refunds) pose greater risks and were found to have more serious errors. The error rates for CAP expenditure on area aid and animal premium schemes reported by the United Kingdom to the Commission were lower than the average for the European Union.

- The Court identified a number of weaknesses in Member States' management and control systems for Structural Measures. Examples of specific problems identified in Member States, including the United Kingdom, were: persistent errors in transactions; failure to comply with regulatory requirements; delays in closing the 1994-99 structural programmes; and poor forecasting of expenditure.

## Progress in financial management

5 The Court noted the progress made by the Commission on internal control standards and the improvements in the quality of the Annual Activity Reports of the Directors-General following changes by the Commission to their structure and content. But the Court commented that if it is to place reliance on the reports in future when considering the legality and regularity of expenditure the Commission needs to build on these improvements.

6 The number and value of cases of irregularities, including possible fraud, reported by Member States to the European Anti-Fraud Office (known as OLAF) in 2003 were lower than in 2002 but higher than in 1999, when OLAF was established. OLAF considered this was due to better detecting and reporting by Member States.

7 Member States do not report fraud and irregularity on a consistent basis. However, OLAF is developing a methodology which will distinguish between fraud and irregularity and is taking steps to estimate the levels of fraud in individual sectors of the budget.

# CONCLUSIONS

**8** Our main conclusions are:

- Despite the progress made by the Commission and the reduction in the number of qualifications on the reliability of the accounts from four in 2002 to only one in 2003, the Court, for the tenth consecutive year, qualified its opinion and did not provide positive assurance on the legality and regularity of five out of six expenditure headings. As the qualification on the reliability of the accounts was largely attributable to weaknesses in the accounting system, we welcome the introduction, on 1 January 2005, of a new accruals based system and supporting IT. The new system will be used to account for the Communities' income and expenditure for the current financial year, 2005. The Court's report on the audit of the 2005 financial year will appear towards the end of 2006.
- In our May 2004 report *Financial Management of the European Union*, we concluded that Annual Activity Reports offered a significant opportunity to improve accountability in the European Union. We therefore welcome the improvements to these important documents, resulting from action taken by the Commission. Further improvements will enable the Court to place more reliance on them in reaching its conclusions.
- We welcome the progress made by the Commission on the design of the new internal control framework, but note the Court's comments that not all the internal control standards had been implemented. We are therefore encouraged by the Commission's statement that it will concentrate on how well the internal control arranagements are working in practice.
- We note that there is scope for improvements in the management and control systems of Member States. For example, the United Kingdom has experienced particular problems with Structural Measures leading to delays in closing the 1994-99 programmes. However, our financial audit of the main departments responsible for the Structural Measures in the United Kingdom indicated that the departments had learned important lessons from the difficulties encountered in the previous period and have created procedures designed to prevent a repetition of these problems for the 2000-06 programmes.
- We support the steps taken by OLAF (the Commission's anti-fraud body) to estimate levels of fraud in individual sectors of the budget and its commitment to developing a methodology which will distinguish between fraud and irregularity in the European Union's finances.




- Member States still do not report fraud and other irregularities to OLAF on a consistent basis. The United Kingdom's Presidency in the second half of 2005 provides another opportunity for the United Kingdom authorities to continue, as far as is practical, to encourage Member States to improve detection and reporting of irregularities and fraud. Specifically, they should:
  - set an example by reporting irregularities to OLAF within time limits set by the Commission (as recommended in the Court's Special Report, the Financial Control of Structural Funds[2]); and
  - encourage Member States to agree a common interpretation of the concept of irregularity so as to provide a more complete and reliable image of the protection of the Communities' financial interests.
- The United Kingdom authorities should also support the Commission's work to simplify and reduce the number of definitions of types of fraud and methods of detection in the arrangements for reporting irregular CAP payments.
- As the Court has now qualified its opinion on the Community accounts for a decade, it is essential for all the authorities involved to contribute to the strengthening of the audit of European Union revenue and expenditure and improving accountability for the financial management and use of European Union resources. The Commission, with the support of Parliament, the Council and the Court, are already implementing changes to improve financial management. During its Presidency, the United Kingdom should engage with other Member States and the European Institutions to find ways of enabling the Court to provide a meaningful Statement of Assurance.

2 Special Report No 10/2001.

# PART ONE

## The European Union budget and the European Court of Auditors' findings for 2003

**1.1** This part of the report deals with:

- the European Union's budget and annual accounts;
- the 2003 budget, including the budget surplus and the United Kingdom's net contribution; and
- the Court's role and its conclusions arising from its work for the 2003 financial year.

## The European Union's budgetary process

**1.2** The structure of the European Union is shown in **Figure 1 overleaf**. The Council of Ministers (the Council) and the Parliament act jointly as the budgetary authority to approve the budget proposed by the Commission, which is set within a seven-year expenditure framework known as the Financial Perspective **(Figure 2 on page 9)**. Once the budget is adopted, it is implemented by the Commission which distributes funds to Institutions and Member States. Over 80 per cent of Community funds are administered through shared management arrangements with national, regional and local authorities within the Member States.

**1.3** In June 2002, the Council approved a new Financial Regulation **(Figure 3 on page 9)** – secondary legislation governing budget and control procedures – which applies to budgets from 2003 onwards. The budget process now operates as follows.

- The Commission presents a Preliminary Draft Budget for the following year to the Council and the Parliament.
- The Council and the Parliament both hold two 'readings' of the Preliminary Draft Budget and make amendments.
- At the conclusion of the procedure the President of the Parliament declares the Budget adopted.

### The Community's annual accounts

**1.4** Following liaison between the Commission and the Court, the Commission provided the Council, the Parliament and the Court with the consolidated draft accounts by the end of April, and co-ordinated its replies and those of the other Institutions to the Court's observations. The Commission presented corrected accounts in September. The Court presented its Annual Report and Statement of Assurance on the Community's accounts to the Parliament and the Council on 30 November.

**1.5** Following the publication of the Court's report, the Council and the Parliament examine the accounts and the Court's report. The Council, by 31 March of the year following publication, makes a recommendation to the Parliament to grant discharge for the Budget (to signify that the Parliament considers the stewardship of Community monies has been sound and according to instruction, and that expenditure is in line with the objectives set when the Budget was adopted). The Parliament's Budgetary Control Committee subsequently produces a draft discharge decision and motion for a resolution. By 30 April, the Parliament votes on the decision and motion. A positive discharge resolution means that the Parliament accepts that the Commission has satisfactorily discharged its responsibilities for implementing the Budget.

## The European Union's budget for 2003

**1.6** The Community's original budget for payments in 2003 was €97.5 billion (£68.1 million), two per cent more than in 2002. Following modifications, including revenues from third parties and amounts carried over from 2002 (an increase of €5.8 billion (£4.1 billion)), and a reduction of €5.0 billion (£3.5 billion) in the provision for Structural Measures, the final payments budget was €98.3 billion (£68.6 billion).

## 1 The five Institutions of the European Community

### The Council of the European Union

- One minister from each Member State
- Senior legislative body of the Community
- Administrative spend: €0.4 billion (£0.3 billion)

### The European Parliament

- 732 elected members
- Scrutinises the European Union's decision making process
- One arm of the Community's budgetary authority
- Administrative spend: €1.0 billion (£0.7 billion)


### The European Commission

- One Commissioner from each Member State
- Proposes and executes Community policies and ensures Member States meet their Treaty obligations
- Implements the budget
- Administrative spend: €3.5 billion (£2.4 billion)

### The European Court of Justice

- One judge from each Member State
- Rules on questions of Community law and whether actions taken by Community Institutions, Member Governments and other bodies are compatible with the Treaties
- Administrative spend: €0.1 billion (£0.07 billion)

### The European Court of Auditors

- One Member from each Member State
- External auditor of the accounts of all revenue and expenditure of the Community
- Administrative spend: €0.1 billion (£0.07 billion)

*Source: National Audit Office*

## 2 The Financial Perspective

The Parliament, the Council and the Commission agree in advance on the main budgetary priorities for a seven year period and establish a framework for Community expenditure, known as the **Financial Perspective**. It shows the maximum amount and composition of foreseeable Community expenditure. Its purpose is to:

- strengthen budgetary discipline;
- control increases in expenditure; and
- ensure that the annual budgetary procedure runs smoothly.

The Financial Perspective imposes a financial ceiling on individual expenditure headings (such as the Common Agricultural Policy and Structural Measures).

The Financial Perspective can be revised to take account of events not foreseen when it was agreed.

*Source: National Audit Office*

**1.7** The budget was financed by:

- **Traditional own resources**, consisting of agricultural and sugar levies charged on imports to the Community from non-member states and customs duties on trade with non-member states.
- **Value Added Tax (VAT) contributions**, based on a uniform rate (calculated by the Commission) applied to the VAT base in each Member State, subject to a cap.
- **Gross National Income (GNI) contribution**, from national budgets calculated according to the Member States' GNI.
- Other revenue and the surplus brought forward from 2002.

**1.8** The Community's budget was spent in six areas:

- **Common Agricultural Policy**, schemes to support farmers and agricultural markets.
- **Structural Measures**, programmes to strengthen the European Union's economic and social cohesion by reducing regional disparities in wealth, development, and employment opportunities.
- **Internal policies**, a range of measures including research and development.
- **External actions**, including food, humanitarian and development aid.
- **Administrative expenditure**, for the five Community Institutions and other bodies.
- **Pre-accession aid**, supporting countries joining the European Union.

## 3 Main features for budgetary control and audit under the new Financial Regulation

**Budgetary control**

- The Commission reports twice a year to the Parliament and the Council on budgetary guarantees and the corresponding risks.
- The Commission presents monthly revenue and expenditure figures to the Parliament and the Council.
- Three times a year, the Commission reports to the Parliament and the Council on the implementation of the Budget.

**Accounting and auditing procedures**

- Accounts are to be prepared on an accruals basis (though the Budget is prepared on a cash basis).
- The Commission sends individual and consolidated accounts to the Court.
- The Court sends to the Commission and the Institutions concerned its observations on the draft accounts which should appear in its Annual Report.
- The Commission prepares the final Community consolidated accounts and transmits them to the Parliament, the Council and the Court.
- Each Institution responds to the Court's observations.
- The Court transmits its Annual Report to the authorities responsible for giving discharge to the Budget and to other Institutions.
- The Commission informs 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 replies to the Commission.
- The Commission sends a summary of the replies to the Court, the Council and the Parliament.

*Source: National Audit Office summary of Financial Regulation 1605/2002*

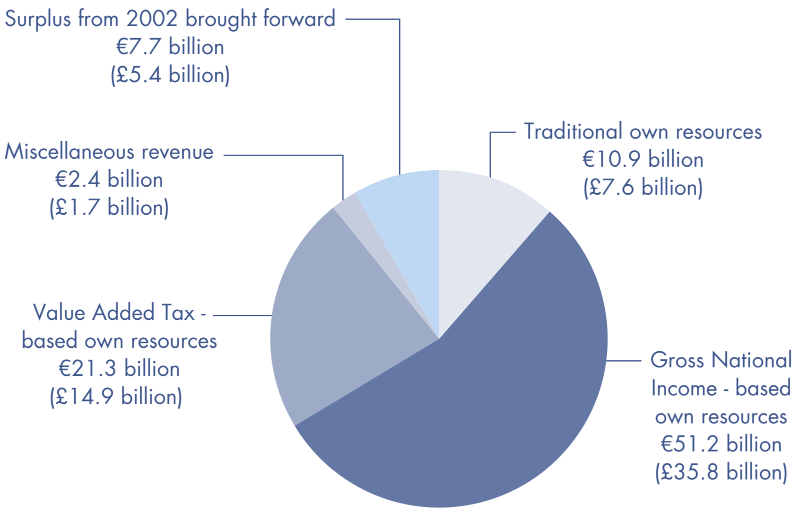
**1.9** The reduction in the budget for Structural Measures by €5.0 billion (£3.5 billion) was based on information provided by Member States and beneficiaries when the Commission took action to improve forecasting. The revenue budget was decreased by an equal amount, to €92.5 billion (£64.6 billion).

**1.10** Actual revenue was €93.5 billion (£65.3 billion) and actual expenditure was €90.6 billion (£63.3 billion) **(Figure 4 overleaf)**, leading to an actual surplus of €2.9 billion (£2.0 billion).

**4** Revenue and expenditure for 2003

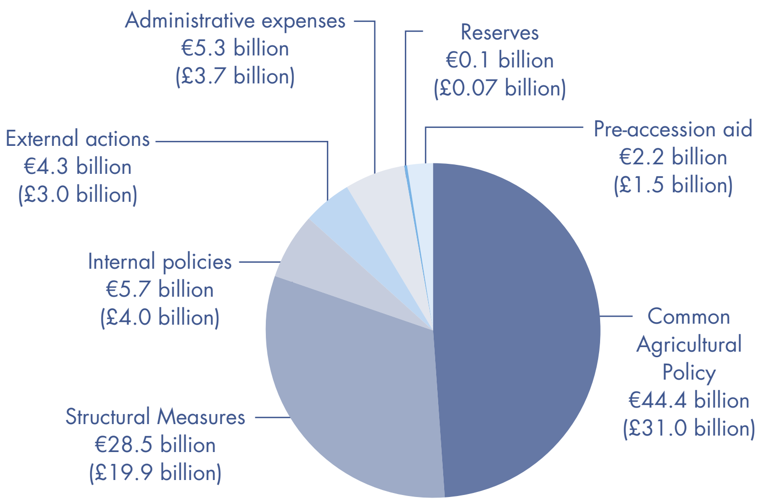
**Revenue**

Total revenue for 2003 was €93.5 billion (£65.3 billion)




**Expenditure**

Total expenditure for 2003 was €90.6 billion (£63.3 billion)




*Source: Data from the European Court of Auditors' report on the 2003 financial year*

NOTE

Not all figures cast due to rounding.

## The budget surplus

**1.11** The Community's final budget was underspent by €7.7 billion (eight per cent) or £5.4 billion. Of this, €2.2 billion (£1.5 billion) was carried forward to the budget for the 2004 financial year, leaving a budget surplus of €5.5 billion or £3.8 billion (a budget surplus cannot be spent or be used in future years; unused amounts are, in most cases, cancelled and returned to Member States in the form of reduced contributions). The Court noted that the surplus was lower than in previous years, as shown in **Figure 5**. The Court attributed the decrease in surplus to improved budgetary managment. But it commented that, despite such improvements, the large remaining surplus indicated that there was scope for substantially greater reductions in appropriations.

**1.12** The Court recognised it would be unrealistic for outturn to be exactly in line with the budget. However, it concluded that continued underspending (equating to €62 billion in five years) was responsible for a build up of amounts committed but not paid. At the end of 2003, outstanding commitments reached €105 billion or £73.3 billion (a five per cent increase on 2002), after the Commission had decommitted €4.1 billion (£2.9 billion) during 2003. The Court observed that an increase in commitments leads to a concentration in payments at the end of the programming period which can be difficult to manage effectively. The Court also contrasted the continued underspend with increases in the budget and it recommended that the budgetary process take more realistic account of the ability of Member States and beneficiaries to make payments.

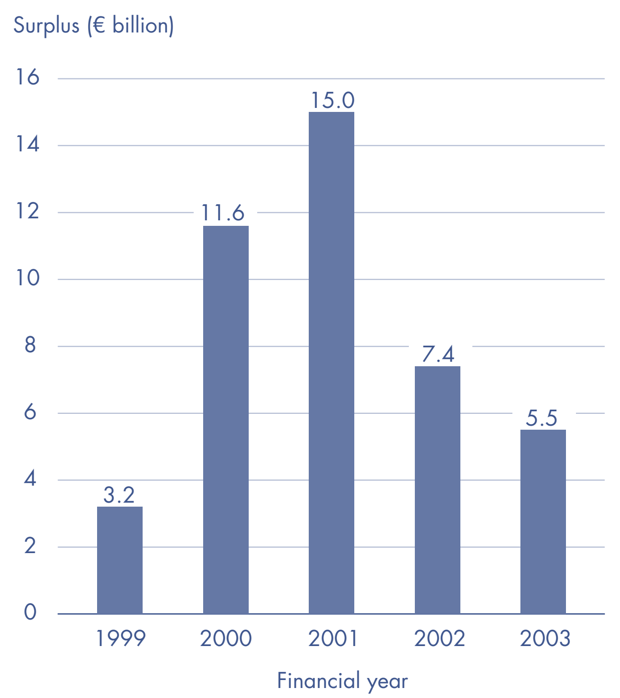
## The United Kingdom's net contribution

**1.13 Figure 6** shows the net Community revenue and expenditure by Member State for 2003. The United Kingdom provided a net contribution of €4.0 billion (£2.8 billion), after a rebate of €5.2 billion (£3.6 billion), the second highest net contribution after Germany. **Figure 7 on page 12** analyses the United Kingdom's payments to and receipts from the Community.

# The Court's findings

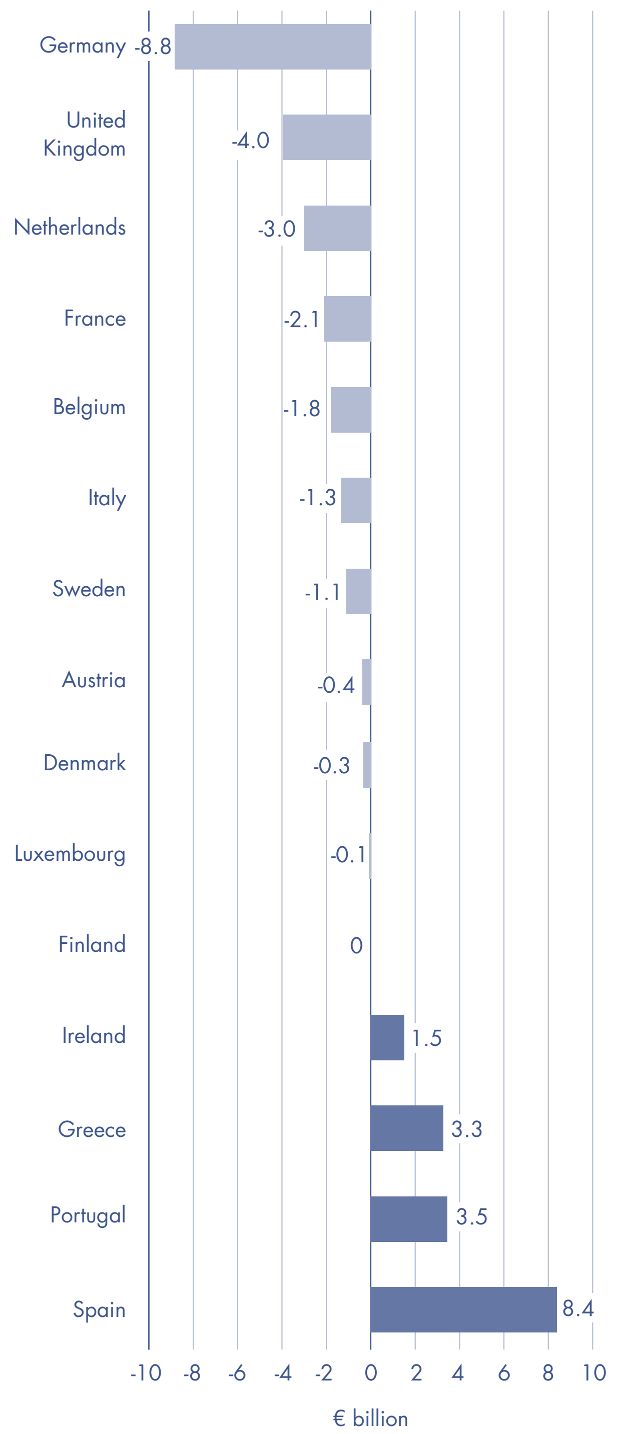
**1.14** The Court is the European Union's external auditor. The Treaty establishing the Community requires the Court to examine all revenue and expenditure of the Community and of bodies established by the Community, and whether financial management has been sound. It also requires the Court to provide the Parliament and the Council with a Statement of Assurance[3]. The Court can carry out investigations into specific topics, and publishes its findings in Special Reports. For 2003, it published eight such reports which are listed in Appendix 1.

**5** Annual surpluses, 1998 to 2003




*Source: Data from the European Court of Auditors' reports for the 2000 to 2003 financial year*

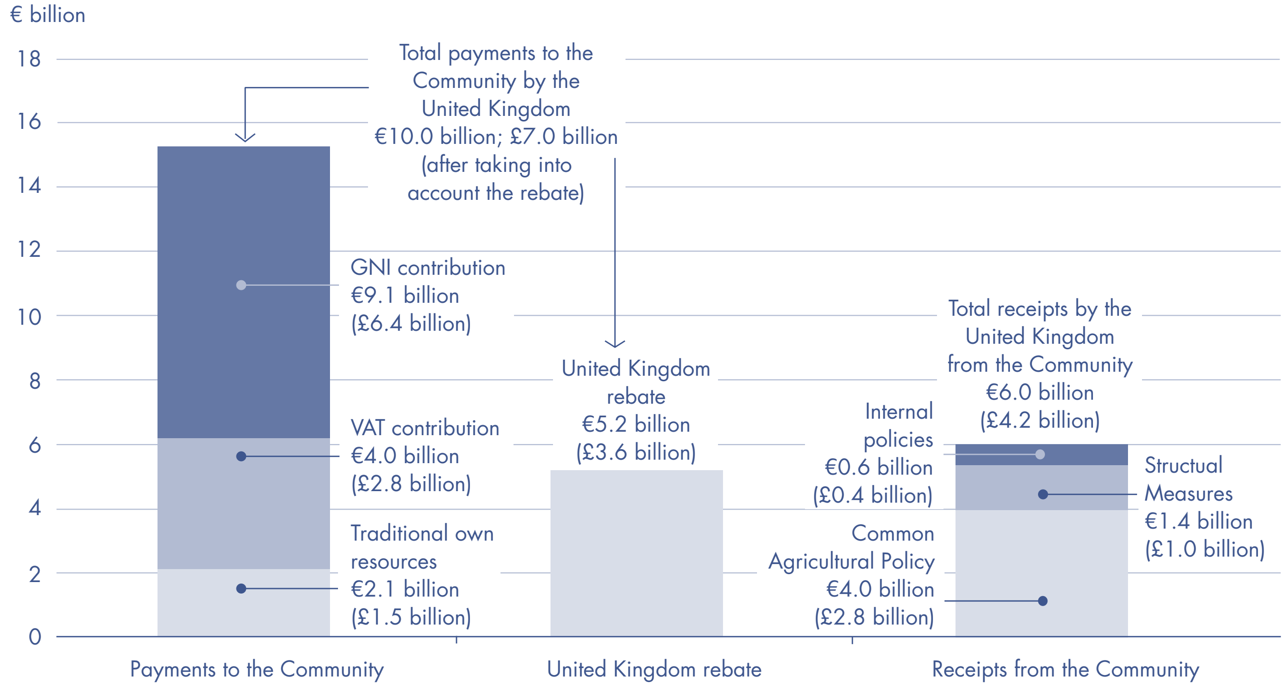
**6** Member States' net receipts and payments for 2003




*Source: Data from the European Court of Auditors' report for the 2003 financial year*

3 In French, Déclaration d'assurance (DAS).

**7** The United Kingdom's payments to and receipts from the Community for 2003




*Source: Data from the European Court of Auditors' report for the 2003 financial year*

NOTE
Not all figures cast due to rounding

## The Court's methodology and Statement of Assurance

**1.15** The Court's examination of the Community's annual accounts is based on international audit and accounting standards, adapted to reflect the Court's duties and responsibilities and to take account of the Community context. The Statement of Assurance covers the **reliability of the accounts** and the **legality and regularity of the underlying transactions** (explained in **Figure 8**). The Court's methodology for its audit of the 2003 financial year was based, as it had been for the previous two years, on four main sources.

- An examination of the operation of the supervisory systems and controls of Community Institutions, Member States and other countries; these systems are designed to confirm the legality and regularity of revenue and expenditure.
- Sample checks of transactions for each major area by carrying out checks down to the level of the beneficiary.
- An analysis of the Annual Activity Reports[4] and the declarations of the Directors-General and the procedures applied in drawing them up.
- An examination of the work of other auditors, who are independent of the Community's management procedures.

**1.16** The Court has supplemented its Statement of Assurance with specific assessments of the Community's major areas of activity[5] (Appendix 2). It also has sought to rely increasingly on the Commission's controls in these areas[6]. The Court also examined the Commission's efforts to re-organise its internal control system and to follow up on the action plans that formed part of the Commission's Synthesis Report[7] and declarations of the Directors-General.

4 An annual report, from each Director-General to the Commission, on the Directorate-General's performance in relation to its management of the budget.
5 Own resources, Common Agriculture Policy, Structural Measures, internal policies, external actions, administrative expenditure, and pre-accession aid.
6 Following the Treaty of Nice.
7 A summary of the Directors-Generals' Annual Activity Reports.

**8** The Statement of Assurance explained

The Court's Statement of Assurance concerns the **reliability** of the accounts and the **legality** and **regularity** of the underlying transactions.

- **Reliability of the accounts** – the Court's aim is to obtain reasonable assurance that all revenue, expenditure, assets and liabilities have been properly recorded and that the annual accounts faithfully reflect the Community's financial position at the end of the year. The Court uses the following criteria in this context.
  - For revenue and expenditure items: completeness, existence, measurement, and presentation and disclosure.
  - For balance sheet items: completeness, existence, ownership, valuation, and presentation and disclosure.
- **Legality and regularity of the underlying transactions** – the Court seeks to ensure that transactions conform to applicable laws and regulations, and that they are covered by sufficient budgetary appropriations.

*Source: National Audit Office summary of the European Court of Auditors' Glossary of Terms*

## The reliability of accounts

**1.17** The Court concluded that, in general, the Community's consolidated accounts faithfully reflected revenue and expenditure for the year and the financial position as at 31 December 2003 . However, because of the absence of effective control procedures for miscellaneous revenues and advances, the Court qualified its opinion on the value of sundry debtors (amounts due to the Community from Member States, such as unpaid fines relating to the infringement of competition rules). The Court could not be certain that all transactions had been recorded in the accounts, or that those that had been recorded were accurate. Last year, the Court qualified its opinion with respect to four items. The improvement this year was partly due to the Commission sending its draft accounts to the Court for comment before formally being required to do so.

**1.18** The Court commented, as in previous years, that the Commission's accounting system, which is largely cash-based, does not identify all assets. It noted that the annual financial statements are largely based on records outside the accounts and that central accounting departments could not always guarantee that transactions were accurate and had been taken into account. The accounting system was also unable to distinguish between current and capital expenditure.

## The legality and regularity of underlying transactions

**1.19** The Court's opinion was that the transactions underlying the Community's consolidated annual account, when taken as whole, were legal and regular in respect of revenue, commitments, and administrative expenditure. However, the Court qualified its opinion in five areas of expenditure. **Figure 9 overleaf** provides further details; and Appendix 2 summarises the Court's findings on underlying transactions by sectoral area.

**1.20** In March 2002, the Parliament asked, separately, the Commission and the Court to provide advice on the feasibility of introducing a 'single audit' approach. In April 2004, the Court published a paper[8] on the 'single audit model', proposing the introduction of a Community internal control framework. Under this model, the Commission would remain responsible for promoting improvements in internal control systems and for providing assurance that they are working effectively. The internal control systems would follow common principles and standards (the Court emphasised that the cost of the controls should be in proportion to their benefit). The Court's model implied that it could place increased reliance on the work of other auditors.

**1.21** In response to the paper, the Commission has proposed that a key feature of the single audit model would be the introduction of voluntary 'contracts of confidence', for structural funds. This would enable the Commission to obtain reasonable assurance that Member States' management and control systems complied with the regulatory requirements and that the relevant authorities had established a sound audit strategy. Once a contract of confidence was agreed, the Commission would undertake to reduce the number of its own audits carried out on programmes to which the contract applied. Contracts of confidence are currently under negotiation and have yet to be signed.

8 Published in the Official Journal of the European Union C107/1, 30 April 2004.

**9** A summary of the Court's findings for the five expenditure areas for which it qualified its opinion

- Payments under the **Common Agricultural Policy** were materially affected by errors (as they had been in previous years).
- Due to persistent weaknesses at Member State level for monitoring and checking expenditure, **Structural Measures** were subject to the same type and frequency of errors noted in previous years.
- Payments related to **internal policies** were subject to significant errors of legality and regularity despite improvements in supervisory systems and controls.
- For **external actions**, legality and regularity errors affected the bodies responsible for implementing the projects and the projects themselves.
- For **pre-accession aid**, shortcomings in supervisory systems and controls, already noted in the Court's report on the 2002 financial year, resulted in errors and greater risk affecting the regularity and legality of transactions.[1]

*Source: National Audit Office summary of the European Court of Auditors' report for the 2003 financial year*

NOTE

1 For 2002, the Court did not qualify its opinion on pre-accession aid.

## The United Kingdom Parliament's interest in European matters

**1.22** 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 (see Appendix 3). 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.

**1.23** Each year the House of Commons European Standing Committee B considers the Court's Annual Report. The Committee will consider the Court's report on the 2003 financial year on 2 March 2005.

# PART TWO

## The Court's findings on main items of expenditure

**2.1** This part of the report reviews the Court's findings for two main expenditure areas – the Common Agricultural Policy and Structural Measures – including issues of relevance to the United Kingdom. Responsibility for this expenditure is shared with management and control of expenditure delegated by the Commission to the Member States. They are also required to co-operate with the Commission to ensure that expenditure is made in accordance with the principles of sound financial management.

## The Common Agricultural Policy

**2.2** The Common Agricultural Policy (CAP) supports farmers and agricultural markets. Although there has been a slight but constant decrease in the share of the budget devoted to CAP expenditure over the years, it is still the biggest item in the European Union budget, totalling €44.4 billion (£31.0 billion) in 2003. The two main actions financed by the CAP are:

- Support to agricultural markets through guaranteed prices, export subsidies or contribution to storage costs.
- Development of rural areas.

**2.3** Agricultural spending in the United Kingdom is administered by six paying agencies[9]. Each paying agency is required to prepare annual accounts for the CAP financial year. These accounts must be audited by a certifying body (in the United Kingdom, the Comptroller and Auditor General) and submitted to the Commission. The Commission may then examine the payments made and can 'disallow' expenditure which it finds irregular or where the paying agency's financial control systems pose a risk to Community funds. Disallowed expenditure is borne by the Member State.

### The European Court of Auditors' findings

**2.4** The Court:

- reviewed the work of the certifying bodies;
- evaluated supervisory systems, notably Integrated Administration and Control Systems **(Figure 10)**;
- tested transactions directly; and
- examined the report and declaration by the Director-General for Agriculture.

**2.5** The IACS principally cover the two largest areas of CAP expenditure: area aid schemes (payments to growers of specific crops on eligible land) and animal premium schemes (direct support to producers of certain livestock, particularly cattle). The primary function of this system is to detect, correct and then sanction incorrect claims from farmers. For those Member States which had satisfactorily implemented the IACS[10], their inspection results represent an important source of evidence of the legality and regularity of CAP transactions. However, errors by the Member States in reporting the results to the Commission reduced the reliability of the figures produced.

9 Rural Payments Agency for England (RPA); Scottish 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).

10 Fourteen of the 15 Member States.

**10** Integrated Administration and Control Systems (IACS)

**The IACS comprise a:**

- computerised database of holdings and aid applications for identifying and registering parcels of agricultural land and animals; and
- set of administrative checks and on-farm inspections.

*Source: National Audit Office*

## Area aid schemes

**2.6** While the Court reported that the majority of payments under area aid schemes (arable crop subsidies) were free from error, its own testing corroborated the error rate found by inspections in the Member States. The Court therefore concluded that area aid payments were likely to be materially affected by error. Inspectors in the United Kingdom reported that more than one in three applications for payment contained error (comparable with the figure for the Union as a whole) but the impact of these errors was significantly lower (0.4 per cent of the area claimed, compared to 1.7 per cent for the European Union as a whole).

## Annual premium schemes

**2.7** The Court found that error rates reported by Member States to the Commission for animal premium schemes were higher than those for area aid schemes and showed considerable variation from year to year and Member State to Member State. Reasons for this include the complex requirements for the animal premium schemes and the frequent movement of animals. However, the Court considered that animal premiums had been subject to a generally satisfactory system of checks, which resulted in the rejection or correction of many claims made by farmers.

**2.8** IACS inspection statistics for animal premiums show the number of animals claimed by farmers which inspectors found did not exist or were not eligible. Checks for payments in 2003 for the largest scheme – the suckler cow premium – revealed 2.0 per cent of animals were ineligible or missing. The figure for the United Kingdom was 0.8 per cent. The Court considered inspection statistics for animal premiums to be less reliable than those for area aid schemes.

**2.9** Categories of expenditure not covered by IACS (such as export refunds and veterinary expenses) pose greater risks and the underlying transactions were found by the Court to have more serious errors.

## Clearance of accounts

**2.10** The clearance of accounts is a procedure designed to provide the Commission with assurance that CAP payments have been legal and regular and appropriate amounts have been charged to the Community budget. It involves:

- an annual financial clearance decision on whether to accept CAP paying agencies' accounts in light of the audit reports by the certifying bodies; and
- a conformity decision on whether to accept expenditure by the paying agencies or make 'corrections'.

**2.11** The Court found that overall the certification of paying agencies' accounts by the Commission worked satisfactorily. But the Court also noted that the financial clearance decision had not yet been taken for 43 per cent of expenditure declared for 2003, or for 21 paying agency accounts for 2001 or 2002. The Commission initially did not include the accounts of the United Kingdom paying agencies in its annual financial decision because it was concerned about the United Kingdom's audit strategy. The United Kingdom authorities maintained that the audit strategy complied fully with the Commission's regulations. The Commission and the United Kingdom authorities have since resolved these issues. The Commission responded to the Court's observations on financial clearance of cases that it continued to make efforts to clear the backlog of cases. For most of the corrections to expenditure in 2003 the Court concluded the Commission's procedures were well founded and the amounts disallowed were consistent.

## The Courts' Special Reports on agricultural issues

**2.12** Each year, the Court selects a number of budgetary areas or management topics of specific interest for a more detailed audit which results in a Special Report. Appendix 3 lists the Special Reports published by the Court during 2004, four of which concerned agriculture.

- Recovery of irregular payments under the Common Agricultural Policy.
- The organisation of the system for the identification and registration of bovine animals.
- The Commission's management and supervision of the measures to control Foot and Mouth Disease and of the related expenditure.
- The audit of the common organisation of the market of raw tobacco.

We reviewed the first three in detail because they referred, inter alia, to the United Kingdom.

### Recovery of irregular payments under the Common Agricultural Policy

**2.13** The Court assessed the role of the Commission and the Member States in recovering irregular payments under the CAP since 1971. Member States are obliged to inform the Commission when they detect irregular payments over €4,000 (£2,793) and to attempt to recover such payments. Where recovery is not possible the sums are written off and the losses borne by the Community, unless non-recovery is due to the negligence of Member States.

**2.14** The Court's audit revealed a number of weaknesses in the arrangements for recording, recovering and writing off irregular CAP payments including:

- differing interpretations from Member States of fraud and irregularity;
- slow reporting from Member States; and
- the Commission's lack of adequate criteria for recommending write off.

**2.15** For 2003, the United Kingdom's cumulative recovery rate was 40 per cent compared to a European Union average of 17 per cent. The United Kingdom certifying body reported to the Commission that there were long delays in the recording and recovery of debts and no reconciliation between the accounting records and debtors ledgers. The Court also found that the average delay from discovery to reporting of irregularities in the United Kingdom was below the average for the European Union.

### The organisation of the system for identification and registration of bovine animals

**2.16** The Court evaluated systems for identifying and registering cattle in the European Union, at the Commission and in the four Member States with the largest bovine herds (France, Germany, Italy and the United Kingdom). The systems consist of ear tags, cattle passports, herd registers and a computerised database. In the Member States visited, the systems showed significant weaknesses. For example, the Court found the identification and registration systems did not guarantee the traceability of cattle movements between Community countries and between Community and non-Community countries. The Court's recommendations, which were agreed by the Commission, included improvements to the legislative framework to give the Commission adequate means to take on a guiding role and for drawing up precise criteria for the operation of national databases.

**2.17** The Court reported that Community legislation required the operation of a single system as it noted that the United Kingdom had two computerised databases, one covering Northern Ireland and the other the rest of the United Kingdom, only the former of which has been approved as fully operational. The Court also noted that the legislative arrangements in the United Kingdom did not require animals to be identified and registered in accordance with the regulation in order to be eligible for payments under the scheme for slaughter and destruction of cattle over 30 months old. The Court recommended that the legislation should be amended accordingly.

**2.18** In May 2004, the Committee of Public Accounts produced a report, *Identifying and Tracking Livestock in England*[11]. The Committee examined progress made in implementing livestock identification and tracking in England to meet domestic and European Union requirements to safeguard human and animal health, assist in control of farming subsidies and improve the industry's commercial performance. The Committee concluded that the Cattle Tracing System used in England was more expensive and less efficient than systems used by other Member States. The Committee made a number of recommendations to produce savings and improve performance, which the Government accepted.

### The Commission's management and supervision of the measures to control Foot and Mouth Disease and of the related expenditure

**2.19** The Court's report examined the Commission's response to the 2001 outbreak of Foot and Mouth Disease in Europe. Whilst it found a number of shortcomings in the Commission's strategy and in the prevention and control arrangements, the Court stated these were mostly remedied after the crisis. The Court noted, however, that the financial framework had still not been revised. The Commission replied that since 2002, it had been reviewing the arrangements for joint Community and Member State funding so that overstatement of the value of animals, which particularly affected claims by farmers for payments in the United Kingdom, could be curbed and the high costs of eradicating diseases reined in. A proposal to this effect would be made soon. The Court made three main recommendations for the Commission, to:

- carry out regular evaluation of the prevention and control arrangements of Member States outside crisis periods and increase its supervision of their implementation;
- study ways of including farmers in the disease control system with a view to involving them more closely in rapid notification of disease and compliance with movement restrictions; and
- clarify the financial framework applicable to epidemics of animal disease, while reducing as far as possible the financial risk to the Community budget.

**2.20** In March 2003 the Committee of Public Accounts reported on the 2001 outbreak of Foot and Mouth Disease[12]. It made a number of recommendations to improve the management of future livestock epidemics by the Department for Environment, Food and Rural Affairs (DEFRA). On 2 February 2005, the Comptroller and Auditor General published his report *Foot and Mouth: Applying the Lessons*[13], which examined DEFRA's progress in implementing the Committee's recommendations. Our key findings were:

- DEFRA had taken action, through improved animal health policies, to reduce the risk of an outbreak on the scale of 2001 - although further outbreaks could never be ruled out.
- Preparedness for another outbreak was much improved – in terms of contingency planning, staff training, the availability of vaccination as an adjunct to culling, improved dialogue with stakeholders and standing arrangements with contractors to make resources available to fight any future outbreak. In addition, DEFRA's disease control strategy was better documented, and further research into disease control strategies was underway.
- Some arrangements to control the cost of a future outbreak had been improved but new compensation arrangements awaited legislation, and discussions continued on establishing a levy scheme to share the cost of future outbreaks with the farming industry.

## Reform of the Common Agricultural Policy

**2.21** From 2005 most existing subsidy schemes are being rolled into a single payment to each farm, and will no longer be linked to either types or levels of production. At the heart of the reforms is the concept of 'decoupling' – breaking the link between subsidy and production. This will give farmers the opportunity to re-establish links with their markets, freeing them to produce what consumers want rather than what the subsidy regimes dictate and enabling them to reduce costs by maximising profit rather than production.

**2.22** The Comptroller and Auditor General's report *Helping Farm Businesses in England*[14] examined DEFRA's programmes to help English farm businesses adapt to changing markets and reforms to the Common Agricultural Policy. We found the transition to a more open and competitive market would be difficult for some farmers and that DEFRA had a range of measures including the provision of advice, capital grants and, where appropriate, regulation. DEFRA was also operating four specific schemes to help farmers become more business-like, three of which were co-funded by the European Union.

11 Twenty-seventh Report, Session 2003-04.
12 Fifth Report, Session 2002-03.
13 HC 184, Session 2004-05.
14 HC 1028, Session 2003-04.

**2.23** We examined farm business development schemes in Ireland, France, Germany, Denmark, Sweden, New Zealand and Wales. We found there was much greater emphasis on providing training and advice to farmers as opposed to the emphasis in England on capital grant schemes. Based on the good practices found in other countries we made a number of recommendations on how DEFRA should adapt its programmes. These included increasing the proportion of funds spent on advice to farmers; making it easier for farmers to apply for support; widening the support available to farm businesses; encouraging the use of local partnerships; giving farmers and local communities a greater say in how support was delivered; and shifting some support from individual farms to wider local initiatives to promote demand.

**2.24** The Committee of Public Accounts intends to publish its report on the subject during 2005.

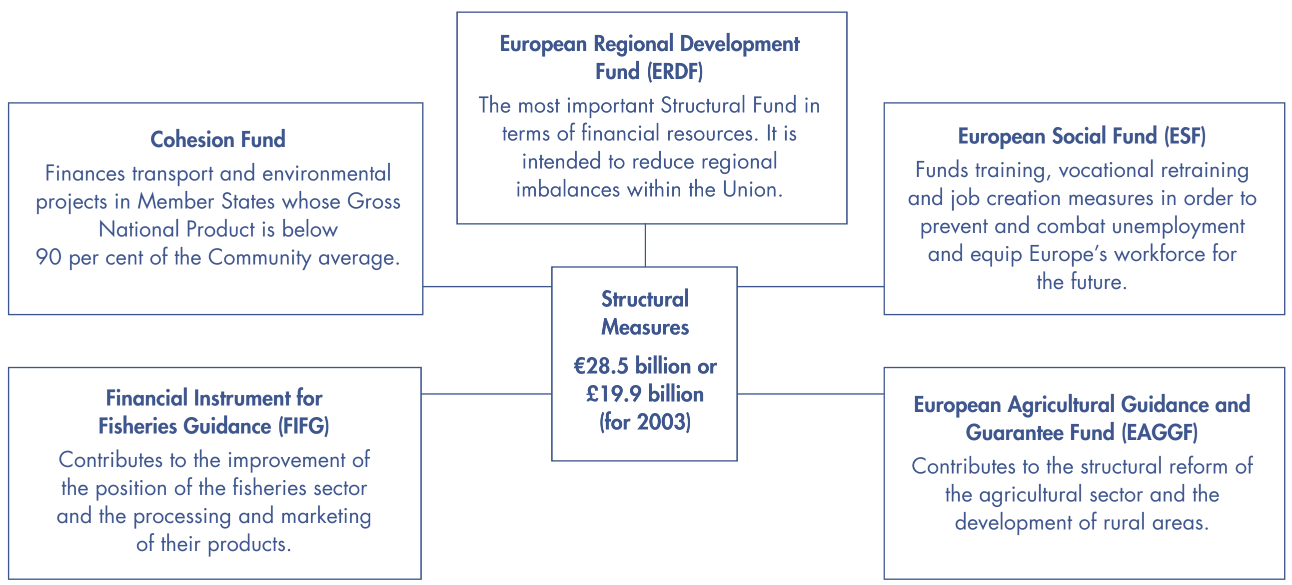
## Structural Measures

**2.25** Structural Measures expenditure is targeted at three main policy objectives:

- Objective 1: promoting the development and structural adjustment of regions whose development is lagging behind;
- Objective 2: supporting the economic and social conversion of areas facing structural difficulties; and
- Objective 3: supporting the adaptation and modernisation of policies and systems of education, training and employment.

**2.26** Structural Measures mainly comprise payments from the four Structural Funds and from the Cohesion Fund **(Figure 11)**. Expenditure is allocated on a multi-annual basis with each period lasting for the duration of the Financial Perspective (see paragraph 1.2 and Figure 2). Structural Funds assistance takes the form of 'operational programmes' which are made up of large numbers of operations or projects; and Cohesion Fund assistance which is based on contributions to individual projects. In the current period, 2000-06, the total budgeted expenditure is approximately €230 million to support 470 operational programmes under the four Structural Funds and a further 450 Cohesion Fund projects.

**11** The five components of Structural Measures




*Source: National Audit Office*

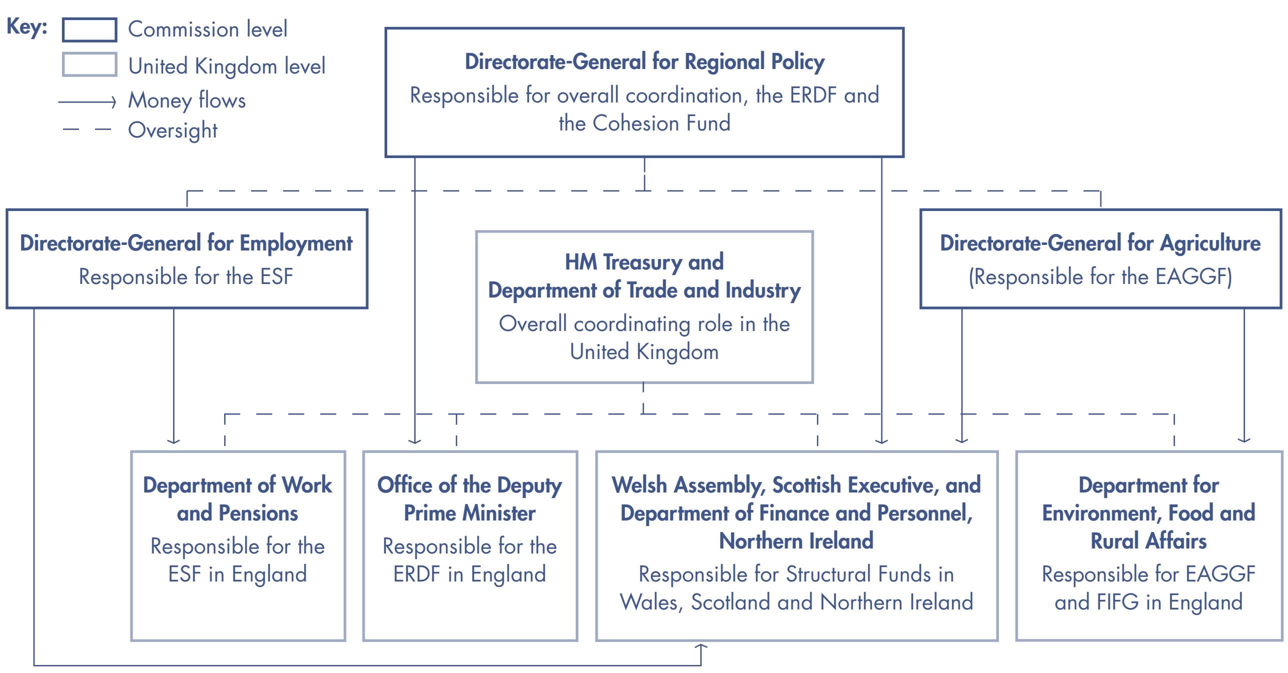
**2.27** Structural Measures are subject to shared management. At Commission level the Directorate General for Regional Policy has the coordinating role for matters concerning all the Funds with the appropriate Directorates-General taking the lead for their area. In the United Kingdom, the Department of Trade and Industry has overall responsibility for the Funds with the appropriate national department or devolved body leading the Programmes in their area. **Figure 12** explains the structure in more detail.

**2.28** The Court found that reforms begun in 2001 had reinforced the internal control environment of the Commission. The audit also revealed that the Directorates-General involved had made generally satisfactory progress in implementing internal control standards. But the Court was unable to take assurance from the declarations of the Directors-General due to the serious and justified reservations expressed on the management and control systems of the Member States. Future Annual Activity Reports will include details of the Commission's ability to detect weaknesses in the Member States and the actions taken to remedy the problems. The Commission hoped this would enable the Court to take assurance from the declarations. The Court told us that the reservations would have to be quantified and the explanations improved for it to take assurance from the Annual Activity Reports.

## Structural Measures in the Member States

**2.29** The Court examined the management and control systems in selected Member States, including the United Kingdom, and carried out substantive testing of transactions for both the 1994-99 and the 2000-06 programme periods. In 2003, the Court's criticisms mainly related to the Member States' implementation of the financial control arrangements; in previous years the Court had also been concerned with the design of these systems.

**12** The division of responsibilities between the Commission and the United Kingdom for Structural Funds




Source: National Audit Office

**13** Commission Regulation (EC) No 2064/97

**Commission Regulation (EC) No 2064/97** introduced a set of common minimum requirements for the Member States' management and control systems including:

- A sufficient audit trail
- A minimum level of independent checks (at least five per cent sample) to verify effectiveness of systems
- An annual statement providing an overall conclusion on the legality and regularity of underlying operations

*Source: National Audit Office summary*

## Audit of the 1994-99 Programme Period

**2.30** As there have been delays in closing the 1994-99 period the Court has had to continue to audit the programmes and projects concerned. The Court found that, despite the requirements of Commission Regulation (EC) No 2064/97 **(Figure 13)**, there were a number of weaknesses in Member States' management and control systems. The testing of transactions for the 1994-99 period also revealed a number of problems which affected most Member States' systems including weaknesses in carrying out the independent five per cent checks and failure to assess properly the financial impact of control weaknesses. Such errors and weaknesses occurred in the United Kingdom.

**2.31** The Court found that delays in the Member States and problems with the files submitted to the Commission had slowed the closure of the 1994-99 period; 759 out of 1,090 (70 per cent) of the main programmes and 829 out of 1,080 (77 per cent) of Community Initiative programmes had not been closed by the end of 2003.

**2.32** The Commission recognised the problems encountered in closing the 1994-99 programmes. It considered these were primarily caused by the lack of effective controls at the beginning of the period and delays in Member States carrying out audits. But the Commission considered that Member States had generally made serious efforts to comply with Regulation 2064/97. The Commission was aware that the delays in closure had affected the Member States' ability to perform the necessary checks for programmes and projects in the current period. United Kingdom Government departments with responsibility for Structural Measures told us that attempting new checks while continuing to carry out the closure audit had the potential to overburden resources.

**2.33** Both the Court and Member States cited late provision of guidance by the Commission as a problem for the closure of the 1994-99 programmes. The United Kingdom Government told us that the guidance was not consistent with the 1994-99 regulations, and that regulations designed for the 2000-06 programme period were also applied by the Commission to the 1994-99 period. There were also problems regarding unclear or inconsistent interpretation of the guidance from various offices within the Commission. The Commission acknowledged that there had been some initial problems with the methodology but considered it had made every effort to provide guidance to Member States and had clarified the methodology. For the 2000-06 period the Commission would continue to liaise with Member States on improvements to the process and Directorates-General meet frequently to try and ensure consistency in the advice and guidance they provide.

## The 2000-06 Programme Period

**2.34** The Court found that, although the financial control framework had been reinforced in the 2000-06 period through new Commission Regulations introduced in 2001[15], there remained weaknesses in the Commission's ability to provide assurance on the management and control systems in the Member States. In response the Commission committed itself to continuing its efforts to increase assurance through provision of guidance; dissemination of good practices; audit work; and financial corrections where appropriate.

**2.35** The Court also found there had been failure by the Member States to respect regulatory requirements. Problems found in Member States, including the United Kingdom, were:

- serious weaknesses in the day-to-day management checks such as failure to check compliance with the rules on eligibility of expenditure; and
- weaknesses in the quality of audits and reports in the independent checks including failure to apply an appropriate sampling basis.

15 Commission Regulations 438/2001 and 448/2001.

**2.36** The Court's testing of transactions revealed errors in the current period, corroborating systems weaknesses. Failures found in the United Kingdom included:

- ineligible expenditure and projects;
- expenditure without proper supporting documents;
- incorrect calculation of the Community contribution; and
- failure to follow Community rules for the award of public contracts.

**2.37** The Court noted that, without significant improvements, the same type of errors as found for the 1994-99 period would lead to a repetition of the problems encountered in closure. The Court recommended that the Commission should require improvements to the systems in the Member States and should use the possibility to suspend payments in cases of serious systems weaknesses. In responding, the Commission stated that it had already used powers to interrupt payments in problematic cases and intended to continue with this practice.

**2.38** In December 2004, an audit in the United Kingdom by the National Audit Office of specific aspects of the management and control systems for the European Structural Funds[16] found that improvements had been made for the 2000-06 programme period. Lessons learned from the 1994-99 programme closure exercise contributed to the establishment at each of the Government Offices of independent inspection teams staffed with experienced auditors/inspectors to carry out work for both the European Regional Development Fund and the European Social Fund. At all the Government Offices visited, the audit trails were clear and the five per cent inspection approach was well advanced. Moreover, the policies in place for both activities were being consistently applied at each Office. Although there were clearly errors and omissions relating to supporting evidence for final claims in 1994-99 programmes, we found that improved procedures meant that similar problems were not foreseen for 2000-06 programmes. The Commission had also taken action on the lessons learned from the closure of the 1994-99 programmes and had produced a draft guidance paper on the closure of the 2000-06 programmes (which it discussed with Member States on 15 February 2005).

## Developments in the Structural Operations

**2.39** In order to ensure effective checks for the 2000-06 period the Commission considered that Member States should have started audits in 2003 and have an effective audit strategy covering the entire period until final closure in 2009. The Commission and Member States are currently negotiating the possible implementation of a 'Contract of Confidence' (see paragraph 1.21). The Commission told us that such a contract would help to ensure programmes were being managed properly and that it would allow the Commission to implement a risk-based audit strategy.

**2.40** HM Treasury believes that the 'Contract of Confidence' is a desirable initiative which should improve planning and provide a better assurance of the legality and regularity of Structural Measures expenditure, provided that it can be operated without creating unnecessary bureaucracy.

**2.41** In 2003, the net underspend on Structural Measures was €3.3 billion. However, the Court found that there had been a large increase in spending in support of the economic and social development of areas facing structural difficulties, where the rate of implementation increased from 48 per cent in 2002 to 91 per cent in 2003. The Commission told us that its multi-annual strategy for Structural Measures made it difficult to assess spending levels on an annual basis. Spending levels will differ over the years, and the total spending level for Structural Measures would only accurately be assessed at the end of the period. The Court told us that the budget should be profiled to reflect planned patterns of expenditure.

**2.42** One of the problems encountered by the Commission when trying to predict spending levels was the reliance on the forecasts of Member States. These forecasts were usually over-optimistic. The Commission recommends that forecasts should be based on information from the managers of the projects in each Member State. But it feels that some national governments use forecasts more as political statements of intent. Government departments told us that different financial year ends to the Commission, exchange rate problems and changes to expenditure profiles against commitments make accurate forecasting in the United Kingdom problematic. The Commission is trying to improve forecasting in future by predicting spending levels based on a combination of Member State forecasts and information gained from previous experience.

16 The requirements to provide a sufficient audit trail and to organise a sample (of at least five per cent) of independent checks to verify the systems and expenditure declarations.

**2.43** The Contact Committee is a group comprising the heads of the National Audit Institutions of the 25 Member States and the President of the Court. As outlined in our report in 2003, as a member of the Contact Committee's Working Group on Structural Funds, we participated with several other state audit institutions in the Parallel Audit of the Management and Control Systems for Assistance Granted under the Structural Funds. The aim was to identify controls within regulatory structures which needed to be improved and to highlight best practice in complying with European regulations. The audit focused on the conduct of checks and the maintenance of an audit trail. Its main findings are shown in **Figure 14**.

**2.44** The Contact Committee adopted a resolution, in December 2004, which urged all members to publicise the report to wider audiences and adopt any appropriate actions within the scope of their own reporting mandates. It also mandated the Working Group to develop its ideas further and take forward work on the processes for identifying, reporting and following up irregularities, in compliance with Commission guidelines. The Working Group will present a further report to the Contact Committee in 2005.

**2.45** In October 2004, another Working Group of the Contact Committee produced a paper encouraging Member States' state audit institutions to produce an annual report on financial management of the European Union.

**14** The findings of a Parallel Audit of the Management and Control Systems for Assistance Granted under the Structural Funds (December 2004)

- In most countries there was a sufficient audit trail as required by Regulation 438/2001. The weaknesses discovered were usually not systemic weaknesses but individual project failings.
- Progress reporting of projects was felt to be relatively weak, focusing largely on financial monitoring without providing any link to the outputs and outcomes of the projects.
- The execution and reporting of the five per cent checks complied with Regulation 438/2001 and where this was not the case the relevant authorities had taken steps in the right direction to ensure that the required checks would be carried out by the end of the programme period. However, the Working Group felt that the way the Structural Fund rules were formulated by the Commission left room for ambiguous or even contradictory interpretations.
- The implementation of the five per cent checks across all countries was relatively slow and often not very evenly spread over the period to date. The Working Group recommended that the new Structural Fund regulations (post 2006) should contain a legal obligation to spread the execution of the five per cent checks more evenly over the programme period. In addition, the audit of management and control systems should be given higher priority to detect weaknesses in the systems at an early stage of the programme period.
- Some Member States expressed concern about an increasing burden to implement the new provisions for the 2000-06 programme period with associated resource costs out of proportion to the funding provided by the European Union. The Working Group recommended that risk assessments should be routinely used when selecting projects for the five per cent checks.

*Source: National Audit Office summary of Parallel Audit of the Management and Control Systems for Assistance Granted under the Structural Funds*

# PART THREE
## Progress in financial management




**3.1** This part of the report examines developments in financial management and control; progress in implementing a new accounting system; the work of the Commission's anti-fraud office; and the readiness for accession of candidate countries.

## Developing financial management and control arrangements

**3.2** Following the resignation of all 20 European Commissioners in March 1999, the new Commission issued a White Paper on Reform in March 2000[17]. The White Paper addressed, amongst other things, improvements to financial management and accountability. Specifically, it looked to apply internal control standards and to introduce activity based management. A new Financial Regulation to implement the improvements came into effect on 1 January 2003. In December 2002, the Commission, building on these reforms, approved the development of an accruals based accounting system.

**3.3** For 2003, the Court continued to evaluate the Commission's internal control systems, started in 2002, by examining statements from the Director-Generals (Annual Activity Reports and Declarations) and from the Commission (its annual Synthesis Report). It also looked at progress in implementing internal control standards.

### Annual Activity Reports and the 2003 Synthesis Report

**3.4** Since 2001, each Director-General is required to prepare an Annual Activity Report – a management report to the Commission on the performance of the Directorate-General in relation to its management of the budget. These reports outlined the achievements for the year and the resources used, with the primary aim of increasing the accountability of the Directors-General for expenditure in their areas. The reports also incorporate a statement of assurance that the resources had been used for the purpose for which they were intended and that the control processes guaranteed that underlying transactions were legal and regular. Following a request from the Parliament, the Annual Activity Reports for 2003 were published on the Commission's website.

17 White Paper on Reforming the Commission - COM (2000) 200, 1 March 2000.

**3.5** All 39 Directors-General stated that they had received reasonable assurance as to the legality and regularity of the underlying transactions. Where internal control weaknesses are identified, the Director-General is required to include a reservation in the Annual Activity Report and produce action points to address the issue. In 2003, 21 of the 39 of the Directors-Generals' Annual Activity Reports included reservations (22 of 36 in 2002). The Budget Director-General's Annual Activity Report included reservations about the Commission's accounting system. Despite the improvements in Annual Activity Reports and the declarations of the Directors-Generals noted by the Court, it concluded that they did not serve as a useful basis for its audit conclusions. However, the Court told us that they did contain information on the results achieved (in terms of economy, efficiency and effectiveness) by the Directorates-General as regards political activities and the management of the resources allocated.

**3.6** In December 2003, the Commission introduced changes to the Annual Activity Report. The timetable for their production was brought forward; management indicators and a standardised reservation were introduced; and each Director-General had to certify the reliability of specific elements of the Report. Peer review was also introduced - for example, the Directors-General for Structural Funds reviewed each others' Annual Activity Reports. The Court attributed improvements in the quality of the reports to these changes.

**3.7** The Court also found that for the first time, the Commission had, through its 2003 Synthesis Report (a summary of the Directors-Generals' Annual Activity Reports), provided an analysis of the degree of assurance provided by the supervisory systems. The Commission noted that it could not provide an unqualified assurance with respect to the legality and regularity of Structural Funds. It highlighted reservations with grants based on the reimbursement of costs declared by beneficiaries. The Court noted that the Commission did not comment on the Common Agricultural Policy.

### Progress in implementing internal control standards

**3.8** An important part of the Commission White Paper on Reform, issued in March 2000, was the implementation of 24 internal control standards. For 2003, the Court noted that the Commission had made progress on the new internal control framework's design. But it concluded that all controls had not yet been implemented or were not operating effectively. The Court analysed the application of internal control standards in 16 Directorates-General and found that the available evidence related more to the design and existence of the internal controls than to their workings. It was therefore unable to rely on the controls when seeking assurance as to the legality and regularity of underlying transactions.

## Introducing an accruals based accounting system

**3.9** Over a number of years, the Court has commented on weaknesses in the Commission's accounting and the impact that this has had on its opinion (see paragraph 1.18). In December 2002, the Commission adopted an Action Plan to modernise its accounting system so that its accounts could be produced on an accruals, rather than a cash, basis[18]. The Action Plan has two parts – the adoption of a new accounting framework and the development of information systems for its implementation. The modernisation of the accounting system is intended to meet three principles.

- Compliance with internationally accepted accounting principles on accruals accounting.
- Integration of financial and accounting systems.
- Improving security and consistency between data from different sources.

The deadline for implementation of the Action Plan was 1 January 2005.

**3.10** When its report was published, in November 2004, the Court noted that the Commission's progress to date indicated that deadlines relating to the adoption of a new accounting framework were optimistic. It also noted progress in the development of information systems. But the Court re-iterated the view, made in its report for 2002, that the timetable for this aspect of the programme was 'very ambitious' and that there was a risk that the

18 COM (2002) 755, 17 December 2002.

Commission would have to make gradual adjustments to its current system. In response, the Commission commented that this aspect of the project was being implemented largely in accordance with the Action Plan's timetable. It also stated that the modernisation programme had largely met its objectives and that the 'ambitious' deadline was feasible, while still subject to the risks associated with large IT projects.

**3.11** The Court also commented that crucial to the success of the Commission's move from a cash to an accruals based system was the operation to establish the opening balance as at 1 January 2005. The Court concluded that the Commission should provide adequate resources to carry out this task properly. The Commission responded that it had allocated appropriate resources to the exercise. For example, it had provided Directors-General with extra staff; and had arranged meetings to provide information and support.

**3.12** On 28 January 2005, the Commission announced that the transition to the new accounting system had been successful and that it would continue to develop and improve the system during 2005.

## Fraud and irregularity and the work of OLAF

**3.13** Under the Treaty establishing the Community, Member States are required to 'take the same measures to counter fraud affecting the financial interests of the Community as they take to counter fraud affecting their own financial interests'[19]. The European Anti-Fraud Office (known by its French acronym, OLAF, Office Européen de Lutte Anti-Fraude) was established in June 1999. Its mission is to protect the European Union's financial interests, to fight fraud, corruption and any other irregular activity, including misconduct within the European Institutions, in an accountable, transparent and cost-effective manner. It fulfils its mission by conducting *internal* (within the Commission and/or other Union Institutions) and *external* (in Member States) investigations. The vast majority – around 90 per cent - of the cases currently under investigation by OLAF are external, involving irregularities including alleged fraud in Member States. OLAF also collates and analyses information on fraud from Member States, and conducts its own investigations and develops anti-fraud policy.

**3.14** OLAF is formally part of the Commission, under the authority of the Commissioner for the Budget (until November 2004; OLAF is now under the authority of the Vice-President for Administrative Affairs, Audit and Fraud). But OLAF has budgetary and administrative autonomy, making it operationally independent. OLAF's Director-General is in charge of its investigative functions, with independence overseen by a Supervisory Committee. As an investigative body, OLAF produces two major outputs:

- case reports on its investigations for judicial and non-judicial (such as police) authorities which can be used as evidence in legal proceedings in Member States; and
- reports to disciplinary committees as part of Community disciplinary processes.

**3.15** Member States must report to OLAF cases of irregularity or suspected fraud[20] valued at over €10,000 (£6,983) in the revenue sector, and €4,000 (£2,793) in Common Agricultural Policy and Structural Measures expenditure. Each year OLAF publishes information about suspected fraud and irregularities reported by Member States. It defines fraud as a deliberate criminal act with intent to achieve financial advantage. Irregularities are any failures to comply with Commission regulations resulting from an act or an omission. In 2003, Member States notified the Commission of a total of 8,177 cases of irregularity and suspected fraud, with an estimated value of some €0.92 billion (£0.64 billion). **Figure 15 overleaf** gives a breakdown by sector and a comparison with reported rates in 2002. **Figure 16 overleaf** and **Figure 17 on page 31** present the number and value of reported cases in 2003 by Member State.

**3.16** Figure 15 shows a reduction by nearly 50 per cent in the number of cases reported for Structural Funds expenditure in 2003 compared with 2002. This was preceded by a substantial increase in the number of reported cases in Structural Funds expenditure between 2001 and 2002. The Commission indicated that this was due to the detailed audit of closing projects from the 1994-99 period which brought irregularities to light. OLAF told us that the decrease in the number of cases reported in 2003 compared with 2002 for Structural Measures, therefore, reflects the natural decrease in reporting of irregularities, including possible frauds, as the final audit of projects came to a close.

19 Article 280 of the Treaty establishing the European Community.

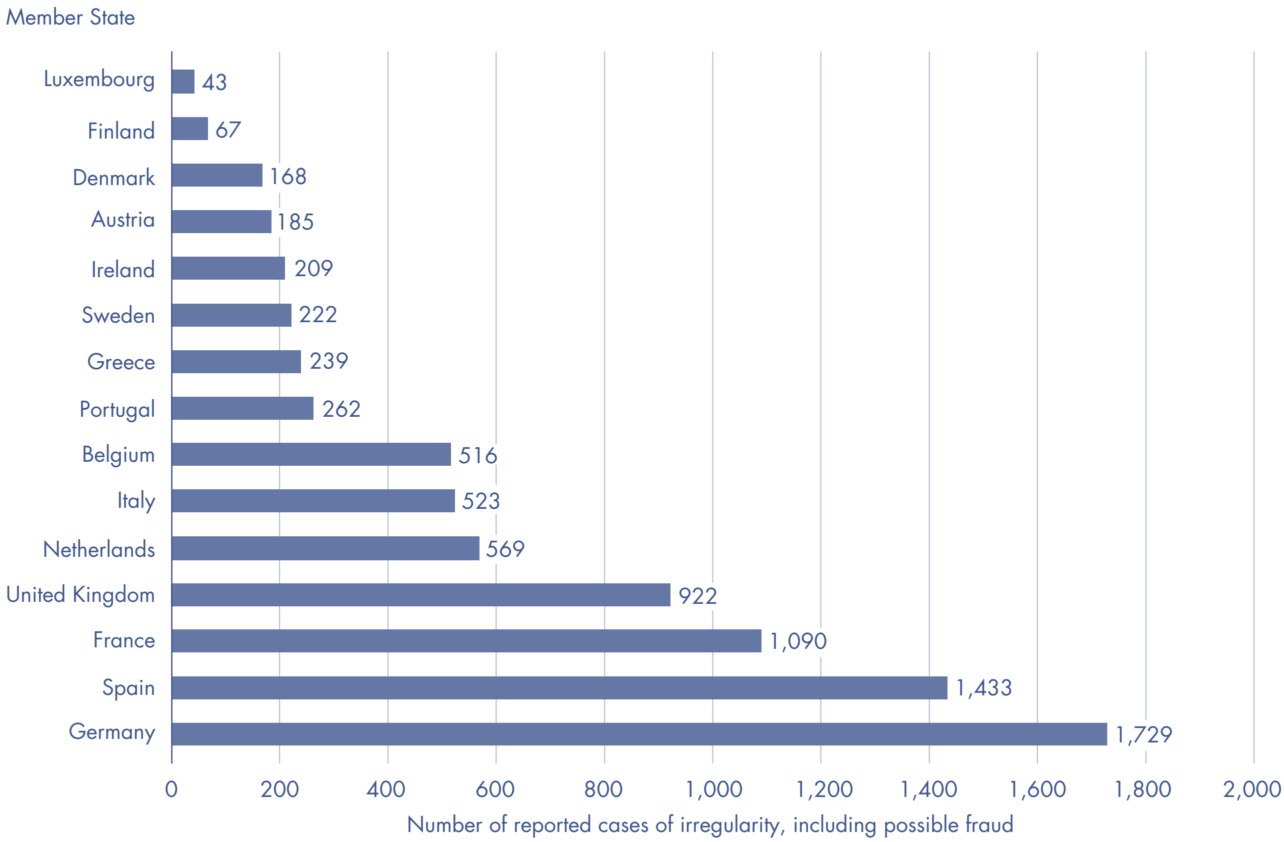
20 Article 1(1) of the Convention on the Protection of the Financial Interests of the European Communities: an intentional act or omission in respect of expenditure or revenue which may involve false or incorrect documents, non-disclosure of information, or the misapplication of funds. Irregularity is defined in Article 12 (2) of Regulation 2988/95 as any infringement of Community law from an act or omission, which has the effect of prejudicing the Community budget.

## 15 Cases of irregularity, including possible fraud, notified to OLAF by Member States in 2002 and 2003

| | 2002 | | 2003 | | Percentage change | |
|---|---|---|---|---|---|---|
| Area of the budget (€ million) | Number of cases | Amounts involved (€ million) | Number of cases | Amounts involved | Number of cases | Amounts involved |
| Traditional own resources | 2,335 | 342 | 2,453 | 270 | +5% | -21% |
| Common Agricultural Policy expenditure | 3,285 | 198 | 3,237 | 170 | -1% | -14% |
| Structural Funds expenditure | 4,656 | 614 | 2,487 | 482 | -47% | -21% |
| **Total** | **10,276** | **1,154** | **8,177** | **922** | **-20%** | **-20%** |

*Source: Data from OLAF's Protection of the European Communities' financial interests and the fight against fraud annual report, 2003*

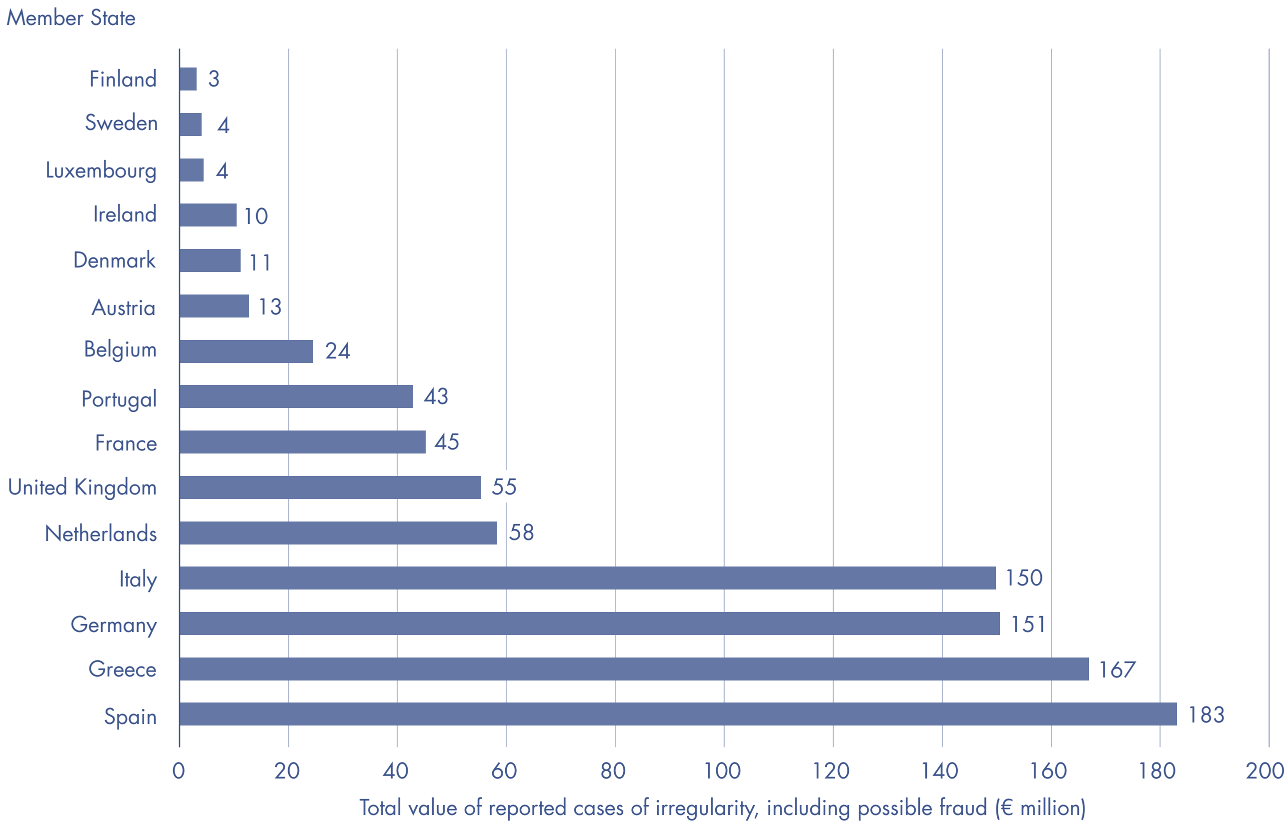
## 16 Number of reported cases of irregularity, including possible fraud, by Member State in 2003




*Source: Data from OLAF's Protection of the European Communities' financial interests and the fight against fraud annual report, 2003*

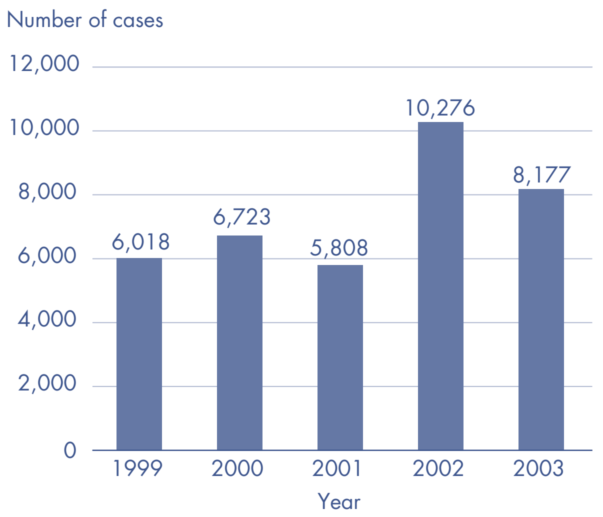
**3.17 Figure 18** and **Figure 19** show the number and total value of reported cases of irregularity, including possible fraud, by year since OLAF was established in 1999. The annual number of reported cases rose by 36 per cent between 1999 and 2003. There was an increase of 51 per cent in the total value of cases in the same period. OLAF attributes this increase to better detecting and reporting by Member States. Year on year variations may also be caused by specific events (such as the audits carried out at the end of the 1994-99 Structural Fund programme) or by the inclusion of figures following the resolution of long-running cases.

**17** Value of reported cases of irregularity, including possible fraud, by Member States in 2003



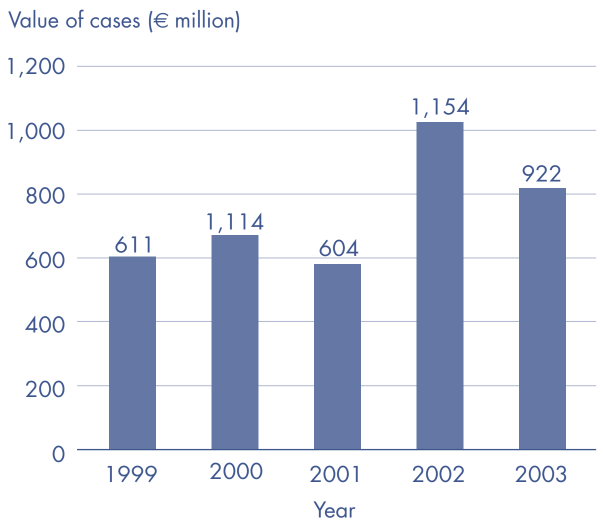

*Source: Data from OLAF's Protection of the European Communities' financial interests and the fight against fraud annual report, 2003*

**18** Total number of cases of irregularity, including possible fraud, reported to OLAF from 1999 to 2003




*Source: Data from OLAF's Protection of the European Communities' financial interests and the fight against fraud annual report, 2003*

**19** Total value of cases of irregularity, including possible fraud, reported to OLAF from 1999 to 2003




*Source: Data from OLAF's Protection of the European Communities' financial interests and the fight against fraud annual report, 2003*

**3.18** On the revenue side, smuggling of cigarettes was the most significant type of fraud and irregularity both in number and value of cases. There was, however, a slight decrease compared with 2002. Although customs duties are a Community resource, and paid over to the Commission (less 25 per cent for collection costs), improvements in collection and customs duties benefit the Member States as extra collection of customs duties reduces the amount the Member States need to pay in GNI contributions. In an attempt to combat cigarette fraud, in 2000 and 2001 the Commission and ten Member States launched a civil action in the courts in New York against three cigarette manufacturers, alleging that they bore responsibility for cigarette smuggling. Following negotiations, in July 2004 the Commission, the ten Member States and Philip Morris International announced a multi-annual Anti-Contraband and Anti-Counterfeit Agreement that includes a system to fight cigarette smuggling. Philip Morris also agreed to make substantial payments, which could total approximately US$1.25 billion over 12 years, and which could be used to improve the fight against cigarette fraud.

**3.19** As in previous years, OLAF highlighted a continued trend of irregularity and suspected fraud in importing aluminium. There were also false declarations regarding the country of origin of imported bananas in order to take advantage of more favourable tariff rates. Suspected fraud cases also often involved the manipulation of quota or set-aside schemes, or false applications for subsidies. For Structural Measures, cases of fraud often involved false invoices and declarations and some cases of organised fraud between multiple recipients of Structural Funds However, overall for Structural Measures the majority of cases involve irregularities of an 'administrative' kind that are mostly detected in the course of the normal documentary checks before any payment of European money is made. For instance, the two most frequent types of irregularity reported by Member States are 'not eligible expenditure' and 'missing or incomplete supporting documents'. Only six per cent of cases of irregularity in Structural Funds involved suspected 'falsifications'.

**3.20** It is very difficult to determine the breakdown of cases between fraud and irregularity. Cases tend to be identified unevenly within programmes and reported levels may fluctuate considerably from one year to another. OLAF is currectly working to estimate probable levels of fraud. By their nature, the reported statistics can only include identified cases. The statistics also depend on the quality of the information supplied by Member States. Some Member States consider that fraud cannot be recognised until a conviction has been obtained through their national legal system and therefore report all errors as irregularities until the courts judge fraud has taken place.

**3.21** In 2003, the United Kingdom notified the Commission of 922 cases of suspected fraud or irregularity, involving some €55 million (£38.4 million) compared with 831cases with €51 million in 2002 and 545 cases with €55 million in 2001.

## Recent developments in OLAF

**3.22** OLAF has reduced the duration of its initial investigation into allegations of fraud from an average of 18 months in the 2000-01 to an average of five months in 2003-04. OLAF now also applies stricter assessment procedures to incoming information, so that it can better allocate its resources to appropriate cases. In its annual Operational Activity Report, OLAF stated that it had made considerable efforts to extend to new Member States the Anti-Fraud Information System (AFIS), an electronic system for reporting agricultural cases, which allows secure transfer of information between anti-fraud bodies in the Commission and Member States.

### The Eurostat case

**3.23** The Comptroller and Auditor General's report on European Union financial management, published in 2004, described the Eurostat case. Following allegations from a whistleblower, Eurostat, the Commission's statistical office, was suspected of fraud relating to improper contracting processes and of channelling Community funds through unofficial bank accounts. OLAF investigated the case and has sent reports to the relevant legal authorities in France and Luxembourg. OLAF is still examining nine cases, concerning contract irregularities, abuse of public money, and professional misconduct. It expects to collate results by early 2005, to allow suspected individuals to be charged by the legal authorities. OLAF has closed three cases in which no fraud was detected.

**3.24** Following the Eurostat case, the Commission put forward proposals in February 2004 to strengthen the regulatory framework which governs OLAF's investigations. The Commission's proposals are intended to:

- strengthen OLAF's operational efficiency;
- improve the information flow between OLAF and European Union Institutions and bodies;
- ensure the rights of individuals under investigation;
- fill a number of gaps jeopardising the effectiveness of OLAF's investigations; and
- enhance the role of OLAF's Supervisory Committee.

### The House of Lords report on OLAF

**3.25** The House of Lords European Union Committee examined documents and key personnel about the Commission's proposals. In July 2004, it published its report *Strengthening OLAF, the European Anti-Fraud Office*[21]. The report concluded that the Commission's proposals were premature and would do little to enhance the independence or accountability of OLAF. It recommended that OLAF's Supervisory Committee should not get involved in the operational activities of OLAF. The key points arising from the examination are shown in **Figure 20 overleaf**.

**3.26** The Court is expected to produce a report on OLAF in April 2005.

## Readiness of candidate countries

**3.27** Last year we commented on the readiness of the new Member States in the field of financial control and on developments towards possible further enlargement. In 2004, the Commission adopted a Strategy Paper on progress towards accession by Bulgaria and Romania, as well as a pre-accession strategy for Croatia. The Council agreed that negotiations should begin with Turkey.

**3.28** The National Audit Office assisted the new Member States to prepare for accession to the Union through capacity building projects[22] in audit institutions in Lithuania, the Czech Republic, Hungary, Slovenia, Slovakia, Latvia, Estonia and Poland. We hope to provide similar assistance to the current candidate countries and have already completed projects in Romania and Bulgaria, with major new projects starting in Croatia and Turkey.

21 Twenty-fourth report, Session 2003-04.
22 Such as advice on financial and performance audit, establishing human resource development units, and providing strategic management advice.

**20** Key points arising from the House of Lords report, *Strengthening OLAF, the European Anti-Fraud Office*

- The Council should not make any decisions on the future of OLAF until the European Court of Auditors has published its report.
- The proposed Regulation would do little to strengthen OLAF's independence or clarify its accountability.
- OLAF's Director-General should have some discretion to decide when, to whom and how much information to disclose.
- OLAF and national authorities should work closely together to ensure that evidence obtained during investigations is admissible in national prosecutions.
- OLAF's Supervisory Committee should not become involved in the Office's operational activities.
- The possibility of establishing a European Public Prosecutor should not distract the Commission from the need to consider ways in which OLAF can be more effective in the fight against fraud.

*Source: National Audit Office summary of the House of Lords report, Strengthening OLAF, the European Anti Fraud Office*

**3.29** Bulgaria and Romania are close to completing the negotiations and will join the European Union as members in January 2007 if they are ready. Regarding financial controls, the Commission in its 2004 Regular Report noted that Bulgaria had made further progress, such as extending the remit of its national audit office. However, the Commission also noted that more effort is needed to protect European financial interests and the euro against counterfeiting. There have also been positive developments in Romania, but the legislative framework needs to be completed in the area of external audit and protection of the Community's financial interests.

**3.30** In December 2004, the Council set 17 March 2005 as the opening date for negotiations with Croatia. The Commission's Opinion adopted in April 2004 noted that Croatia would need to develop efficient mechanisms for monitoring, controlling and auditing European funds before joining the Union.

# APPENDIX 1

## Special Reports published by the European Court of Auditors in 2004

| | |
|---|---|
| **1/2004** | The management of indirect RTD actions under the 5th Framework Programme (FP5) for Research and Technological Development (1998 to 2002) |
| **2/2004** | Pre-accession aid: has Sapard been well managed? |
| **3/2004** | Recovery of irregular payments under the Common Agricultural Policy |
| **4/2004** | The programming of the Community Initiative concerning trans-European cooperation – Interreg III |
| **5/2004** | Phare support to prepare Candidate Countries for managing the Structural Funds |
| **6/2004** | The organisation of the system for the identification and registration of bovine animals in the European Union |
| **7/2004** | The common organisation of the market in raw tobacco |
| **8/2004** | The Commission’s management and supervision of the measures to control foot and mouth disease and of the related expenditure |

# APPENDIX 2

## Summary of the European Court of Auditors' findings by sector

### Own resources

- Own resources is the term for European Community revenue. The main elements are VAT and GNI contribution from, and customs duties collected by, Member States.
- Revenue in 2003: €93.5 billion (£65.3 billion) including the 2002 surplus of €7.7 billion (£5.4 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. The transactions were not affected by material errors. The Court noted that VAT and GNI contributions (79 per cent of the Community's income in 2003) were based on macroeconomic statistics in Member States which cannot be tested directly. It found that VAT and GNI resources were being correctly calculated by the Commission and entered into the Community accounts.

### Agriculture

- This heading comprises programmes to support the production of crops and animals and to further rural development in Member States.
- Expenditure in 2003: €44.4 billion (£31.0 billion), 49 per cent of the total expenditure budget.
- The Court examined a representative sample of 203 payments drawn from the expenditure of 25 paying agencies which were collectively responsible for 75 per cent 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 found that for those Member States which had satisfactorily implemented the IACS, their inspection results represented an important source of evidence of the legality and regularity of CAP transactions. However, the Court was unable to provide positive assurance on agricultural expenditure, stating it was materially affected by error. The highest rates of error were found in areas outside the IACS scheme. The lowest rates of error were found in support programmes for the production of arable crops.
- The Court found that the Commission's processes for certifying the expenditure of the paying agencies worked satisfactorily, although there was room for improvement.

### Structural Measures

- These measures aim to promote economic and social cohesion, mainly by providing financial assistance to the less developed regions of the European Union.
- Expenditure in 2003: €28.5 billion (£19.9 billion), 32 per cent of the total expenditure budget.
- 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 noted there had been satisfactory progress in the internal control environment at the Commission. However, it was not able to take assurance from the Annual Activity Reports of the Directors-General due to serious and justified reservations expressed on the management and control systems of the Member States.
- The Court was unable to provide positive assurance on the Structural Measures due to financial errors. The majority of errors were found at Member State level. The Court noted the problems encountered in closing the 1994-99 period programmes and concluded that, without substantial improvements, similar difficulties would occur in the closure of the current programme period.

## Internal policies

- Internal policies focus on the implementation and development of the single market through activities such as technological research and development.
- Expenditure in 2003: €5.7 billion (£4.0 billion), six per cent of the total expenditure budget.
- The Court examined the first year of implementation of the 6th Framework Programme (FP6) for Research and Technological Development – the Union's main instrument for funding research in Europe which makes grants to research centres and universities.
- The Court found weaknesses in the Commission's internal control systems and numerous errors at final beneficiary level. It considered that the Commission's attempt to simplify the model contract had not been successful. The Court also noted that the common IT system to manage the projects was not operational in 2003.

## External action

- External action largely comprises humanitarian aid and support for development projects.
- Expenditure in 2003: €4.3 billion (£3.0 billion), five per cent of the total expenditure budget.
- The Court was unable to provide positive assurance. While the audit revealed few errors affecting transactions at the level of the Commission's headquarters or its Delegations, a relatively high number of irregularities were detected at the implementing agencies at local level.
- The Court was unable to take assurance on the control systems from the Annual Activity Report of the Director-General as essential supervisory systems and controls for the legality and regularity of underlying transactions at the level of the implementing organisations were not yet fully operational.

## Pre-accession aid

- Pre-accession aid is financial support for the candidate countries to assist them with preparations for membership of the European Union. There are three programmes: Phare (institution-building and investment); ISPA (environment and transport); and Sapard (agriculture and rural development).
- Expenditure in 2003: €2.2 billion (£1.5 billion), two per cent of the total expenditure budget.
- The Court's audit comprised an examination of the supervisory systems and controls over payments, supported by detailed transaction testing.
- The Court gave a qualified opinion on pre-accession aid. It concluded that shortcomings in the internal control systems of candidate countries had affected the legality and regularity of the transactions examined. The Court also found the Commission's own supervisory systems and controls unsatisfactory and affected by delays.

# APPENDIX 3

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

| House of Commons number | Title |
|---|---|
| **HC 184, 2004-05** | Foot and Mouth: Applying the Lessons |
| **HC 1028, 2003-04** | Helping Farm Businesses in England |
| **HC 529, 2003-04** | Financial Management of the European Union – a progress report |
| **HC 357, 2003-04** | 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, 2002-03** | National Audit Office Standard Report (published with Customs and Excise Account) |
| **HC 939, 2001-02** | The 2001 outbreak of Foot and Mouth Disease |
| **HC 859, 2001-02** | Financial management of the European Union: Annual Report of the European Court of Auditors for the year 2000 |
| **HC 615, 2001-02** | Agricultural fraud: the case of Joseph Bowden |
| **HC 402, 2000-01** | Financial Management of the European Union |
| **HC 131, 2000-01** | 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 |