National Audit Office

Financial Management in the European Union

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 401 Session 2006-2007 | 18 April 2007

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Comptroller and Auditor General
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4 April 2007

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SUMMARY

1 In 2005, expenditure by the European Union totalled €104.8 billion (£71.7 billion)[1] and its revenue was €105.7 billion (£72.3 billion). The United Kingdom made a net contribution to the European Union of €3.7 billion (£2.5 billion), comprising payments of €12.2 billion (£8.3 billion) after deducting an abatement of €5.2 billion (£3.5 billion), less receipts of €8.5 billion (£5.8 billion).

2 In October 2006, the European Court of Auditors (the Court) published its report on the implementation by the European Commission (the Commission) of the 2005 budget. For the twelfth successive year the Court decided not to provide a positive Statement of Assurance on the legality and regularity of European Community expenditure. The Court concluded that the Community's accounts faithfully reflected revenue and expenditure for the year but some errors were noted in relation to balance sheet items. The underlying transactions taken as a whole were legal and regular with respect to revenue, administrative expenditure and expenditure on pre-accession[2] but there were material errors on the main operational programmes, although progress was maintained on agricultural payments subject to the Integrated Administration and Control System.

3 In January 2005, the Barroso Commission made it a strategic objective to strive for a positive Statement of Assurance from the Court. The Commission has embarked on a number of initiatives aimed at improving financial management and, in January 2006, it published an Action Plan setting out a series of measures designed to achieve a positive Statement of Assurance.

4 This report, following similar reports produced by the National Audit Office in previous years: summarises the main findings from the Court's work; provides an update on the various initiatives at European and national level to improve financial management; and sets out the information available on the level of irregularities and possible fraud. Our approach and methods used in this examination are summarised in Appendix 1.

Main findings and conclusions

5 The Court's latest report suggests that the improvements in financial management noted in recent years, for example the strengthening of the declarations provided by Directors-General in their Annual Activity Reports, were consolidated in 2005.

6 In 2005 the Commission produced the annual accounts on an accruals basis for the first time. This development was achieved within an ambitious timescale. The Court noted some errors in its implementation which the Commission will need to address in order to move towards a positive Statement of Assurance on the reliability of the accounts.

7 The lack of a positive Statement of Assurance does not indicate that European Union expenditure is subject to an excessive level of fraud. OLAF, the European anti-fraud office, has strengthened the systems for Member States to report potential fraud although it still has difficulty in ensuring that all Member States report fraud accurately and promptly.

8 Significant further progress towards a positive Statement of Assurance depends on success in implementing the Commission's Action Plan and in addressing the issues noted by the United Kingdom Committee of Public Accounts in its 2005 report *Financial Management in the European Union*.[3] In particular this involves simplifying the rules and regulations governing European Union programmes. Efforts to simplify regulations must be maintained, while ensuring that they are sufficiently clear to avoid disputes between the Commission and Member States. The United Kingdom authorities, with other Member States, should work to ensure that the Commission's intention to simplify the framework of regulations governing programmes is carried through into the day-to-day regulations governing the management of programmes.

9 The risk of errors occurring in the administration of programmes is increased by delays in closing programmes. Delays in closing some 1994-1999 Structural Measures programmes, for example, continue to divert administrative resources, in both the Commission and Member States, away from managing the current programmes. Setting up new programmes while others are running down requires officials to work to different sets of rules drawn up for different time periods. Prompt and efficient closure of the 2000-2006 programmes is essential if the Commission is to reduce errors and thereby increase the chances of obtaining a positive Statement of Assurance.

10 The Court's report notes some weaknesses in the United Kingdom's management and control of Structural Measures programmes. As recommended in our report last year, the Department for Communities and Local Government and the Department for Work and Pensions should redouble their efforts to ensure that the guidance they issue to the relevant public bodies makes clear the scheme requirements and that day-to-day management checks are carried out. The relevant United Kingdom authorities should ensure that their risk management arrangements place sufficient, yet proportionate, emphasis on the need for proper control and management of European Union funds.

11 In November 2006 Her Majesty's Treasury announced that the United Kingdom will produce a consolidated national Statement of Assurance on the use of European Union funds.[4] The Government intend to lay before Parliament such a statement which will be prepared to international accounting standards and audited by the National Audit Office, also to international standards. The Commission has endorsed this initiative, which might provide a useful source of assurance for the whole Community were it to be adopted more widely. The United Kingdom Government should seek the agreement of the other 26 Member States to adopt a similar approach in their jurisdictions.

12 In its 2005 report *Financial Management in the European Union*, the United Kingdom Committee of Public Accounts urged the Court to consider arranging a peer review of its audit approach and to test the quality and relevance of its work. The Court is currently preparing for an external peer review. In advance of this, the Court has carried out a self-assessment using a structured model developed by the European Institute for Public Administration and the Innovative Public Service Group. The self-assessment has resulted in an action plan that is currently being implemented.

Overall conclusion

13 There has been welcome progress in strengthening the financial management of European Union funds. Producing accruals-based accounts for 2005 was a considerable achievement by the Commission. The achievement of a positive Statement of Assurance nevertheless remains a significant challenge for the future. It is essential to maintain the momentum which will involve support and cooperation by all the authorities – the Commission, the Council of the European Union, the Court and Member States.

PART ONE

Background

1.1 This Part summarises the main conclusions of the Court's Statement of Assurance on the consolidated financial statements for the European Communities for the year ended 31 December 2005. A brief background to the 2005 budget is provided below and more details of the European Union's budgetary process are provided in Appendix 2.

The European Union's budget for 2005

1.2 2005 was the first full year of the enlarged European Union following the accession of ten new Member States[5] on 1 May 2004. The final budget for payments[6] was €109.4 billion (£74.9 billion), a 4.2 per cent increase on the €105.0 billion (£71.8 billion) final budget in 2004. The main sources of funding for this budget are a contribution based on Member States' gross national income, a VAT-based contribution and customs duties on a range of commodities imported from non-Member States. These income categories and the seven main expenditure programmes are described in **Figure 1**.

1.3 In 2005 payments totalled €104.8 billion (£71.7 billion) and revenue received was €105.7 billion (£72.3 billion). These totals are analysed in **Figures 2 and 3 overleaf**.

1.4 The annual budget of the European Union is set within the framework of a multi-annual Financial Perspective which spans a seven year period. This sets limits, in terms of commitments and payments, that may be approved in any year for different categories of expenditure. Recent and current cycles cover the 1993-1999, 2000-2006 and 2007-2013 periods.

1 European Union income and expenditure

Sources of income

- Traditional own resources: customs duties, including those on agricultural products, on a range of commodities imported from non-Member States and levies on the production of sugar to meet part of the cost of subsidising the export of surplus Community sugar into the world market.
- Value added tax (VAT) contributions: based on a uniform rate applied to the VAT base in each Member State, subject to a cap.
- Gross national income (GNI) based contributions: calculated according to the Member States' gross national income.
- Other revenue and the surplus brought forward from 2004.

Expenditure programmes

- Common Agricultural Policy: schemes to support farmers and agricultural markets.
- Structural Measures: programmes to tackle economic and social problems, supporting economic and social development in areas facing structural difficulties and to support the adaptation and modernisation of policies and systems of education, training and development.
- Internal policies: a range of measures including research and development.
- External actions including food aid, humanitarian and development aid.
- Administrative expenditure for the five Community Institutions and other bodies.
- Pre-accession aid: supporting candidate countries joining the European Union.
- Compensation: temporary payments to new Member States to ensure they are not net contributors to the European Union immediately following accession.

Source: National Audit Office

2 Sources of receipts in 2005

Source of receipt	Value (€ billion)	Percentage
GNI-based own resources	70.9	67
VAT-based own resources	16.0	15
Traditional own resources	13.9	13
Miscellaneous revenue	1.6	2
Surplus carried forward from 2004	3.3	3
	105.7	

Source: Data from the European Court of Auditors' Annual Report concerning the financial year 2005

3 Breakdown of expenditure for 2005

Area of expenditure	Value (€ billion)	Percentage
Common Agricultural Policy	48.5	46.2
Structural Measures	32.8	31.3
Internal Policies	8.0	7.6
Administration	6.2	5.9
External Action	5.0	4.8
Pre-accession Aid	3.0	2.8
Compensation	1.3	1.2
Reserves	0.1	0.1
	104.8	

Source: Data from the European Court of Auditors' Annual Report concerning the financial year 2005. These figures do not cast due to rounding.

1.5 The Commission must therefore manage payments and commitments to ensure that these conform to the budget for the year and to the limits for the Financial Perspective as a whole. At the end of 2005, the Court noted that despite the high spending rate, outstanding commitments to make future payments had increased by €9.1 billion (£6.2 billion), or eight per cent, to €119 billion (£81 billion). A further €48.4 billion (£33.1 billion) of allocated expenditure had not been recognised as budgetary commitments. These figures indicate that a substantial part of the expenditure agreed for the 2000-2006 period is unlikely to be made before the regulatory deadline.

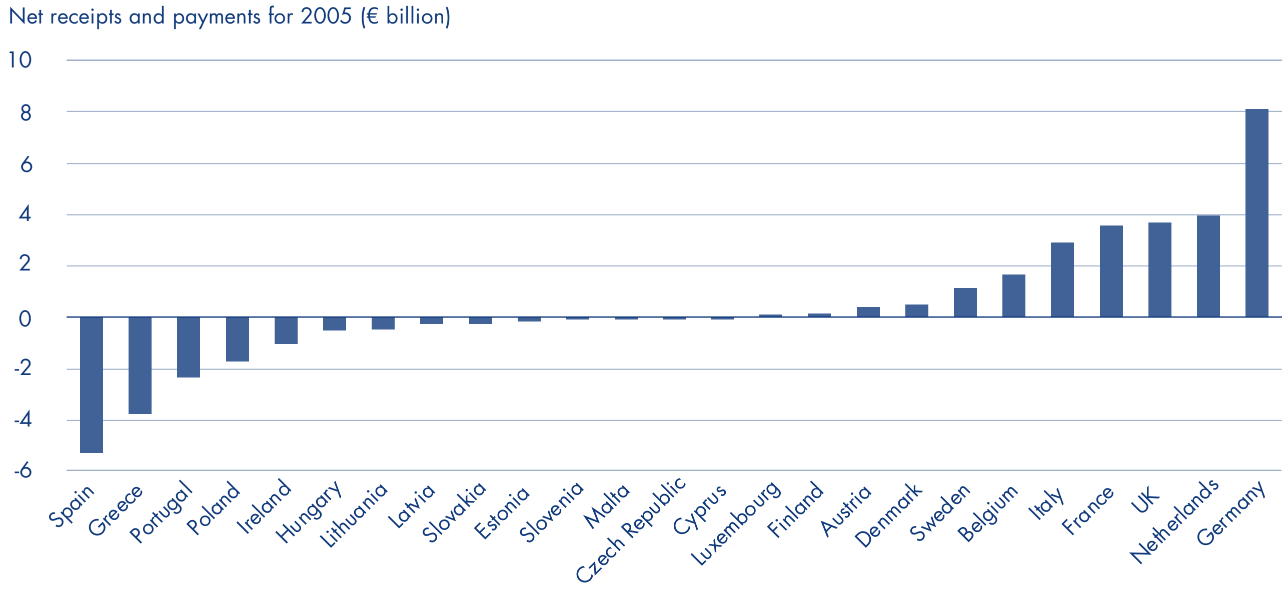
1.6 €106 billion (£73 billion) of the €119 billion outstanding commitments at the end of 2005 related to Structural Measures. This represents 3.6 years' expenditure at the 2005 spending rate. The Court noted that in order to meet the time limit of end of 2008,[7] Member States will have to increase further their current high level of spending. From 2007 spending should start on the 2007-2013 Financial Perspective, but the Court noted that the need to complete the 2000-2006 programmes risks delaying the start and subsequent implementation of the new programmes. The Court recommended that the Commission makes a careful analysis of the forthcoming completion of the 2000-2006 Structural Measures programmes and the effect this will have on the start of the new programmes. Closure arrangements for Structural Measures are examined in more detail in Part 2 of this report.

The United Kingdom's contribution

1.7 The United Kingdom made a gross contribution of €12.2 billion (£8.3 billion) to the budget of the European Community in 2005. After taking account of receipts, the United Kingdom's net contribution was €3.7 billion (£2.5 billion) in 2005. This was the third highest net contribution in 2005, and compares with €4.8 billion (£3.3 billion) in 2004. Some fluctuations in net contributions are to be expected as receipts from the European Union in any given year can in part be recompense for expenditure incurred in previous years. Member States' net contributions are shown in **Figure 4**.

1.8 These figures are inclusive of the United Kingdom's abatement, which was €5.2 billion (£3.5 billion) in 2005. The abatement works out at around 66 per cent of the United Kingdom's payments less receipts,[8] and was originally granted as part of the negotiations leading to the agreement on the European Union's budget in 1984. The abatement was introduced because the United Kingdom benefited less than other Member States from the high proportion of the European Union's budget which was spent on the Common Agricultural Policy (CAP). In December 2005, the Council of the European Union (the Council) concluded that after a phasing-in period the abatement should be adjusted in order for the United Kingdom to participate fully in the financing of enlargement. The total reduction in the abatement arising from this adjustment over the next Financial Perspective has been capped at €10.5 billion (£7.2 billion).

4 Member States' net payments position for 2005



Source: Data from the European Court of Auditors' Annual Report concerning the financial year 2005

The European Court of Auditors' opinion on the 2005 financial statements

1.9 The European Court of Auditors is the European Union's external auditor. The Maastricht treaty[9] requires the Court to examine whether all revenue has been received and all expenditure has been incurred in a lawful and regular manner, and whether financial management has been sound.[10] It also requires the Court to provide the European Parliament and the Council with a Statement of Assurance.[11] The Court publishes an Annual Report after the close of each financial year. It also examines specific topics and publishes its findings in Special Reports. During 2006 it published eleven such reports which are listed in Appendix 3.

1.10 After the accession of ten new Member States on 1 May 2004, the Court comprised 25 members, one from each Member State. The members are nominated by their Member State and the nominations are scrutinised by the European Parliament. Appointment to the Court is made by the Council after consultation with the European Parliament.

The Court's Statement of Assurance on the 2005 accounts

1.11 For the twelfth successive year the Court was unable to provide a positive Statement of Assurance on the European Union's accounts. Their report found that the Commission had continued to make progress in strengthening its internal control system, but noted that there remained significant weaknesses in the supervisory and control systems in several areas of the budget.

1.12 The main components of the Statement of Assurance are explained in **Figure 5 overleaf**.

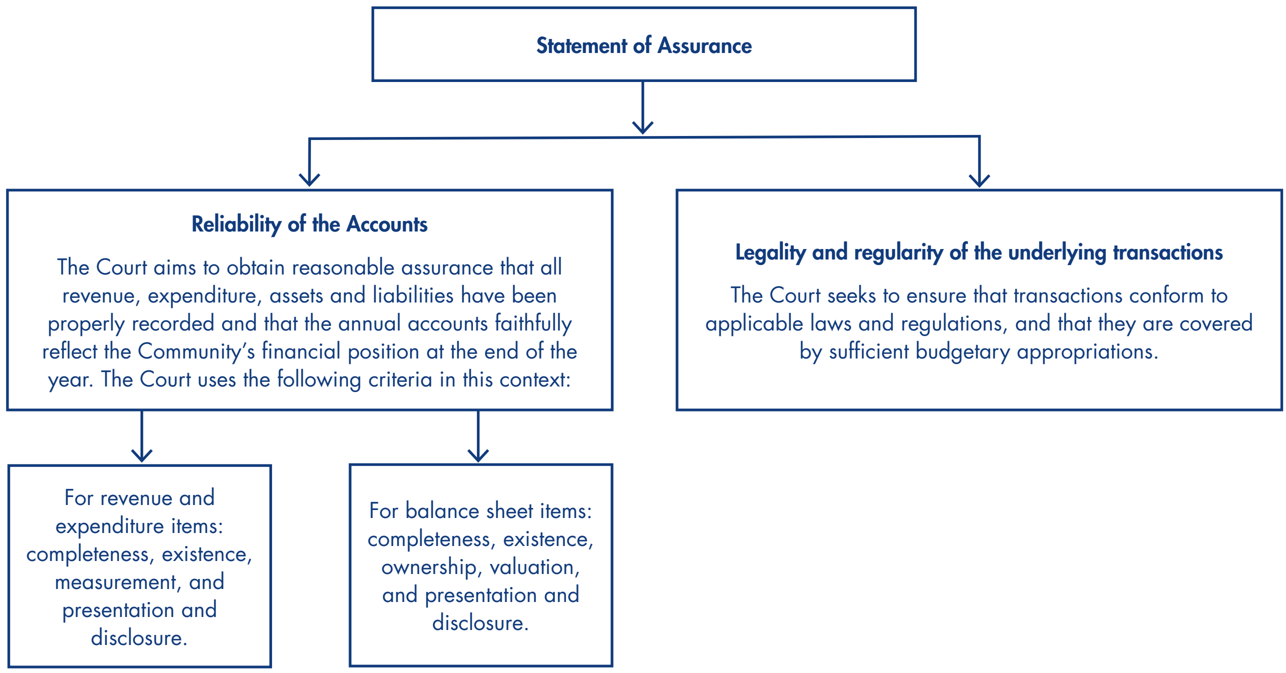
1.13 The Court's overall conclusions are set out below.

i) On the **reliability of the accounts** the Court concluded, generally, that the Community accounts faithfully reflected the Community's revenue and expenditure for the year and financial position at the year end, except for the following:

- The existing financial reporting framework was not consistently applied, in particular for cut-off, and the accounting systems in certain Directorates-General[12] of the Commission were not able to ensure the quality of financial information.

- The Court identified errors in amounts registered in the accounting system as invoices/cost statements and pre-financing[13] which resulted in errors in some of the opening and closing balance sheet items. The errors noted in relation to pre-financing were similar to the one noted in previous years in relation to sundry debtors, though to a lesser degree, although the Commission has attempted to address this ongoing issue by preparing an inventory of all pre-financing amounts.

5 The Statement of Assurance covers the reliability of the accounts and the legality and regularity of the underlying transactions



Source: National Audit Office

ii) On the **legality and regularity of the transactions underlying the accounts**, the Court concluded that they were, taken as a whole, legal and regular with respect to revenue, administrative expenditure and expenditure on the pre-accession strategy (with the exception of the SAPARD programme). For CAP expenditure the Court found that, where properly applied, the Integrated Administration and Control System (IACS) is an effective system to limit the risk of irregular expenditure. The Court identified five areas of expenditure however which were materially affected by errors: parts of CAP expenditure not covered by IACS or where IACS had not been properly applied; Structural Measures; Internal Policies; External Actions; and Pre-accession expenditure under the SAPARD programme. In its previous report on the financial year 2004 the Court qualified its opinion on the same areas with the exception of the SAPARD programme. Part 2 of this report provides further details of the Court's opinion on the main areas of expenditure.

The Court's audit methodology

1.14 The Court's examination of the Community's annual accounts is based on international auditing standards,[14] adapted to reflect the Court's duties and responsibilities and take account of the European Union context.

The Court's methodology for its audit of the financial year 2005 was based, as it had been for the previous four years, on four sources of evidence:

- An examination of the operation of the supervisory systems and controls applying to expenditure of European funds by 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 revenue and for each major area of expenditure down to the level of the final beneficiary.
- An analysis of the Annual Activity Reports and the declarations of the Commission's Directors-General (examined in Part 3 of this report) 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, where possible.

1.15 The Court's report for 2005 supplements its Statement of Assurance with specific assessments of the Community's major areas of activity,[15] as it has done in recent years. The Court also examined the Commission's efforts to improve its internal control system and examined developments relating to qualifications in the 2004 Statement of Assurance.

PART TWO

Key findings in respect of the main expenditure areas, irregularities and possible fraud

2.1 This Part considers the Court's findings in respect of:

i) the Common Agricultural Policy; and

ii) Structural Measures;

and OLAF's findings in respect of:

iii) irregularities, including possible fraud.

i) The Common Agricultural Policy

2.2 In 2005, expenditure on the Common Agricultural Policy (CAP) was €48.5 billion (£33.2 billion), compared to €43.6 billion (£29.8 billion) in 2004. This represents 46 per cent (the largest area) of European Union expenditure in 2005 (2004: 44 per cent).[16] The increase in 2005 was mainly due to the accession of the 10 new Member States.

2.3 There are two main activities:

- rural development (such as investment in farm holdings and schemes to help farmers manage their land in an environmentally-friendly way); and
- support for the agricultural sector through direct aid and intervention measures.

2.4 Expenditure on rural development has increased steadily in recent years, and for 2005 represented €6.3 billion (£4.3 billion), or 13 per cent, of CAP expenditure.

2.5 2005 was the first year of the application of the new Single Farm Payment, which is being phased in during the period 2005-2007. The Single Farm Payment to farmers is independent of the volume of production, and is made so long as the farmers have met certain criteria concerning environmental standards, health and safety, and the requirement to keep farmland in good condition. This is intended to remove the incentive for over-production. The decoupling of aid from production is the latest phase in reforms of the CAP which have been ongoing since 1992, and is intended to make farmers in the European Union more competitive and market-orientated whilst continuing to provide income stability.

The Court's overall findings on the Common Agricultural Policy

2.6 The system of management and control of CAP expenditure is divided into four levels, as described in **Figure 6 overleaf**. In order to obtain assurance over the legality and regularity of payments made under CAP, the Court audited the main supervisory and control systems described, and tested a random sample of payments drawn from the expenditure of 25 Paying Agencies in the 15 old Member States and 20 payments under the Single Area Payments Scheme[17] in the new Member States.

2.7 The key management and control arrangement for area aid, animal premiums and the Single Area Payments Scheme is the Integrated Administration and Control System (IACS). IACS is a system for identifying parcels of agricultural land and animals and registering and recording this information in a computerised database. The system also records aid applications so these can be cross-checked. In 2005, CAP expenditure managed and controlled by IACS totalled €25.5 billion (£17.4 billion) in the old Member States and €1.4 billion (£1.0 billion) in the new Member States. IACS is being progressively applied to an increasing proportion of CAP expenditure. In 2005 IACS covered some 68 per cent of expenditure on market support and direct aid; this is expected to increase to 90 per cent by 2013.

6 The system of management and control of Common Agricultural Policy expenditure is divided into four levels

1. Compulsory administrative structure at Member State level, centred around the establishment of Paying Agencies and an authority at a high level which is competent for issuing and withdrawing the Agency's accreditation. Some 98 per cent of CAP expenditure is made under shared management with Member States. It is distributed by Paying Agencies situated in Member States. In 2005 there were 95 Paying Agencies across the 25 Member States, six of which were in the United Kingdom.[1]
2. Detailed system for controls and dissuasive sanctions to be applied by those Paying Agencies. The controls generally provide for administrative checks of 100 per cent of the aid applications, cross-checks with other databases, and pre-payment on-the-spot checks of a sample of payments.
3. Ex-post controls through certified audit bodies and special departments. Paying Agencies are required to provide the Commission with assurance on the admissibility of claims and compliance with rules.
4. Clearance of accounts through the Commission (both annual financial clearance and multi-annual conformity clearance). Each Paying Agency is required to prepare annual accounts, which must be audited by a certifying body (in the United Kingdom, a consortium consisting of the National Audit Office, the Northern Ireland Audit Office, the Wales Audit Office, and Audit Scotland) and submitted to the Commission.

Source: Directorate-General for Agriculture and Rural Development

NOTE

1 The Rural Payments Agency for England; the Scottish Executive Environment and Rural Affairs Department; the National Assembly for Wales Agriculture Department; the Department of Agriculture and Rural Development Northern Ireland; the Forestry Commission; and the Countryside Council for Wales.

2.8 For area aid schemes, the Court analysed the inspection statistics of IACS for all Member States and examined how it had been implemented in seven new Member States. For all Member States, 40 per cent of applications checked contained errors where the amount of land claimed had been overstated. These errors were, however, generally small in nature and represented 2.1 per cent of the land area verified by the Paying Agencies. For the 14 Member States that the Court deemed had implemented IACS satisfactorily, the error rate was 1.95 per cent. In the old Member States, serious deficiencies in the operation of IACS were, as in previous years, noted in Greece, which accounted for €2.8 billion (£1.9 billion) of CAP expenditure in 2005. Authorities in Greece are implementing an action plan to address these deficiencies, which is being monitored by the Commission. In the new Member States, deficiencies were identified in the accuracy of data recorded in IACS, and in calculation of payments under the Single Area Payments Scheme.

2.9 For the largest animal premium scheme (the Suckler Cow Premium), inspectors in Member States examined 14.9 per cent of the animals claimed, and reported that 1.8 per cent of these were missing or ineligible. The Court noted that the error rate for this scheme and other cattle schemes generally showed only small variations between most Member States, but for Italy, Malta and Slovenia it was particularly high (for example, error rates for the special beef premium were 11.8 per cent in Malta, 21.8 per cent in Italy, and 56.2 per cent in Slovenia). For the sheep and goat premiums, the number of overclaimed animals was 6.3 per cent. Again, Italy and Slovenia reported significantly higher error rates (10 per cent and 24.1 per cent respectively) than the other Member States (1.2 per cent).

The United Kingdom's performance

2.10 For area aid schemes, the United Kingdom was found to have a higher than average frequency of error (61 per cent of applications contained errors compared to 40 per cent for the European Union as a whole), but the effect of these errors was comparatively small. Errors represented 0.8 per cent of the total land area claimed by the United Kingdom (2004: 0.6 per cent), compared to an average of two per cent for the European Union as a whole. For animal premium schemes, error rates in the United Kingdom were comparable with the rest of the European Union, as in previous years. These data are dependent on the quality of reporting by Member States, and should be treated with caution.

2.11 The Court noted, however, that producers in the United Kingdom, along with Greece, Spain, France and the Netherlands, did not maintain good flock registers for sheep and goats, which prevented the checking of some claims. An accurate flock register and supporting documents are a fundamental requirement of the scheme and must be presented in all cases. Where inspections uncover records which are non-compliant, the keeper or producer is informed and sanctions are applied. In relation to export refunds, the Court noted some problems with the application of physical checks in the United Kingdom, such as non-compliance with the requirement that exporters should not have tacit prior warning of checks, and a lack of checks on customs seals. The United Kingdom authorities are aware of the Court's concerns and are considering actions to address them.

2.12 In 2005-06 there were considerable delays by the Rural Payments Agency, the Paying Agency responsible for administering CAP payments in England, in making payments to English farmers. The National Audit Office reported in October 2006[18] that the delays were caused in part by changes to the development of the IT systems used to administer the payments, and an underestimation of the work involved in mapping farmer's land and processing each claim. There is a risk that the Commission will impose a substantial financial correction as a result of the delays. The Department for Environment, Food and Rural Affairs included provisions and contingent liabilities totalling some £131 million in its accounts for 2005-06 for potential financial corrections arising from late or disallowed payments. Further provisions and contingent liabilities may be required for 2006-07, which will be subject to financial audit by the National Audit Office in due course. The Court may explore this issue in its report on the European Union's annual accounts for 2006, which is expected in the autumn of 2007. The level of any future financial correction is currently uncertain.

The clearance procedure

2.13 One of the key elements of the control system for CAP expenditure is the audit work carried out during the clearance of accounts procedure. Each year the Commission examines the accounts and the supervisory and control systems of Member States in relation to CAP expenditure, and comes to a conclusion on the accuracy and reliability of the accounts provided by the Paying Agencies. There are two elements to this:

- **Accounting clearance.** Examination of the accreditation of Paying Agencies and examination of the work they carry out when certifying accounts.
- **Conformity clearance.** Examination of conformity of expenditure and exclusion from Community financing of transactions in breach of Community rules.

2.14 The Court noted that the Commission's decision on accounting clearance is based on the work and the certificates of the certifying bodies. The Court considered that although the accounting clearance process was a useful method of highlighting control weaknesses, the assurance provided by the certifying bodies could not be relied upon to confirm the legality and regularity of payments made to farmers and traders. This was because certifying bodies often did not carry out on the spot physical inspection checks on payments at the level of the final beneficiary, but instead relied on information held by the Paying Agencies. The Commission considered that this system does effectively manage the risk of irregular transactions at the level of the final beneficiary but has accepted the Court's recommendation that the certifying bodies should do more work to verify and validate inspection statistics and post-payment checks.

2.15 Where the conformity clearance procedure identifies weaknesses in control systems, the Commission may impose financial corrections on Member States based on a standard tariff related to the seriousness of the weaknesses identified. The Court noted that the cost of these corrections was borne by Member States rather than the final beneficiary that had received the payment. As such, the Court considered that these corrections do not correct irregular payments. In addition, conformity decisions are not taken until several years after the payments in question have been made and therefore do not provide assurance over the legality and regularity of transactions that the Court can rely on in its annual audit. The Commission considered that conformity decisions and financial corrections are an important means to improve Member State's control systems, which may help to prevent irregular payments to final beneficiaries. They are however made primarily for the purpose of protecting the European Union's financial interests as a whole rather than recovering individual irregular payments from final beneficiaries, which is the responsibility of Member States.

2.16 In conclusion, the Court found that CAP expenditure viewed as a whole was still affected by a material level of error, although the Court noted that IACS, where properly applied, is an effective control system for limiting the risk of error or irregular expenditure. The Commission considers that where IACS has not been applied correctly it makes financial corrections in the context of the clearance of accounts procedure.

ii) Structural Measures

2.17 In 2005, expenditure on Structural Measures totalled €32.8 billion (£22.4 billion), or 31 per cent (the second largest area) of the European Union's budget.[19] Funding is provided on a multi-annual basis, with programmes often spanning several years and sometimes more than one Financial Perspective.[20] Over the new programming period 2007-2013, Structural Measures will account for almost half of the total European Union budget.

2.18 Structural Measures provide funding for four interlinked areas of European Union policy: regional policy; employment and social policy; rural development; and fisheries. Ninety-two per cent of Structural Measures expenditure comes from four Structural Funds: the European Regional Development Fund (ERDF), the European Social Fund (ESF), the European Agricultural Guidance and Guarantee Fund, Guidance section

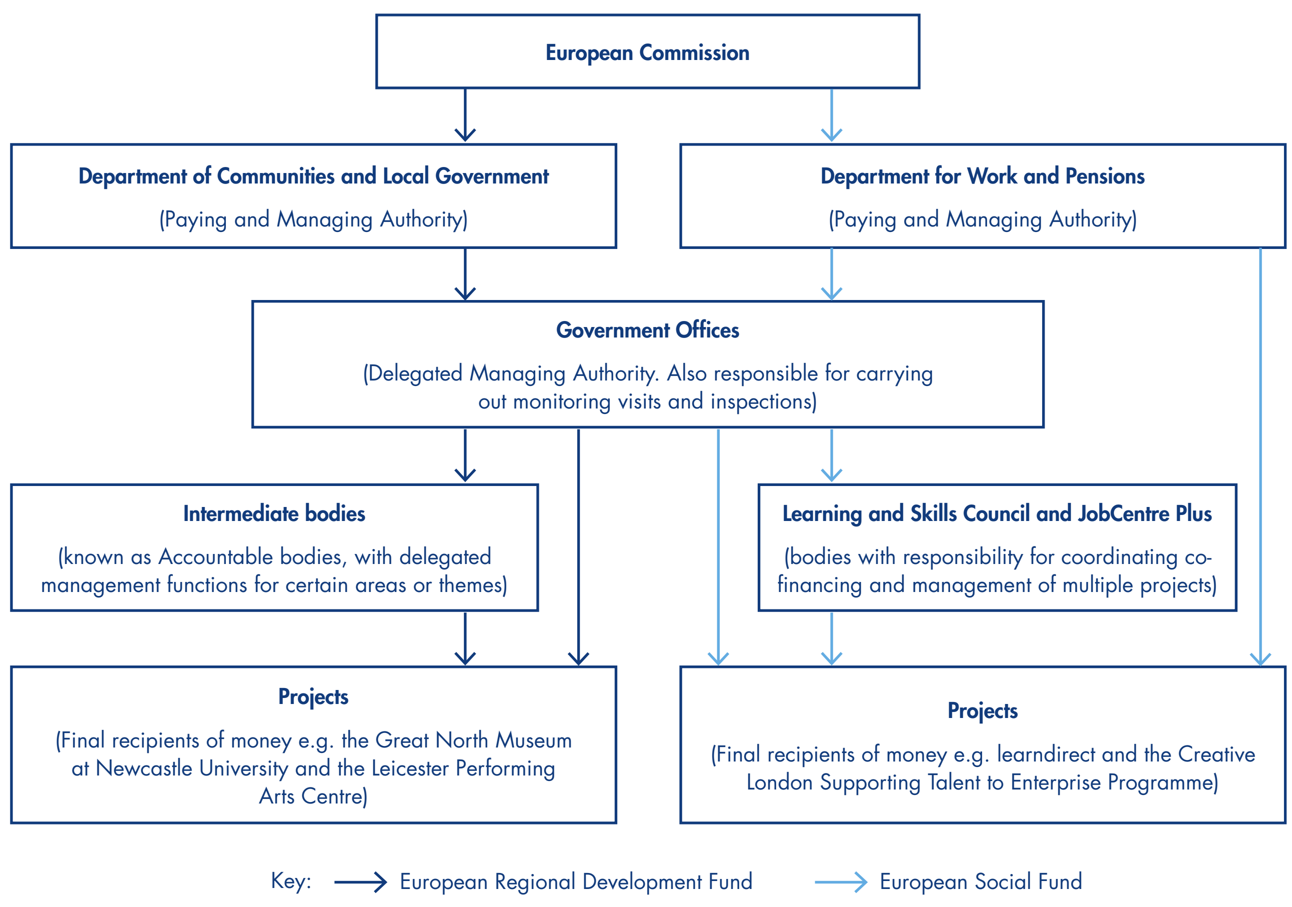
(EAGGF-Guidance)[21] and the Financial Instrument for Fisheries Guidance (FIFG). The funding is allocated according to three main objectives:

- 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.

The remainder of the funding comes from the Cohesion Fund, which co-finances projects to develop transport infrastructure and improve the environment in Member States whose gross national income per head is less than 90 per cent of the European Union average. Structural Funds programmes vary enormously in size and complexity. In addition project expenditure within each programme can range from a few hundred euros to an individual recipient up to several hundred million euros for a major infrastructure project.

2.19 Responsibility for managing these funds is shared between the Commission and Member States. Member States are responsible for ensuring project costs are correctly reported and have met the eligibility criteria. The Commission is responsible for ensuring Member States' arrangements for verifying expenditure comply with European Union law. Within each Member State, each programme is allocated to a Managing Authority, which is responsible for the overall management and monitoring of the programme. The Managing Authority receives its funds from a Paying Authority, which is responsible for submitting applications for payments and receiving payments from the Commission, and certifying the expenditure made by the Managing Authority. Intermediary bodies may act on behalf of either in dealing with the final beneficiaries of the funding. **Figure 7** shows how these arrangements work in the United Kingdom.

7 Management and control systems for the main Structural Measures funding streams in the United Kingdom



Source: National Audit Office

The Court's overall findings on Structural Measures

2.20 Figure 8 shows the results of the audits of Structural Measures programmes carried out by the Court. The Court found material errors in declared expenditure programmes for both the 2000-2006 and the 1994-1999 funding period. For the 2000-2006 period, 60 of the 95 projects (63 per cent) were affected by material errors, and for the 1994-1999 period, 33 of the 65 projects (51 per cent) contained material errors. For the 2000-2006 period, the most common problems were:

- in all 10 of the programmes audited the Court found a lack of day-to-day management checks on the implementation of the projects. The Court considered such checks to be the most effective way of identifying or addressing any potential problems before expenditure was declared to the Commission;
- in seven of the 10 programmes there was an insufficient audit trail to support declared expenditure; and
- in seven of the 10 programmes interim certification to ensure compliance with the necessary conditions had not been carried out effectively by the Paying or Managing Authority.

Similar errors were found in relation to the 1994-1999 period. In some instances the recipients of the funding had not retained supporting evidence for their declared expenditure. The Court also conducted a limited examination of nine Cohesion Fund projects, which led to no material observations.

8 The results of the Court's audits of Structural Measures programmes

	Period	
	1994-1999	2000-2006
Number of Structural Funds programmes audited	6[1]	10
Number of projects covered by audit sample	65	95
Number of projects found to contain material errors	*33 (51%)*	*60 (63%)*
Number of Cohesion Fund projects audited	9	
Observations	*No material observations were noted*	

Source: Data from the European Court of Auditors' Annual Report concerning the financial year 2005

NOTE

1 These programmes were not closed by the time of the audit – see 2.28.

2.21 The Court noted the Commission, up to the end of 2005, had made a total of €1.4 billion (£1.0 billion) of financial corrections for errors found in Structural Funds and Cohesion Fund programmes and projects for the 2000-2006 period. These corrections arose almost exclusively as a result of audits performed by Commission officials in Member States. Where Member States made corrections for irregularities, they were allowed to replace the disallowed expenditure with other eligible expenditure according to the legislation in force. This reduced the original financial corrections by €0.9 billion (£0.6 billion) to €0.5 billion (£0.3 billion). The Court considered that the scale of the correction was not sufficient to encourage Member States to take action to prevent irregularities or to improve their management and control systems, although the Commission considered that their audit work does have a deterrent effect which helps to prevent irregular payments.

2.22 The Court also found that Member States had not systematically supplied details to the Commission of cancellations of European Union funding, amounts recoverable and adjustments they had made to strengthen management and control systems. The Court considered that the Commission had therefore been deprived of an important indicator on the functioning of the management and control systems. In addition, the Commission had continued to make payments against declared expenditure despite having not systematically received from Member States information regarding recoveries made since their previous declaration. Guidance describing the nature of the information required was only issued by the Commission in 2005. The Commission reported that the inclusion of recoveries information with payments claims is now checked systematically and payment procedures are interrupted if it is missing.

2.23 In summary, the Court considered that the Commission did not maintain effective supervision to mitigate the risk that the controls delegated to Member States failed to prevent reimbursement of overstated or ineligible expenditure. The Commission considered it had taken steps to address these risks.

The United Kingdom's performance

2.24 For ERDF expenditure in the 2000-2006 period, the Court found certain types of error appearing systematically in projects for some programmes. The United Kingdom was identified as having such errors in ERDF expenditure under Objective 1 in South Yorkshire, where the declaration of European Union grant was found to have exceeded the co-financing rate without proper justification. This programme was found to have not complied with the regulations in relation to segregation of duties (between those managing expenditure and those certifying that expenditure), day-to-day management checks on projects and interim certification of expenditure. Only partial compliance was noted in relation to maintaining a proper audit trail and recovery procedures. The Department of Communities and Local Government informed us that these issues have subsequently been addressed by the programme authorities.

2.25 The Director-General for Regional Policy issued a reservation in relation to these errors in the United Kingdom in his Annual Activity Report. The reservation was one of three; the other two concerned problems in Spain. The United Kingdom reservation concerned deficiencies in first-level management checks and in the certification of expenditure. The reservation noted that there were significant deficiencies referring to key elements of the management and control systems affecting all English programmes and that the Director-General did not have reasonable assurance as regards the legality and regularity of underlying transactions.

2.26 The Commission undertook further audit work in autumn 2006 in areas relating to its reservation, and has issued a report containing provisional findings. The Commission has warned the United Kingdom authorities that payments to ERDF programmes in England may be suspended if sufficient assurance over declared expenditure is not provided. The Department informed us that it has a programme of work dating back to 2005 to address the Commission's concerns by enhancing its control procedures. In May 2006 it issued targets for additional monitoring of ERDF expenditure, which were strengthened in November 2006 in the light of the provisional audit findings. Discussions with the Commission regarding the provisional audit findings and the Department's programme of work are ongoing. The Commission is likely to announce its conclusions on the reservation in its Synthesis Report for 2006, which is expected to be published in June 2007.

2.27 The Commission's examination of ESF expenditure in the United Kingdom in 2005 also raised some concerns, although this expenditure was not tested by the Court as part of its annual audit. In Wales, a financial correction of 10 per cent has been made due to weaknesses identified in the control systems for ESF expenditure. The Director-General for Employment, Social Affairs and Equal Opportunities issued a reservation in his Annual Activity Report for 2005 in relation to ESF expenditure in England. The reservation states that there was a failure of management and control systems, in particular with regard to segregation of duties, project selection, implementation of verification checks, maintaining an audit trail, and the certification process, which could have led to irregular payments. The potential error arising from these weaknesses was quantified at €107 million (£73 million). The Department for Work and Pensions has informed us, however, that these problems have been addressed satisfactorily and no financial correction is now expected to be imposed by the Commission in England. A self-correction of some £30 million has been made by the Department, this has no effect on the United Kingdom's net payments position as the Department can substitute this expenditure with eligible expenditure of the same amount. Follow-up audits by the Commission in 2006 at the Government Offices for the North-West and Eastern regions have given 'reasonable assurance' that the control systems that manage this expenditure are effective.

Closure arrangements

2.28 At the end of each programming period, the Commission is responsible for closing the programmes. The process involves pre-closure compliance audits of selected programmes, desk checks of final claims and closure documentation, and ex-post audits of closed programmes. Closure audits and thorough analysis of closure documentation are important in order to reduce the risk of irregular payments. Financial corrections may be applied where ineligible payments have been made. Because Structural Measures projects often cover a number of years, and may span more than one Financial Perspective, the closure process takes a number of years.

2.29 The Court examined the closure of 30 Structural Funds programmes from the 1994-1999 period, and examined the application of the procedures for reporting recoveries and making financial corrections for Structural Funds programmes and Cohesion Fund projects in the 2000-2006 period. In relation to the closure of programmes from the 1994-1999 period, the Court again found lengthy delays were occurring. Payments were still being made to programmes for this period in 2005, and 355 out of the 2,170 programmes for this period (16 per cent) remained open as at 31 March 2006. In its audit of the closure process, the Court noted three cases where the Commission had closed programmes without making financial corrections, despite having significant reservations on the certified expenditure. In some instances the Court noted that the closure process on the part of the Commission had contributed to the delays in closing programmes, with the Commission sometimes taking longer than a year to address correspondence to Member States.

2.30 Delays in closing programmes risk damaging the credibility of the Commission and diverting management attention from ongoing programmes. Delays may also result in a higher risk of irregularities, as programmes receiving funding simultaneously from two different programming periods are subject to different regulations. The Court considered that the lengthy closure process for the 1994-1999 period diverted resources from ensuring that the supervisory and control systems for the 2000-2006 period operated effectively. Consequently, there is a risk that closure of the 2000-2006 programming period may also be delayed if controls have not operated effectively during the period and substantial errors are found during the closure process. The Court recommended that better preparations should be made for the closure of the 2000-2006 period.

2.31 The Commission has introduced new regulatory requirements, such as compliance assessments, which it believes will ensure the supervisory and control systems operate effectively from the beginning of the new programming period. In the United Kingdom, the Department of Trade and Industry have set up and chaired a 'Closure Group' including representatives from the relevant authorities. This group has produced a set of Closure Guidelines for use in the United Kingdom which were sent to the Commission in March 2006.

iii) Fraud and irregularity and the work of OLAF

2.32 In considering errors in the European Union's accounts, it is important to distinguish between fraud and irregularity. Irregularities are transactions which have not complied with all of the regulations that govern European Union income and expenditure, and may be intentional or unintentional.[22] If a project in receipt of Structural Funding, for example, does not receive the agreed amount of additional funding from national sources, the monies received from European sources would be irregular. Fraud is an irregularity that is committed intentionally and constitutes a criminal act, that only the courts can determine as such.[23] For example, a situation where a farmer deliberately falsified records of land areas in order to claim additional payments could constitute fraud.

2.33 The European Anti-Fraud Office is known as OLAF.[24] It is part of the Commission and able to exercise Commission powers, but is autonomous in its investigative role in order to protect the financial interests of the European Union. OLAF's role is to fight fraud, corruption, and any other illegal activity (including misconduct) that has financial consequences for the European Union. OLAF reports annually on the number and value of irregularities and suspected frauds reported by Member States and on the results of its internal and external investigations.

Irregularities and suspected fraud reported in 2005

2.34 Member States are required to notify the Commission of irregularities, including possible frauds, that are detrimental to the European Union's financial interests.[25] In 2005, Member States notified the Commission of 12,076 irregularities, with a total value of €1,042 million (£713 million). These totals are analysed in **Figure 9**.

9 Cases of irregularity, including possible fraud, notified to the Commission by Member States in 2004 and 2005

	2004		2005		Percentage change	
	Number of cases	Amount € million	Number of cases	Amount € million	Number of cases %	Amount %
Structural Measures	3,339	696	3,570	601	+6.9	-13.6
Traditional Own Resources	3,205	212	4,982	322	+55.4	+51.9
CAP	3,401	82	3,193	102	-6.1	+24.4
Pre-accession funds	227	8	331	17	+45.8	+112.5
Total	**10,172**	**998**	**12,076**	**1,042**	**+18.7**	**+4.4**

Source: Data from OLAF's Protection of the European Communities' financial interests – Fight against fraud – Annual Report 2005

2.35 Figure 9 shows that the number of irregularities reported to the Commission, including possible fraud, increased by 19 per cent in 2005, and the total value of reported irregularities increased by four per cent. The Commission believes that these increases may in part be explained by improved communication of irregularities by some Member States.

2.36 The most marked difference from 2004 was in the area of Traditional Own Resources, where the number and value of reported irregularities increased by more than 50 per cent. Most of these concerned cigarette smuggling. Reported irregularities also increased significantly in the area of pre-accession aid, although this area represents only a small proportion of the European Union's budget.

2.37 Member States are required to report where they suspect that irregularities have arisen as a result of fraud. In the area of Traditional Own Resources suspicions of fraud accounted for approximately 20 per cent of the cases of irregularities notified in 2005 and involve some €95.2 million (£65.1 million). For agricultural expenditure, suspicions of fraud account for approximately 13 per cent of reported cases, involving some €21.5 million (£14.7 million). This is equivalent to 0.05 per cent of the European Agricultural Guidance and Guarantee Fund (EAGGF) Guarantee Section appropriations. In the area of Structural Funds, 15 per cent of notified irregularities were considered to be possible frauds, involving €205 million (£140 million).

2.38 OLAF also receives information regarding suspicions of fraud from other sources, such as the Commission and whisteblowers. In 2005 OLAF received a total of 857 such reports of suspected fraud (an increase of 20 per cent from 2004). This rise is attributed in part to changes in the way new information is recorded and in part to an increase in referrals from staff in European Union institutions and the general public.

2.39 OLAF noted that its estimates were dependent on the quality of information reported by Member States and should be treated with caution. For instance, approximately 26 per cent of irregularities and suspected frauds related to transactions which took place more than three years previously. Less than 70 per cent of irregularities were reported within one year of their discovery.

The United Kingdom's performance

2.40 In 2005, the United Kingdom reported 1,241 irregularities (including possible fraud) to OLAF, an increase of 48 per cent compared to 2004. This was the fourth highest number of reported irregularities, behind Germany (2,108 cases), the Netherlands (1,941 cases) and Spain (1,564 cases). The value of irregularities reported by the United Kingdom was €98.7 million (£67.5 million), 102 per cent more than in 2004. This was the fifth highest figure in the European Union, behind Germany, Greece, Spain and Italy. These data are also dependent on the quality of reporting by Member States, and should be treated with caution. OLAF considered that it is possible that some Member States are under reporting. As such, it may be inappropriate to make comparisons between Member States based on these data.

2.41 The increase in reported irregularities in the United Kingdom arose in the areas of Structural Funds and Traditional Own Resources. For Structural Funds (where the number of reported irregularities increased by 9,901 (45 per cent)) the Commission has attributed the increase to improved reporting compliance, improved audit programmes and the closure of projects. For Traditional Own Resources (where the number of reported irregularities increased by 40,625 (187 per cent)) the Commission has suggested that the increase is due to improved reporting compliance.

Fraud investigations pursued by OLAF in 2005

2.42 In 2005, OLAF opened 257 new cases, including cases for which OLAF monitors the investigations carried out by the authorities in Member States. Thirty-nine of these cases were in the United Kingdom, which was the fifth highest total behind Belgium (102 cases), Germany (87 cases), Italy (81 cases), and Spain (72 cases). These data are similar to 2004. OLAF closed 233 cases, leaving 452 cases outstanding at the end of 2005. Of the 233 cases that were closed, 133 were forwarded for prosecution and/or recovery of funds, while in the remaining 100 there was insufficient evidence of fraud to justify prosecution. 2005 was the first year where the number of cases closed that were forwarded for prosecution and/or recovery of funds exceeded the number of cases closed that were not. OLAF considered that this is indicative of an increase in substantive results obtained from investigations. Financial recovery also reached a new peak in 2005, with a total of €203 million (£139 million) recovered.

PART THREE

Improving financial management

3.1 The management of European Union finances is an issue of major interest to the United Kingdom Parliament. This was recognised by the House of Lords Select Committee on the European Union, who in 2006 carried out an inquiry in response to the Court's Annual Report concerning the financial year 2004. On 13 November 2006 the Committee published its report *Financial Management and Fraud in the European Union: Perceptions, Facts and Proposals*[26] which concludes on many of the issues examined below. This Part examines initiatives by the Commission and Member States to improve the financial management of European Union monies, in particular:

i) the introduction of an accruals-based accounting system;

ii) progress in implementing the Commission's Roadmap and Action Plan; and

iii) developments within the Court.

i) The introduction of an accruals-based accounting system

3.2 2005 was the first year in which the Commission produced accruals-based accounts. The 2005 accounts reflect the underlying legal obligations to make and receive payments entered into during the year, rather than simply the cash payments made. This change required a restatement of the opening balance sheet as at 1 January 2005 and changes in the presentation and content of the consolidated financial statements.

3.3 Despite the complexity of the issues raised by accruals accounting, the Commission met the deadlines set in the Financial Regulation for the presentation of the financial statements. This required updating and enhancing the accounting controls, which began in 2005 and has continued throughout 2006 and into 2007.

3.4 The Commission recognises that some further improvements in the accounting control environment are necessary. All but one of the 37 Directors-General were able to validate the relevant opening and closing balances in the accounts. In relation to the Directorate-General for Education and Culture, the Court's audit confirmed the general reservation regarding its share of assets and liabilities. This reservation arose due to inconsistent treatment of accrual accounting requirements in its accounting system. The Court also noted other concerns arising from the introduction of accruals-based accounts, for example with regard to the cut-off procedures for ensuring that transactions were recorded in the correct year. Overall, however, both the Court and the Commission considered that the introduction of accruals-based accounts was largely successful and was an important step in modernising the Commission's accounting systems.

ii) Progress in implementing the Commission's Roadmap and Action Plan to an Integrated Internal Control Framework

3.5 In January 2005, President Barroso made it a strategic objective of his Commission for 2005-2009 to strive for a positive Statement of Assurance.[27] In June 2005 the Commission published *A Roadmap to an Integrated Internal Control Framework*[28] (the Roadmap) based on an assessment carried out by the Commission to identify where existing internal controls fell short of those recommended by the Court. It set out its proposals for strengthening the financial management of European Union expenditure with a view to moving towards a positive Statement of Assurance.

3.6 In January 2006 the Commission published its *Action Plan towards an Integrated Internal Control Framework*[29] (the Action Plan), which identified four specific themes for action in implementing the Roadmap: sharing audit results and evaluating the costs and benefits of existing controls; remedying sector-specific gaps; simplification and the introduction of common control principles; and the use of management declarations and deriving greater assurance from audit.

Single audit approach: sharing results and prioritising cost-benefit

3.7 The Action Plan considered that an assessment of costs and benefits could be used to demonstrate that the controls in place for the management of European Union funds are cost-effective in reducing the risk of error at all levels. The Commission is due to present the results of an initial estimation of the cost of regulation per key policy area in 2007.

Remedying sector-specific gaps

3.8 The Action Plan identified the need to address certain specific gaps in the control framework, and to provide clearer guidance on managing the risk of error, in particular in relation to Structural Funds. 'Contracts of Confidence' are identified as one method of improving controls over Structural Funds. These may be offered to Member States, or a region, by the Commission based on its assessment of existing performance. In return for signing the Contract the Member State or region benefits from reduced scrutiny from the Commission. To date, two have been signed, one by Austria and one by the National Assembly for Wales. The Commission has informed us that other Member States have also expressed an interest in this initiative.

Simplification and common control principles

3.9 The Commission's assessment identified that irregularities were more likely to occur in areas where difficulties are encountered by beneficiaries in applying eligibility criteria and other conditions. The United Kingdom Committee of Public Accounts came to a similar conclusion in 2005 when it identified the complexity of existing programmes as a significant factor inhibiting the achievement of a positive Statement of Assurance.[30] To address this problem the Action Plan recommended simplifying the regulatory framework and identified the need for an overarching legal framework regarding internal controls.

3.10 Efforts to implement these two recommendations are ongoing. In relation to Common Agricultural Policy (CAP) expenditure, the introduction of the Single Farm Payment has resulted in some simplification, although verifying compliance with the criteria needed to qualify for the payment remains a complicated exercise. In October 2006 the Commission organised a simplification conference at which various stakeholders discussed their views and proposals for reducing the regulatory burden. The Directorate-General for Agriculture and Rural Development presented an action plan for simplification, which sets out specific actions to be taken in this area. The Council is currently considering a proposal for a single regulation for market support to replace the existing regulations for individual products.

3.11 In relation to Structural Measures, the Commission has agreed a new regulation for 2007-2013 that replaces the nine in force for the previous period. One set of detailed rules will now apply to the Structural Funds and the Cohesion Fund. The number of Council regulations has also been reduced, from seven down to five. In addition, increased decentralisation means that eligibility rules are no longer fixed at Community level for most operational programmes. For the new Financial Perspective national eligibility rules (set at national level only) will now apply, rather than the two sets of rules (one for Community co-financed projects and one for nationally-funded projects) that applied in the previous period. Although the new programmes will operate from 2007, the long lead time required for closing programmes from the previous period means that it will take some time before the full benefits can be realised.

3.12 The Court considered that the need for proportional and cost-effective controls was one of the most important objectives approved by the Commission. The Court noted that, in this context, the process of simplification of the spending programmes for the 2007-2013 Financial Perspective (e.g. greater use of flat-rate and lump-sum payments and simplified rules on procurement and grants), and the use of audit certificates and assurance declarations from third parties responsible for budget implementation tasks, could play a significant role in achieving progress towards this objective.

Management declarations and deriving greater assurance from audit

3.13 One of the recommendations in the Roadmap was the suggestion that Member States provide annual disclosure statements and declarations of assurance detailing how European Union funds had been spent. The European Parliament had previously recommended such declarations in its 2003 discharge resolution, suggesting they be signed by a Minister and then audited by the Supreme Audit Institution of each Member State, to provide assurance to national parliaments over European expenditure.

3.14 This recommendation was not supported by the Council, who concluded instead that existing operational-level declarations could provide an important means of assurance. Consequently, the Action Plan seeks to ensure that operational-level declarations provide the maximum impact for the purpose of gaining assurance over European expenditure.

Assurance provided by the Directors-General

3.15 Since 2001 each Director-General has been required to prepare an Annual Activity Report. This document is a management report to the Commission on the Directorate-General's performance in relation to its management of the budget. If a Director-General considers there are material internal control weaknesses, he will qualify his declaration and issue reservations, which explain the nature of the deficiencies and the effect they have on the assurance that can be taken from the controls. Action plans are required to remedy such weaknesses.

3.16 For 2005 all Directors-General stated they had obtained reasonable assurance that resources allocated to them were used for the specified purposes, and that internal controls ensured the underlying transactions were legal and regular. The Court reported the overall number of reservations was broadly unchanged from last year – 31 in 2005 compared to 32 in 2004. Twenty-one of the 40 declarations contained one or more reservations. The Court noted a general improvement in the quality of the assessment of the functioning of the supervisory and control systems, and also of the overall impact of the reservations on the assurance given in the declarations. As in 2004, however, the Court considered that some significant weaknesses identified by its audits should have been included in the declarations of the Directors-General.

3.17 Although the Commission considered that the Directors-General had substantiated the detail underpinning their declarations, the Court considered that, despite the strengthened preparation process, some Annual Activity Reports[31] do not yet provide sufficient evidence for its Statement of Assurance.

3.18 The Court made three recommendations aimed at strengthening the supervisory and control systems of the Directorates-General as follows:

- the Commission should ensure the full application of the guidelines on the Annual Activity Reports from the central services, especially concerning the materiality and the impact of reservations on the declarations;
- the Commission should improve the effectiveness of the application of the internal control standards by systematically analysing the impacts achieved; and
- the Commission should develop specific indicators regarding the effective functioning of key controls and the legality and regularity of underlying transactions in order to allow the assessment of improvements over time in the supervisory and control systems.

National statements of assurance

3.19 Some Member States have decided to develop national statements of assurance to strengthen their management of European Union funds. In the Netherlands a national declaration will be prepared annually for all European Union expenditure under shared management and for the Dutch contribution to the European Union's own resources from 2007 onwards, with an interim statement covering only agricultural expenditure in 2006. The declaration will be both: on the proper functioning of the control systems; and of assurance on the legality and regularity of the transactions. It will be based on sub-declarations provided by each department covering each area of European Union expenditure. The Netherlands Court of Audit will give an external audit opinion on the consolidated declaration. As this will be in the public domain it can be made available to the Commission and the Court should they wish to make use of it.

3.20 Similar initiatives are being pursued in other Member States. The National Audit Office of Denmark presented a statement on the audit of European Union funds in Denmark to their Committee of Public Accounts in November 2006. The audit is based on the same materiality and risk considerations as apply to the audit of domestic funds. It examines both the control systems that manage European Union expenditure and a sample of transactions and projects in order to confirm compliance with the relevant rules and legislation.

3.21 In the United Kingdom, the Economic Secretary to the Treasury announced in November 2006 that the Government intend to prepare and lay before Parliament an annual consolidated statement on the United Kingdom's use of European Union funds. The statement will be audited by the Comptroller and Auditor General. At present, European Union monies are accounted for within the accounts of the relevant expenditure bodies in the United Kingdom but not consolidated into a single statement. The proposal is intended to improve financial management of European Union funds, and could in addition provide the Court with a source of assurance. Details of the statement's format, timetable for production, and accounting year are currently being finalised by Her Majesty's Treasury in consultation with departments and the National Audit Office.

3.22 Each year the heads of the Supreme Audit Institutions (SAIs) of the Member States and the President of the Court assemble to discuss matters of common interest. This gathering is known as the Contact Committee. The most recent meeting was in December 2006, where the Committee discussed the SAI's contribution to the improvement of accountability for European Union funds, and specifically work undertaken by the Netherlands, Denmark and the United Kingdom in producing national statements of assurance. A range of views were expressed by SAIs during the course of the meeting; the majority were supportive of the concept of national statements. To facilitate this work a Resolution was passed to convene during 2007 a Working Group, chaired by the Court, to develop common auditing standards and comparable audit criteria based on internationally recognised auditing standards, tailored for the European Union.

3.23 In March 2007 the Commission published a progress report on the implementation of the Action Plan[32]. The report considered that the Commission has made concrete progress on the Action Plan, however the effect of this has not yet been examined by the Court.

iii) Developments within the Court

3.24 In its 2005 report *Financial Management of the European Union* the United Kingdom's Committee of Public Accounts urged the Court to consider arranging a peer review of its approach and test the quality and relevance of its work. The Court is currently preparing for an external peer review. In advance of this, the Court has carried out a self-assessment using a structured model developed by the European Institute for Public Administration and the Innovative Public Service Group. The self-assessment has resulted in an action plan that is currently being implemented.

3.25 The 2005 report from the United Kingdom's Committee of Public Accounts also suggested that there was scope for the Court to undertake more audit of the performance of Commission activities. Staff interviewed by us at the Commission reported that they had found the Court's recent Special Reports to be useful in highlighting weaknesses and identifying ways to improve internal procedures and controls. The Court informed us that it is now allocating more resources to carrying out performance audit.

APPENDIX ONE

Study methodology

1 For each of the last twelve years, the Comptroller and Auditor General, the head of the National Audit Office, has reported to the United Kingdom Parliament on financial management in the European Union. This report seeks to identify the key issues in relation to the main areas of expenditure and the Court's opinion on the 2005 accounts, and to bring together the findings contained in various documents produced by the European Institutions. The key documents referred to in the production of this report are:

- The European Court of Auditor's *Annual report concerning the financial year 2005* http://www.eca.eu.int/audit_reports/annual_reports/docs/2005/ra05_en.pdf
- OLAF's *Report from the Commission to the European Parliament and the Council: Protection of the Communities' financial interests – Fight against fraud – Annual report 2005* http://ec.europa.eu/anti_fraud/reports/commission/2005/en.pdf

  and its *Annex* http://ec.europa.eu/anti_fraud/reports/commission/2005/annx2_en.pdf
- OLAF's *Operational Activity Report* for the period 1 July 2004 to 31 December 2005 http://ec.europa.eu/anti_fraud/reports/olaf/2005/en.pdf
- The *Annual Activity Reports* of various Directors-General of the Commission, in particular the Directors-General for: Agriculture and Rural Development; Regional Policy; the Budget; and OLAF http://ec.europa.eu/atwork/synthesis/aar/index_en.htm
- The European Parliament's *Discharge Report* on the European Union general budget for the financial year 2004, Section III – Commission http://www.europarl.europa.eu/comparl/cont/site/auditions/joint_meeting/p6_ta-prov(2006)0157_en.pdf

2 In addition, we examined subsequent developements relating to the recommendations of the United Kingdom's Committee of Public Accounts as set out in its report of January 2005 *Financial Management in the European Union*. This is examined in Appendix 4.

3 Our work for this report is based primarily on a review of the Annual Reports concerning the financial year 2005 produced by the Court and OLAF. This was supplemented by interviews with officials at the following organisations:

- European Court of Auditors
- European Commission:
  - DG REGIO – the Directorate-General for Regional Policy
  - DG AGRI – the Directorate-General for Agriculture and Rural Development
  - EuropeAid – the Directorate-General for External Aid
  - OLAF – the European Union's Anti-Fraud Office
- Foreign and Commonwealth Office
- Her Majesty's Treasury.

APPENDIX TWO

The European Union's budgetary process

1 The structure of the European Union is shown in **Figure 10**. The Council and Parliament act jointly as the budgetary authority to approve the budget proposed by the Commission. The annual budgets are set within a seven year expenditure framework known as the Financial Perspective, which sets out the budgetary priorities for that period. The European Union budget is not allowed to be in deficit.

2 The preliminary draft budget is prepared by the Commission, based on a proposal submitted by the Directorate-General for the Budget. This is submitted to the Council in April or May each year, who examine and amend the figures. The Council's draft budget must be adopted by qualified majority, by 31 July. Parliament conducts its first reading in October, and may propose amendments to the draft budget. These amendments are reviewed again by the Council, before Parliament reviews and adopts the final budget. In the case of disagreement, Parliament can refuse to adopt the budget. In such instances, the Community may have to start the budgetary year with only a provisional budget in place, while the budgetary procedure goes on to an informal 'third reading'. The Commission may also propose amendments to the budget throughout the year, which may be adopted using the same procedures. This allows the Community to adjust the budget for developments during the year, such as unexpectedly high revenue or low expenditure.

3 Once the budget is adopted, it is implemented by the Commission, which distributes funds to Institutions and Member States. Some 80 per cent of Community funds are administered through shared management arrangements with national, regional and local authorities within Member States. Each Directorate-General manages the programmes and activities in their particular policy area, in liaison with their counterparts in Member States.

4 The consolidated financial statements for the European Union are drawn up each year by the Directorate-General for the Budget on behalf of the Commission as a whole, and are audited by the Court. The Commission and Member States provide responses to the findings of the Court. The Council and the Parliament examine the accounts of the European Community together with the Court's report and responses, and a report from the Commission's internal auditors. The Council, by 31 March of the year following publication of the Court's report, makes a recommendation to the Parliament on whether to grant 'discharge' for the budget (to signify that Parliament considers the stewardship of Community funds has been sound and according to instruction, and that expenditure is in line with the objectives set in the budget). Parliament's Budgetary Control Committee examines the report and the Council's recommendations and produces a draft discharge decision and motion for a resolution. By 30 April, Parliament votes on the decision and motion, having received recommendations from the Council. The Commission is obliged to take follow-up action on the conclusions reached and recommendations made by Parliament and the Council.

10 The five institutions of the European Union

The European Parliament

- 732 elected members
- Scrutinises the European Union's decision making process
- An arm of the Community's budgetary authority
- Administrative spend: €1.2 billion (£0.8 billion)

The Council of the European Union

- One Minister from each Member State
- Senior legislative body of the Community
- An arm of the Community's budgetary authority
- Administrative spend: €507 million (£347 million)

The European Commission

- One Commissioner from each Member State
- Proposes and executes Community policies and ensures each Member State meets their Treaty obligations
- Implements the budget
- Administrative spend: €4.0 billion (£2.7 billion)

The European Court of Justice

- One judge from each Member State
- Rules on the questions of Community law and whether actions taken by Community institutions, member Governments and other bodies are compatible with the Treaties
- Assisted in some cases by the Court of First Instance and the European Civil Service Tribunal
- Administrative spend: €211 million (£144 million)

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: €92 million (£63 million)

Source: National Audit Office

NOTE

Total administrative expenditure by European Union Institutions in 2005 was €6.2 billion (£4.2 billion). The five institutions listed above accounted for €6.0 billion (£4.1 billion). The European Economic and Social Committee; the Committee of the Regions; the European Ombudsman; and the European Data Protection Supervisor accounted for the remaining €0.2 billion (£0.1 billion).

APPENDIX THREE

Special Reports published by the European Court of Auditors in 2006

Special Report 1/2006	The contribution of the European Social Fund in combating early school leaving
Special Report 2/2006	The performance of projects financed under TACIS in the Russian Federation
Special Report 3/2006	The European Commission Humanitarian Aid Response to the Tsunami
Special Report 4/2006	Phare investment projects in Bulgaria and Romania
Special Report 5/2006	The MEDA programme
Special Report 6/2006	The environmental aspects of the Commission's development cooperation
Special Report 7/2006	Rural Development Investments: Do they effectively address the problems of rural areas?
Special Report 8/2006	Growing success? The effectiveness of the European Union support for fruit and vegetable producers' operational programmes
Special Report 9/2006	Translation expenditure incurred by the Commission, the Parliament and the Council
Special Report 10/2006	Ex post evaluations of Objectives 1 and 3 programmes 1994-1999 (Structural Funds)
Special Report 11/2006	The Community transit system

APPENDIX FOUR

The Committee of Public Accounts' report *Financial Management in the European Union*: subsequent developments

Committee of Public Accounts report	Subsequent developments
1 **Historically, accountability and audit arrangements of the European Union have been characterised by inertia among the Institutions.** Since the Committee's last visit, the Commission has started to implement a program of reform and there is movement to more accountable and transparent ways of working. The Commission is committed to change but there is still a long way to go to secure the standards that the European taxpayers are entitled to expect.	Work to reform the Commission's accountability and audit arrangements is ongoing. Several developments are examined below.
2 **The size of the European union overall budget and the United Kingdom's contribution to it emphasises the need for strong financial management and frameworks of accountability.** For the tenth year in succession the Court qualified its opinion on the reliability of the Community annual accounts and did not provide a positive opinion on the main five out of the six payment headings. The lack of a positive Statement of Assurance undermines public confidence in European Institutions.	The Court has now issued a qualified Statement of Assurance for twelve years in succession. The Court's opinion on expenditure in 2005 provided a clear opinion for administrative expenditure and pre-accession strategy with the exception of one programme. The other four areas received qualified opinions, although the Court noted that in relation to expenditure under the Common Agricultural Policy, the Integrated Administration and Control System was effective in limiting the risk of irregular payments where it was properly implemented. This is examined in Part 2 of this report.
3 **Despite the continued qualification of the Community accounts, the Commission has made some progress in improving financial management.** The Court identified improvements in the quality of the annual reports intended to enhance the accountability of each Directorate-General and it noted that the Commission had made good progress in designing internal control systems. The introduction of a new accruals accounting system, with supporting IT, is another welcome development especially as the qualification on the reliability of the accounts was attributable largely to weaknesses in the previous accounting systems. The Commission has also established an Internal Audit Service which reports to an independent audit committee with six members, two of which are external appointments.	The Court's most recent Annual Report notes a continued improvement in the Commission's internal control system. Accruals-based accounting has been introduced on time. The Court has commended the Commission's introduction of the new accruals-based accounting system. This is examined in Part 3 of this report.

Committee of Public Accounts report	Subsequent developments
4 It is difficult to obtain a clear indication of the extent of the problems relating to the legality and regularity of European Union expenditure. It would be helpful if the Court's annual report could indicate more clearly its assessment of the legality and regularity of each area of the budget. In addition, the report could usefully give an indication of how much progress or otherwise the Commission is making both generally and under each of the six expenditure headings and it could also point to developments within Member States. Such enhancements could assist the Commission and the Member States in making the necessary improvements to move forwards to an unqualified opinion on the accounts. In the meantime, the Court could consider the scope for producing a separate Statement of Assurance for each expenditure heading and for each Member State.	The Court's most recent Annual Report is shorter than in previous years. The Court currently has no plans to produce a separate Statement of Assurance for each expenditure heading or for each Member State.
5 A major factor contributing to the qualified audit opinion is the level of errors identified by the Court. This is partly due to the complexity of the schemes and programmes, particularly for payments under the Common Agricultural Policy and Structural Measures. In designing schemes and programmes, the European Institutions should consider the relationship between desired outcomes of a particular scheme, the complexity of the rules governing it and the consequential likelihood of an error occurring. There is also a lack of common understanding between the Commission and the Court about the definition of error. This should be resolved.	There has been some progress in simplifying the regulations governing expenditure in the new Financial Perspective. Simplification is one of the themes identified in the Commission's 'Action Plan towards an Integrated Internal Control Framework' (the Action Plan), discussed below. This issue is discussed further in Part 3 of this report.
6 The Barroso Commission has committed, as one of its objectives for the next five years, to move towards a positive Statement of Assurance in order to enhance accountability. The European Institutions, led by the Commission and supported by the Member States, have agreed on the need for a road map intended to achieve this objective. The road map will be built on the principles of the Community Internal Control Framework recommended by the Court. Under the road map, the Commission would be responsible for promoting improvements in internal controls in partnership with Member States.	The 'Roadmap to an Integrated Internal Control Framework' (the Roadmap) was published in June 2005. This was followed by the Commission's Action Plan in January 2006. Progress in implementing the Action Plan is examined in Part 3 of this report.
7 The commitment by all parties concerned to progress towards a positive Statement of Assurance is welcome, but the scale of the task ahead is formidable. The European Union's budget covers six expenditure headings and is spent by 25 Member States as well as third countries and the Institutions. Some of the Member States have federal structures and autonomous regions. With this variety of transactions and the number of bodies and systems which manage and control them it is far from clear how quickly this worthy ambition can be achieved.	The Commission believes that its Action Plan, discussed above, provides the framework for the changes needed to moves towards a positive Statement of Assurance. Some Member States, including the United Kingdom, are developing their own national statements of assurance, which may also be of use to the Court in forming its opinion. This is discussed in Part 3 of this report.
8 There is scope for more value for money work and reporting by the Court. The Court has a duty to examine "whether the financial management has been sound", corresponding broadly to audits of economy, efficiency and effectiveness by the Comptroller and Auditor General in the United Kingdom. The results of the Court's work in this area are included in its Annual Report and in Special Reports. But the scale of this is totally inadequate given the importance of ensuring the effective use of Community funds.	Officials within the Commission interviewed by us rate the Court's Special Reports as useful in identifying weaknesses and opportunities for improvement. The number of Special Reports published by the Court is broadly in line with previous years, although the Court considers that the quality of its reports has improved over time as staff have become more experienced. The Court's most recent Special Reports are listed in Appendix 3.

Committee of Public Accounts report	Subsequent developments
9 No independent review of the Court's work has taken place since it was set up in 1977. Unlike the United Kingdom National Audit Office, the Court does not report on its own performance to anyone. The Court should therefore consider arranging a peer review of its approach and work to test the quality and relevance of what it does and demonstrate its willingness to learn from others.	The Court is currently undergoing a process of peer review. In February 2006, management consultants from the European Institute of Public Administration completed a structured assessment of the Court's operations. The Court is in the process of agreeing an action plan to deal with the issues that have been identified.
10 The precise level of fraud against European funds is unclear at present. Differentiating between fraud and irregularity is complex. For example, Member States are required to report irregularities, including fraud, to the Office Européen de Lutte Anti Fraude (OLAF), the European anti-fraud office, but they do not do so on a consistent basis. OLAF's current work on a methodology to distinguish between irregularity and intentional fraud is clearly a priority.	In his evidence to the House of Lords Select Committee on the European Union, Mr Nicholas Illett of OLAF made it clear that OLAF still faces challenges in determining precisely the level of fraud in the European Union's budget. Estimates of fraud are based on information reported by Member States, and some Member States may not report an irregularity as a suspected fraud until there has been a conviction and therefore not until some significant time after the fraud was perpetrated.
11 The United Kingdom Government should utilise the occasion of the Kingdom Presidency to improve accountability in the European Union. Specifically, it should: a) As a top priority, press for the simplification of the rules and regulations of the Common Agricultural Policy and Structural Funds to reduce the scope for fraud and error so as to increase the prospects of achieving a positive Statement of Assurance; b) Support, and encourage other Member States to support, the development of the road map for a positive Statement of Assurance. In particular, attention should be focused on ■ identifying the reasons the Court is unable to provide a positive Statement of Assurance on the legality and regularity of the underlying transactions; ■ the action the Commission and National Authorities need to take in each of the areas which are a cause for concern, with a specific focus on the major areas of European Union spending, support for agriculture through the Common Agriculture Policy and the Structural Measures; and ■ the prospects of National Authorities entering into 'Contracts of Confidence' and the likely value of such contracts for accountability; c) encourage, with other Member States and the Commission, an increased focus on value for money work in the Court given the importance of ensuring the effective use of Community funds; and d) support OLAF's efforts to obtain a clearer picture of the scale of irregularity, including fraud, by: ■ encouraging Member States to: i) fulfil their obligation to protect Community Funds as they protect National Funds; ii) deter crime against European interests by identifying those responsible and applying effective penalties and sanctions; ■ setting a good example to the other Member States by complying with OLAF's guideline for reporting irregularities; and ■ encouraging a programme of secondments to OLAF from a wide range of United Kingdom institutions, including the police force.	Progress made during the United Kingdom's presidency of the European Union (from 1 July 2005 to 1 December 2005) was examined in our last report on this subject.[33] Progress was made in pursuing the Commission's Roadmap, culminating in the publication of the Action Plan in January 2006. This is examined in Part 3 of this report.

ENDNOTES

1 This, and all figures in this report, has been converted at the 2005 average exchange rate of €1 = £0.68421. The use of a constant exchange rate aids comparisons between different periods, however sterling figures which do not relate to 2005 do not therefore represent the precise sterling value of transactions made in the past or balances outstanding. These exchange gains or losses are not considered material.

2 With the exception of the SAPARD programme (Special Accession for Agriculture and Rural Development) which provides financing for a wide range of measures for structural adjustment of agriculture and rural development in accession countries.

3 *Financial Management of the European Union*, Eighteenth Report of Session 2004-05, HC 498, March 2005. Subsequent developments relating to the recommendations of this report are examined in Appendix 4.

4 Hansard, 20th November 2006, Col 14WS.

5 The ten new Member States were Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Bulgaria and Romania subsequently joined the European Union on 1 January 2007.

6 The Community budget can be analysed both in terms of payments and in terms of commitments. The budget for payments sets a limit for the amount that can be disbursed in the year. The budget for commitments sets a limit to the level of binding agreements to make payments (such as contracts and financing agreements) that can be made in the year, regardless of when the payment takes place.

7 Early or mid 2009 in some cases.

8 The abatement paid each year is a provisional payment, which is subsequently adjusted once the final figures are known.

9 The Treaty of Paris, the Treaty of Rome and the Maastricht Treaty are the main treaties which led to the creation of the European Union.

10 Article 188c of the provisions amending the treaty establishing the European Economic Community with a view to establishing the European Community (Title II).

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

12 The Commission is divided into a number of distinct departments called Directorates-General, each of which is responsible for specific tasks or policy areas. The head of each department is called the Director-General.

13 Pre-financing represents cash payments made to beneficiaries in advance of actual expenditure by them, to provide the recipient with a cash float.

14 Such as those published by the International Organisation of Supreme Audit Institutions (INTOSAI) and the International Federation of Accountants (IFAC).

15 Common Agricultural Policy, Structural Measures, Internal Policies, External Actions, Pre-Accession Strategy and Administrative Expenditure.

16 These figures are the actual payments made from the budget, as opposed to committed expenditure which had not been paid at the year end.

17 The Single Area Payments Scheme replaces all direct aid with a single payment. It involves payment of a uniform amount per hectare of agricultural land. Eight of the ten new Member States (Malta and Slovenia excluded) apply it.

18 *The Delays in Administering the 2005 Single Payment Scheme in England*, HC 1631 2005-06.

19 These figures are the actual payments made from the budget, as opposed to committed expenditure which had not been paid at the year end.

20 As noted at paragraph 1.4, the European Union works within a seven year budgetary cycle known as a Financial Perspective, in addition to the annual budgets.

21 The EAGGF-Guidance fund contributes to the structural reform of the agricultural sector and the development of rural areas.

22 See the definition in Council regulation no 2988/95 of 18 December 1995.

23 See the definition in Article 1 of the Convention on the protection of the European Communities' financial interests of 26 July 1995 (OJ C 316, 27.11.95).

24 From the French, Office Européen de Lutte Anti-Fraude.

25 These statistics relate only to irregularities and suspicions of fraud reported by Member States in the expenditure for which they are jointly responsible under shared management, which represents approximately 80 per cent of European Union expenditure.

26 http://www.publications.parliament.uk/pa/ld200506/ldselect/ldeucom/270/270i.pdf

27 Communication from the Commission of 26 January 2005 Strategic Objectives 2005-2009, Europe 2010: A Partnership for European Renewal: Prosperity, Solidarity and Security (COM(2005)0012).

28 Communication from the Commission to the Council, the European Parliament and the European Court of Auditors on a roadmap to an integrated internal control framework – COM (2005) 252, 15 June 2005.

29 Communication from the Commission to the Council, the European Parliament and the European Court of Auditors Commission Action Plan towards an Integrated Internal Control Framework – COM (2006) 9, 17 January 2006.

30 *Financial Management of the European Union, Committee of Public Accounts*, Eighteenth Report, Session 2004-05, HC 498.

31 Directorates-General for: Agriculture and Rural Development; Employment; Social Affairs and Equal Opportunities; and Regional Policy.

32 Report from the Commission to the Council, the European Parliament and the European Court of Auditors on the progress of the Commission Action Plan towards an Integrated Internal Control Framework – COM (2007) 86, 7 March 2007.

33 *Financial Management in the European Union*, HC 999, 2005-06.

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A report by the Comptroller and Auditor General

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