

Financial management of the European Union

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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 2004¹, 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 year¹, 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.

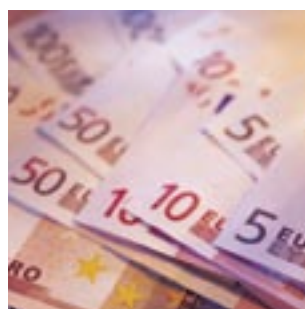




CONCLUSIONS

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 arrangements 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 Funds²); 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.