National Audit Office

Financial Management in the European Union

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 480 Session 2007-2008 | 25 April 2008

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Financial Management in the European Union

A report by the Comptroller and Auditor General

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Tim Burr
Comptroller and Auditor General
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18 April 2008

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SUMMARY

1 In 2006, expenditure by the European Union totalled €106.6 billion (£72.7 billion) and its revenue was €108.4 billion (£73.9 billion). The United Kingdom made a net contribution to the European Union of €4.3 billion (£2.9 billion), the highest after Germany.

2 The European Court of Auditors (the Court) published its report on the implementation by the European Commission (the Commission) of the 2006 budget in November 2007. For the thirteenth successive year the Court did not provide a positive Statement of Assurance on the legality and regularity of most European Community expenditure.

3 In January 2005, the Commission made it a strategic objective to strive for a positive Statement of Assurance from the Court. In January 2006 the Commission published an Action Plan setting out a series of measures designed to achieve this objective. In February 2008 the Commission published its final report on the Action Plan, highlighting that most actions are complete but it will take time before they feed through into a measurable impact on error rates.

4 This report continues our practice of recent years of informing the United Kingdom Parliament of the results of the examination of the European Union accounts by the Court and progress on the range of initiatives by the Commission, in cooperation with Member States, to improve financial management and control. The report follows up themes identified by the Committee of Public Accounts in its 2005 report on Financial Management in the European Union, notably the need to simplify European Union programmes and reduce the risk of error. The findings of the report, including progress made by the Commission, are outlined in Appendix 5. This report covers:

- The European Union's budget and the opinion of the European Court of Auditors on the 2006 financial year;
- The performance on the main expenditure areas; and
- Developments in financial management and accountability.

Our methodology is summarised at Appendix 1.

Findings and recommendations

5 The Court's latest report identified some improvements in the financial management of European Union funds in 2006, specifically in the legality and regularity of expenditure. The Court concluded that the accounts were *reliable*, faithfully reflecting revenue and expenditure for the year, but it noted some errors in balance sheet items. It also found that, with respect to some areas[a] the underlying transactions taken as a whole were *legal* and *regular*. However, on the main areas of expenditure, the Common Agricultural Policy and Structural Funds, it reported material errors which mean that the underlying expenditure transactions, in some cases, are not *legal* or *regular*.

6 In the Common Agricultural Policy, the Court noted a marked reduction in the overall estimated level of error to a point where it was just above the level at which a positive opinion could be given. The introduction of the Single Payment Scheme and the increasing application of the Integrated Administration and Control System were important factors in the reduction in the rate of error. The Court again found a material level of error in Common Agricultural Policy programmes not covered by the Integrated Administration and Control System or where it was not properly applied.

7 The new Single Payment Scheme replaced eleven previous schemes based on subsidies for production with one single subsidy based on land farmed. Its implementation simplified Common Agricultural Policy expenditure in the ten Member States where it was applied in 2005. A further five Member States implemented this system in 2006. In these early stages, however, the Court's findings included some problems with the United Kingdom's implementation of the Scheme. Some of these issues arose because the United Kingdom's interpretation of the European Regulations differed from that of the Court.

8 We have reported separately on the delays and errors in payment that affected farmers in the United Kingdom during the introduction of the Single Payment Scheme, and the action being taken to address these delays. The Department for Environment, Food and Rural Affairs included provisions totalling some £348 million in its accounts for 2006-07 as an estimate for potential financial corrections arising from: disallowed payments under the Single Payment Scheme for 2005 and 2006 (£221.7 million); and for other schemes administered by the Rural Payments Agency and Devolved Administrations (£126.3 million).

9 The Court concluded that expenditure on Structural Measures projects was subject to material error and reported that at least 12 per cent should not have been reimbursed in 2006 because control systems in the Member States were generally ineffective, or moderately effective and their supervision by the Commission was only moderately effective. The Member States and the Commission are working to improve transparency through the use of annual summaries but, due to the relative complexity of the Structural Measures budget area, achieving a positive Statement of Assurance for this expenditure remains the most challenging component of the budget.

10 The Court highlighted a number of problems with the United Kingdom's management of Structural Measures. The Commission formally suspended payments to six English Regions from April 2007 until it could confirm that control systems were working effectively. Following improvements by the Department for Communities and Local Government, the Commission has since lifted the suspensions on all except the North West Objective 2 and URBAN programmes. The Commission has confirmed a decision to impose a financial correction of some €25 million (£17 million) on the United Kingdom.

a Revenue; commitments; administrative expenditure; external action payments managed directly by the Commission; and expenditure on pre-accession (with the exception of the Special Accession Programme for Agriculture and Rural Development).

11 The relevant United Kingdom authorities (administering Structural Measures and the Common Agricultural Policy) should ensure that they design and maintain controls that are sufficient and proportionate to meet Commission requirements and minimise the risk to Exchequer funds. They should redouble their efforts to make sure that guidance issued to the relevant public bodies and funding recipients clarifies the scheme requirements and reinforces the importance of carrying out management checks, as appropriate to the individual schemes.

12 The Commission's ability to reduce the level of error on Structural Measures will depend, in part, on how efficiently and quickly it can close older programmes. In the past, the closure of previous period programmes working to one set of rules created additional complexity for Member States and the Commission as they start up programmes working to a new set of rules. The Court noted that at the end of 2006 some €131.6 billion (£89.8 billion) of commitments relating to the 2000-2006 Financial Framework were yet to be paid. The majority of these related to Structural Measures, equivalent to 2.5 years' expenditure at the 2006 spending rate. **United Kingdom departments responsible for distributing monies should work to close the 2000-2006 programmes as quickly as possible to ensure that resources can be focused on bringing programmes in the new Framework into operation.**

13 A number of Member States have indicated their intention to explore some form of enhanced reporting to improve the transparency of the expenditure of European Union Funds to their national parliaments. In November 2006 HM Treasury announced that it would produce an annual consolidated statement on the United Kingdom's use of European Union funds (sometimes referred to as a National Declaration). It expects to publish the first such statement for the period 1 April 2006 to 31 March 2007 in May 2008. The statement will be prepared to international accounting standards and will be audited by the National Audit Office. **HM Treasury, working with officials at United Kingdom Permanent Representation to the European Union, should play a proactive part in exploring options for increasing transparency, in relation to European Union funds, with other Member States.**

14 In May 2006, the European Parliament, the Council and the Commission agreed that the Commission should undertake a fundamental review of the European Union budget, both of expenditure (including the Common Agricultural Policy) and of resources (including the United Kingdom abatement), to report in 2008-2009. **The United Kingdom departments should engage fully with this process with the aim of encouraging further simplification and improving transparency.**

15 Data from the European Anti-Fraud Office (OLAF) showed that the number of irregularities reported to the Commission, including possible fraud, decreased by 7.3 per cent in 2006, but the total value of reported irregularities increased by some 10 per cent to €1,155 million (£788 million). OLAF noted that its estimates depended on the quality of information reported by Member States and should be treated with caution (particularly comparisons across Member States). **HM Treasury should press OLAF and other Member States to develop a consistent arrangement for reporting and recording fraud across the European Community**.

Overall conclusion

16 The Commission, through its Action Plan, and Member States have made progress in strengthening the financial management of European Union funds, most notably for the Common Agricultural Policy. The achievement of a positive Statement of Assurance remains a significant challenge for the future. It is essential to maintain the momentum begun by the Action Plan; this will involve support and cooperation by all the authorities – the European Parliament, the Council of the European Union, the Commission, the European Court of Auditors and the Member States.

PART ONE

The European Union's budget and the opinion of the European Court of Auditors

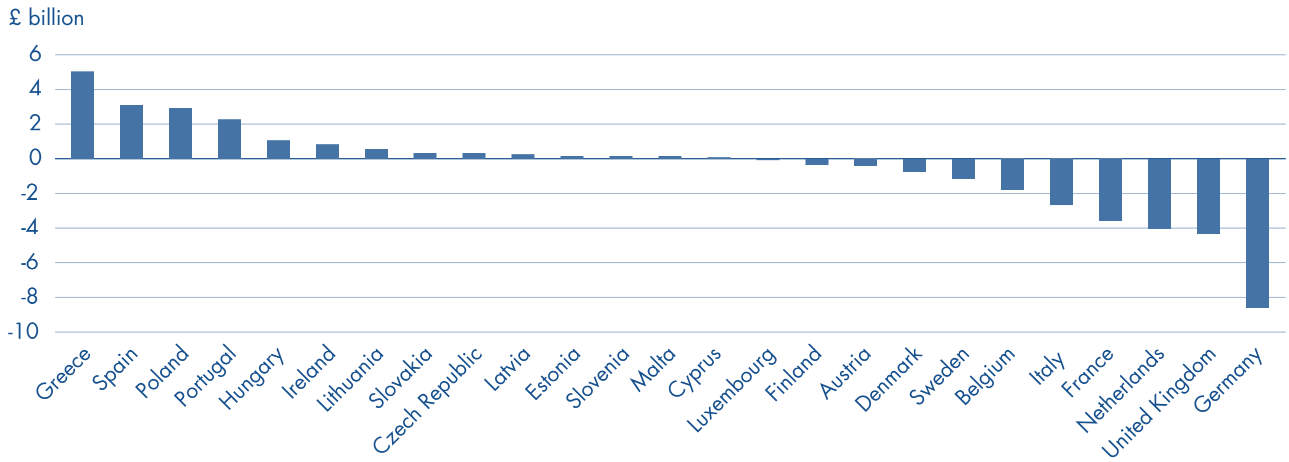
1.1 This Part summarises the main conclusions of the European Court of Auditors' Statement of Assurance on the consolidated financial statements for the European Communities for the year ended 31 December 2006.

1.2 In 2006 the final budget for payments was €107.4 billion (£73.3 billion)[1], a 1.8 per cent decrease on the final budget in 2005. In 2006 actual payments totalled €106.6 billion (£72.7 billion), a 1.7 per cent increase on 2005 and revenue was €108.4 billion (£73.9 billion), a 2.6 per cent increase on 2005. Background to the 2006 budget and more details of the European Union's budgetary process are provided at Appendix 2.

1.3 The United Kingdom, with the second largest economy in the Union, made a gross contribution of €12.4 billion (£8.5 billion) to the budget of the European Community in 2006; its net contribution was €4.3 billion (£2.9 billion)[2], the highest after Germany, and compares with €3.7 billion (£2.5 billion) in 2005. 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 1**.

1.4 The United Kingdom's contribution reflected an abatement, which was €5.2 billion (£3.5 billion) in 2006. In December 2005, the Council of the European Union 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 2007–2013 Financial Framework has been capped at €10.5 billion (£7.2 billion). This reduction is unlikely to alter the United Kingdom's position as second highest net contributor behind Germany.

1 Net Receipts/Payments for 2006



Source: Data from the European Court of Auditors' Annual Report for the financial year 2006

The Court's Statement of Assurance on 2006 accounts

1.5 The Court audits the revenue and expenditure of the European Union. The Treaty establishing the European Community[3] 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.[4] It requires the Court to provide the European Parliament and the Council with a Statement of Assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions **(Figure 2)**.[5] Further information about the Court is included at Appendix 2. 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 2007 it published nine such reports, listed in Appendix 6.

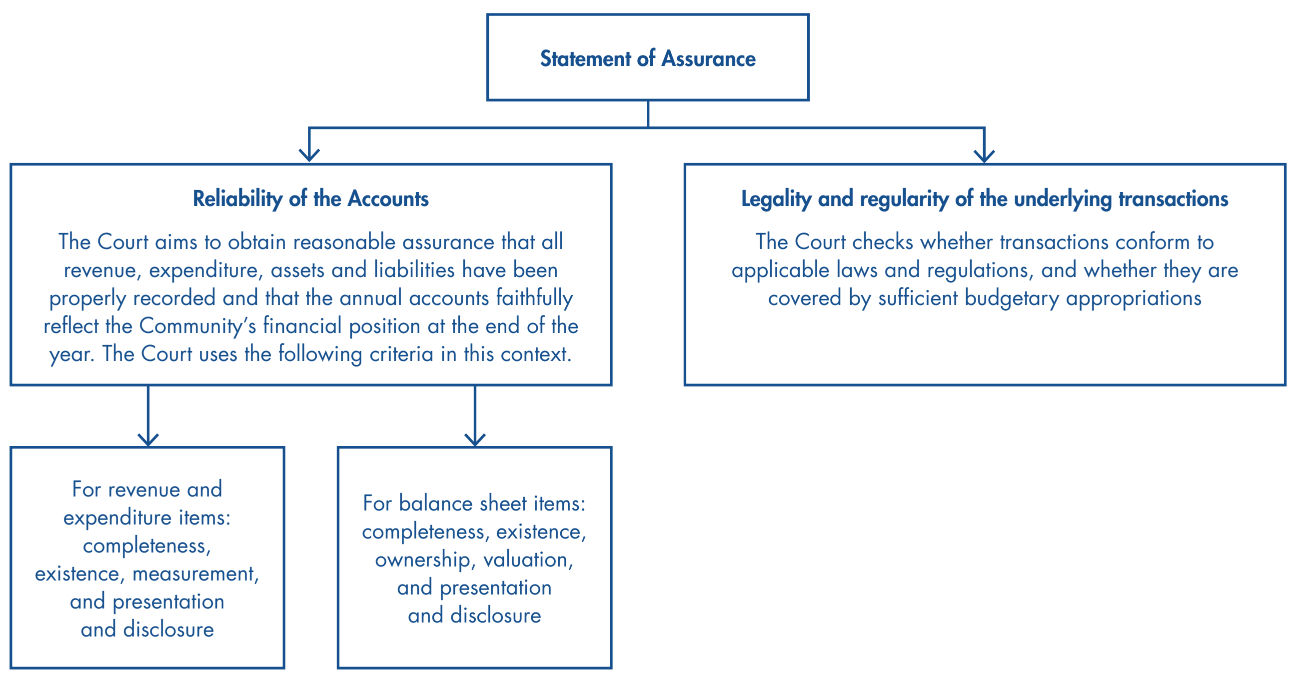
1.6 In November 2007, for the thirteenth successive year, the Court did not provide a positive Statement of Assurance on the accounts of the European Union's accounts. The report, covering the 2006 financial year, noted that significant weaknesses remained in the supervisory and control systems in several areas of income and expenditure, but found a marked reduction in the estimated overall level of error in Common Agricultural Policy expenditure. The main components of the Statement of Assurance are explained in Figure 2.

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

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

- The Court identified errors in invoices/cost statements and pre-financing (cash payments made to beneficiaries in advance of actual expenditure by them, to provide the recipient with a cash float) which resulted in an overstatement of the amounts recorded in the balance sheet; these were of a similar nature to those in the previous year. The Court noted that, although errors were at a material level in terms of frequency and financial impact for certain items, they were not material for the accounts overall.

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



Source: National Audit Office

- The Commission produced accruals-based accounts for the second year in 2006 and a number of measures were introduced to consolidate and improve the system. The Commission recognises that some further improvements in the accounting control environment are still necessary, for example, the cut-off procedures for ensuring that transactions were recorded in the correct year. Overall, however, the Court concluded that the Commission's measures have helped strengthen the financial reporting framework and accounting systems and the Commission states progress is being made in the outstanding areas of concern.
- The Court also noted that, partly because of the complex system of financial management and despite improvements made, weaknesses in the accounting systems of certain institutions and Directorates-General[6] put the quality of financial information at risk.

ii The Court's assessment on the **legality and regularity of the transactions underlying the accounts**:

- The Court has introduced a new traffic light system for specific assessments concerning legality and regularity of underlying transactions and provides red, yellow and green ratings for both the functioning of supervisory and control systems and for the error range identified through its transaction testing. The results for 2006 and further detail about the classifications are included in **Figure 3 overleaf**. The introduction of this traffic light system has been welcomed by the Commission as a helpful improvement in transparency.
- In the Court's opinion, revenue, commitments and payments for administrative expenditure, pre-accession strategy (with the exception of the Special Accession Programme for Agriculture and Rural Development[7]) and external actions (for those payments managed and controlled directly by Commission delegations) were free from material error. For Common Agricultural Policy expenditure the Court confirmed that, where properly applied, the Integrated Administration and Control System (IACS), particularly in respect of the Single Payment Scheme, is an effective system to limit the risk of irregular expenditure.
- The Court identified four areas of expenditure, however, which were materially affected by errors: parts of Common Agricultural Policy expenditure not covered by IACS or where IACS had not been properly applied; Structural Measures; Internal Policies; and External Actions at the level of implementing organisations. In its report on the financial year 2005 the Court qualified its opinion on the same areas with the exception of the Special Accession Programme for Agriculture and Rural Development, which was not qualified in 2005. Part Two of this report provides further details of the Court's opinion on the main areas of expenditure.

The Court's audit methodology

1.8 The Court's examination of the Community's annual accounts is based on international auditing standards in so far as these are applicable in the European Union context. The Court's methodology for its audit of the financial year 2006 was based on two principal sources of evidence:

- An examination of the operation of the supervisory systems and controls applying to the collection and disbursement of European funds by Community Institutions, Member States and other countries. It aims to provide representative information on the implementation and functioning of key controls in respect of their ability to prevent or detect and correct errors.
- Checks based on representative samples of transactions relating to revenue and expenditure, down to the level of the final beneficiary, which aim to provide direct evidence on the legality and regularity of payments.

These principal sources can be complemented by two other sources.

- An analysis of the Annual Activity Reports and the declarations of the Commission's Directors-General, and the procedures applied in drawing them up.
- An examination of the work of other auditors who are independent of the Community's management and control process (for example, Supreme Audit Institutions in the Member States or Third Countries).

1.9 The Court's report for 2006 supplements its Statement of Assurance with specific assessments of the Community's major areas of income and expenditure,[8] as it has done in recent years. The Court also examined developments relating to qualifications in the 2005 Statement of Assurance.

3 Specific assessments concerning legality and regularity of underlying transactions

Specific assessments of the 2006 annual report		Functioning of supervisory and control systems	Errors found through substantive testing
Own Resources[1]		🟢	🟢
Common Agricultural Policy	IACS	🟢	🟡 Overall for CAP 🟢 IACS
	non-IACS	🟡	🟡 🔴 non-IACS
Structural operations		🔴	🔴
Internal policies		🟡	🟡
External actions		🟡	🟢 Headquarters and Delegations 🔴 Implementing organisations
Pre-accession strategy	Phare/ISPA[2]	🟡	🟢
	SAPARD	🟡	🔴
Administrative expenditure[3]		🟢	🟢

Legend:

Functioning of supervisory and control systems		Error range	
Satisfactory	🟢	Less than 2% (below materiality threshold)	🟢
Partially satisfactory[4]	🟡	Between 2% and 5%	🟡
Unsatisfactory	🔴	Greater than 5%	🔴

Source: The European Court of Auditors' Annual Report concerning the financial year 2006

NOTES

1 The Court's audit of the transactions underlying the accounts cannot cover undeclared imports or those that have escaped customs surveillance. For value added tax and gross national income, own resources reflect macroeconomic statistics, for which the underlying data cannot be audited directly. The audit therefore takes its starting point as the receipt by the Commission of the macroeconomic aggregates prepared by the Member States.

2 The Phare programme was created in 1989 as the "Poland and Hungary: Assistance for Restructuring their Economies (PHARE) programme". It was extended in the 1990s to cover 10 accessions States and in 2005 to include Croatia. ISPA stands for Instrument for Structural Policies for Pre-Accession; it finances environment and transport projects. Both were superseded in 2007 by the Instrument for Pre-accession Assistance (IPA), though payments from PHARE and ISPA may continue for several more years.

3 The Court observes that some weaknesses exist in 'Functioning of supervisory and control systems'. See paragraph 10.25 on page 221 of the Court's Report for more information.

4 Systems are classified as 'partially satisfactory' where some control arrangements are judged to work adequately whilst others are not. Consequently, taken as a whole, they might not succeed in restricting errors in the underlying transactions to an acceptable level.

PART TWO

Performance on the main expenditure areas

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

i the Common Agricultural Policy; and

ii Structural Measures;

and the European Anti-Fraud Office's findings in respect of:

iii Irregularities, including possible fraud.

i The Common Agricultural Policy

2.2 In 2006, expenditure on the Common Agricultural Policy[9] was €49.8 billion (£34 billion), compared to €48.5 billion (£33.1 billion) in 2005. This represents 47 per cent (the largest component) of Community expenditure in 2006 (2005: 46 per cent).[10]

2.3 There are two main activities:

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

2.4 The schemes under which Common Agricultural Policy direct aid payments were made in 2006 are:

- *The Single Payment Scheme.* This is the principal agricultural subsidy scheme, put in place in 2005; it improves upon historic schemes by breaking the link between subsidy and production, and better acknowledges and rewards environmental good practice. This scheme is described further at Appendix 3 and below.
- *The Single Area Payment Scheme.* In the first years after accession, the new Member States could opt for a different type of direct aid scheme (the Single Area Payment Scheme) – not on offer in the EU-15.[11] Ten implemented this scheme (including Bulgaria and Romania).[12] Under the Single Area Payment Scheme, a uniform amount is paid for each hectare of eligible land. In due course, the Member States that currently apply the Single Area Payment Scheme will be required to adopt the Single Payment Scheme.
- *Other aid schemes* (including area aid schemes and animal premium schemes). The area aid and animal premium schemes are primarily the older schemes which were replaced by the Single Payment Scheme in 2005 and 2006. Under these schemes[13] payments were linked to agricultural production. In addition to the Single Payment Scheme and the Single Area Payment Scheme, farmers may continue to receive aid under similar schemes linked to the area under crops or to production, depending on the approach adopted by the Member State concerned. From 2007, when all Member States are applying either the Single Payment Scheme or the Single Area Payment Scheme, the other aid schemes will have only a minor impact on agricultural expenditure.

2.5 The Court reported on the application of the new Single Payment Scheme for the first time in 2006. Single Payment Scheme payments in 2006 amounted to 27 per cent of total agricultural expenditure.

The Court's overall findings on the Common Agricultural Policy

2.6 To obtain assurance over the legality and regularity of payments made under the Common Agricultural Policy, the Court audited the main supervisory and control systems described, and tested a random sample of payments drawn from the expenditure of 30 Paying Agencies (which were collectively responsible for 68 per cent of Common Agricultural Policy expenditure). In addition, the Court examined the systems put in place to implement the Single Payment Scheme under which some €14.2 billion (£9.7 billion) was paid to beneficiaries in 2006.

2.7 European Community legislation provides for a system of management and control of expenditure on the Common Agricultural Policy divided into four levels, as described in the box below. The Integrated Administration and Control System (IACS) is the key management and control arrangement for the Single Payment Scheme, the Single Area Payment Scheme, area aid, and animal premiums.

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

1. *A compulsory administrative structure at Member State level*, centred on the establishment of Paying Agencies and an authority at a high level which is competent for issuing and withdrawing the accreditation of Agencies. The responsibility for managing the majority of Common Agricultural Policy expenditure is shared between the Commission and Member States. It is distributed by Paying Agencies situated in Member States. In 2006 there were 98 Paying Agencies across the 25 Member States, six of which were in the United Kingdom.[1,2]

2. *A detailed system for controls and dissuasive sanctions to be applied by 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 claims.

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-year 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.

NOTES

1 In 2007, the number of Member States increased from 25 to 27 and the number of Paying Agencies decreased from 98 to 81.

2 For 2006 these were, 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. For 2007, the number of Paying Agencies in the United Kingdom reduced from six to four (the Rural Payments Agency; the Scottish Executive Environment and Rural Affairs Department; the Welsh Assembly Government; and the Department of Agriculture and Rural Development Northern Ireland).

Source: Directorate-General for Agriculture and Rural Development

The Integrated Administration and Control System (IACS)

- European Union legislation requires Member States to set a system for identifying parcels of agricultural land and animals and for registering and recording this information in a database.
- The system includes: a computerised database; an identification system for farmers and agricultural parcels; a system for identification and registration of payment entitlements, aid applications and integrated controls system checks; and, if needed, calculation of reductions.
- These elements of the system provide a basis for checks of the area and eligibility of land parcels declared by farmers. This includes carrying out geographical information system checks on 100 per cent of applications (using maps/ satellite data) and records aid applications which can be cross-checked with the holdings information.
- The system is being progressively applied to an increasing proportion of CAP expenditure. In 2006 it covered some 68 per cent of expenditure on market support and direct aid and is expected to increase to 90 per cent by 2013.

2.8 For area aid schemes, the Court analysed the inspection statistics of IACS. For all Member States, 29 per cent of applications checked contained errors where the amount of land claimed had been overstated (40 per cent in 2005). These errors were, however, generally small and represented 1.4 per cent of the land area verified by the Paying Agencies. In the 10 Member States where the Single Payment Scheme has been introduced, the error rate is 0.7 per cent compared to 1.8 per cent in other Member States. As in previous years serious deficiencies in the operation of IACS were noted in Greece, which accounted for some €3.1 billion (£2.1 billion), six per cent, of Common Agricultural Policy expenditure in 2006. Authorities in Greece are implementing an action plan, monitored by the Commission, to address these deficiencies. In the newer Member States, deficiencies were identified in the accuracy of data recorded in IACS, and in calculation of payments under the Single Area Payment Scheme.

2.9 As a result of the introduction of the Single Payment Scheme, the number of Member States making payments under the animal premium schemes decreased from 17 in 2005 to 12 in 2006 with a corresponding reduction in errors. The animal premium schemes involve a payment per head of livestock and the incidence of claimants 'over-counting' livestock, identified by checks, decreased from 6.3 per cent in 2005 to 3.6 per cent in 2006. From 2007 all Member States must apply the Single Payment Scheme and payments based on the number of animals held will be minimal.

2.10 Expenditure on rural development has increased over a period of several years. In 2006, new commitments represented €11.3 billion (£7.7 billion)[14]. In total, 21 per cent of Common Agricultural Policy commitments in 2006 were devoted to rural development. This is a slight increase on the 19 per cent of commitments devoted to rural development in 2005. Rural development expenditure will see a further boost to exceed €12 billion (£8.2 billion) in commitments in 2007.

2.11 The Court's audit found a high incidence of errors, by both nature and amount, for the agri-environmental schemes. Payments under these schemes are dependent on respecting (often complex) conditions, such as observance of good farming practices. The Court found that in seven out of eight cases audited, farmers had not met their commitments or some conditions had not been effectively checked by the authorities. In its response to the Court's findings the Commission's observed that the incidence of error is not representative of all rural development expenditure.[15] The proportion of Common Agricultural Policy expenditure allocated to such measures will increase for the 2007-2013 Financial Framework.

The United Kingdom

2.12 As noted in paragraphs 1.5 and 1.8 the Court's work provides an overall conclusion for the European Union. Its Report, however, draws upon findings from audit work in individual Member States. This section looks at those findings in the United Kingdom within the Common Agricultural Policy.

2.13 The United Kingdom had detected a higher than average frequency of error (55 per cent of applications contained errors), but the effect of these errors was comparatively small – errors represented 0.6 per cent of the total land area claimed by the United Kingdom (2005: 0.8 per cent). This compares to an average frequency of error of 38 per cent with errors representing 2.4 per cent of the total land area claimed, for the European Union as a whole. For Member States having their Single Payment Scheme payments audited by the Court in 2006, the average frequency of error was 48 per cent, and errors were an average of 0.7 per cent of the total land area of those claims audited.

2.14 The Court raised a number of concerns about the application of the Single Payment Scheme within the United Kingdom. Many of these issues appear to have arisen because the United Kingdom's interpretations of the European Regulations differed from those of the Court during the implementation of the new scheme, emphasising the need for clarity between the Court, the Commission and Member States. The issues raised are summarised in the box below.

A detailed description of the Court's findings on the Single Payment Scheme programmes in the United Kingdom

The ten months rule: Community legislation requires that land declared for the Single Payment Scheme must be at the claimants' disposal for a minimum period of 10 months each year. In the United Kingdom Single Payment Scheme entitlements were allocated, and aid was paid, to landlords who leased their land for most of the year, rather than the farmer leasing the land. In Northern Ireland, for example, more than 176,000 entitlements worth €13.8 million (£9.4 million) were allocated to such landlords. The United Kingdom authorities consider that, depending on the terms of the letting agreement, landlords may qualify for the Single Payment Scheme and/or rural development aid for land let to, and farmed by, the lessee. According to the Court's interpretation of European Union law however, only the person disposing of the land and exercising an agricultural activity on the land – the farmer – is entitled to Single Payment Scheme payments and rural development aid. The Commission explains that "if the landlord bears the economic risk of the farming activity, it is not excluded to consider him exercising an agricultural activity".[16] The Commission therefore allows that there are cases where a landlord could be eligible for the Single Payment Scheme.

Consolidation of entitlements: In certain situations where a farmer has lost land, for example through a compulsory purchase order, and is no longer able to activate all of his entitlements, they may be consolidated – exchanged for a smaller number with a higher value – to prevent the farmer being disadvantaged. The Court noted that some countries (Austria, Ireland, Wales and Scotland) did not comply with the legislation and instead extended the provision to all farmers who had fewer hectares than entitlements compared to 2005 regardless of the reason.[17] Consolidation was granted in order to have the farmer's reference amount concentrated on a number of entitlements equal to the number of hectares held, and consequently to allow the farmer to activate all his entitlements.[18]

A detailed description of the Court's findings on the Single Payment Scheme programmes in the United Kingdom *continued*

The Court also noted that, in Northern Ireland and England, a consolidation effect arose when, contrary to Community provisions, farmers were allowed to restrict allocation of entitlements to part of the eligible area declared in their 2005 claim. This enabled farmers to have their historical reference amount spread over fewer hectares, for example, they were allocated fewer entitlements with higher values, and allowed landlords to claim entitlements in their own name for land let to farmers. The United Kingdom disagrees with the Court's findings and believes that the approach adopted is consistent with regulations. These issues are being followed-up by the Commission, through the conformity procedure - the procedure with which the Commission investigates potential breaches of Community rules and decides if a financial penalty should be imposed.

New beneficiaries: European Union legislation allows "a natural or legal person, whose holding is located within the Community and who exercises an agricultural activity[19] or maintains the land in Good Agricultural and Environmental Condition" to claim Single Payment Scheme payments. There has been a substantial increase in the number of beneficiaries[20] and hectares in the Member States applying the Single Payment Scheme, partly due to all grassland and land used for fruit and vegetable production becoming eligible. But the Court noted that on the basis of maintaining land in Good Agricultural and Environmental Condition, England has made payments to: railway companies; golf and leisure clubs; and city councils. This issue is not limited to the United Kingdom: horse riding and breeding clubs were noted in Germany and Sweden; and Denmark was also identified as making payments to beneficiaries falling into the category of golf, leisure clubs and city councils. The financial impact of this issue, if any, is likely to be limited with only 700 new beneficiaries belonging to categories such as golf clubs, cricket clubs and such like across the European Union as a whole (fewer than 300 are believed to be located in the United Kingdom, with claims of around €1 million (£0.7 million) in total).

The United Kingdom authorities, including the Department of Environment, Food and Rural Affairs, consider that although, for example, the fairway of a golf course would not be eligible for a payment under the Common Agricultural Policy, other land owned by a golf course can be eligible. At the time of writing its report, the Court had not visited any new beneficiaries of the kind outlined in the paragraph above, The European Parliament Committee on Budgetary Control stated in its discharge report that it regrets the lack of clarity concerning the legality of these payments, and the inevitable impact on the media, resulting from the Court's reporting of this issue.[21]

Redistribution effect: European Union legislation allows Member States to allocate reference amounts from the *national reserve*[22] to new farmers who started their agricultural activity after the reference period. In Scotland several new farmers were given entitlements where the applicant did not meet the criteria of the new farmer scheme. This is being followed-up by the Commission, through the conformity procedure.

Increased entitlements due to investments: Entitlements from the national reserve may be allocated to farmers who made investments in production capacity or purchased additional land. The United Kingdom considered a 10 per cent increase in income as evidence of an investment but this assumption led to an unintended consequence. By increasing the number of cattle slaughtered during 2002 farmers could increase their income by some 10 per cent over the previous year. This provided 'evidence' to the United Kingdom that farmers had made investments and consequently there was a general increase in the cattle premiums paid. In Northern Ireland, for example, the number of animals claimed[23] was more than 20 per cent higher in 2004 than the average for 2000-2002. More than 82 per cent (€10.5 million, £7.2 million) of the allocations from the national reserve were made to investors. The same situation was observed in Scotland and England (85 per cent, €34.4 million (£23.5 million) and 78 per cent, €94 million (£64.1 million) respectively). As a result the national reserve exceeded its limit as set by the Commission. This finding is being followed-up by the Commission and is currently disputed by the United Kingdom who interpret the Regulation as meaning that, where the national reserve is not sufficient to cover the cases, it can be raised.

Delays in establishing entitlements and making payments: With the exceptions of Portugal and Belgium, all Member States visited by the Court allocated definitive entitlements wholly or partly after the legal deadline of 31 December 2005, more than €8.3 billion (£5.7 billion) in value terms. Some Member States consequently missed the 30 June 2006 payment deadline. This was a particular problem in England.

2.15 The National Audit Office reported in October 2006[24] and again in December 2007[25] on the difficulties in administering the Single Payment Scheme in England. The National Audit Office concluded that the delays were caused in part by changes to the development of the IT systems used to administer the payments, and by an underestimation of the work involved in mapping farmers' land and processing each claim.

2.16 The Department for Environment, Food and Rural Affairs included provisions totalling some £348 million in its accounts for 2006-07 as an estimate for potential financial corrections arising from: disallowed payments under the Single Payment Scheme for 2005 and 2006 (£221.7 million); and for other schemes administered by the Rural Payments Agency and Devolved Administrations (£126.3 million). The level of any financial correction is not yet known with certainty and the process of calculation and settlement with the Commission may take several years to conclude.

2.17 In addition to the provision for disallowance, between July 2006 and June 2007, the Rural Payments Agency made non-reimbursable late payments of some £63 million in relation to the 2005 Scheme in England. The Regulation[26] concerning the arrangements for funding the Scheme stipulates that reimbursement by the Commission shall be reduced on a sliding scale for payments made after the payment deadline set out in the Scheme Regulations. The non-reimbursement of £63 million results in losses to Exchequer funds because Scheme payments that could have been eligible to be funded by monies from the Commission will be funded instead from Parliamentary Supply.

2.18 The Department for Environment, Food and Rural Affairs also included in its accounts for 2006-07 a £7 million contingent liability for payments that have still to be made for the 2005 Scheme. As and when the residual further payments are confirmed, they will also have to be met from United Kingdom funds.

ii Structural Measures

2.19 In 2006, expenditure on Structural Measures which, broadly, are projects designed to reduce disparities in the level of development between regions, totalled €32.4 billion (£22.1 billion), or 30 per cent (the second largest component) of the European Union's budget.[27] Funding is provided on a multi-year basis, with programmes spanning several years and, usually, starting in one Financial Framework (see Appendix 2) with some final payments after the next has begun. For the 2000-2006 Financial Framework there were 545 operational programmes. For the 2007-2013 Financial Framework, the proportion of the European Union budget designated for Structural Measures is set to increase to some 36 per cent (from 30 per cent in the 2000-2006 Financial Framework). Resolving the issues in relation to Structural Measures will continue to be a priority if a positive Statement of Assurance is to be achieved in the future.

Findings from the National Audit Office reports on the difficulties in administering the Single Payment Scheme in England (October 2006 and December 2007)

Findings from the 2006 report

The Single Payment Scheme is not a large grant scheme compared to some Government programmes, but the complexity of the European Union Regulations, the complex way in which the Department for Environment, Food and Rural Affairs planned to implement them in England, combined with the deadlines required to implement the scheme for 2005, made it a high risk project. By choosing to integrate the scheme into a wider business change programme, the Rural Payments Agency (the Agency) added to its already considerable challenges.

The Agency encountered difficulties in processing payments due under the scheme, and paid out £1,438 million (95 per cent) against an European Union deadline of 96.14 per cent by the end of June 2006, and 96 per cent of sums due by the end of July.

The cost of implementing the scheme was budgeted at £76 million but, by March 2006, had reached some £122 million, and of the 363 claims tested, 113 contained errors in payments. The Chief Executive was removed from post in March 2006.

Findings from the 2007 report

The new management team has instilled a clearer sense of direction and drive amongst the staff to improve performance. The Agency has also undertaken a substantial exercise to review cases where entitlements used for the 2005 scheme year may be incorrect. In the interim, however, the errors in the first year of the scheme (the 2005 scheme) would have been largely repeated in the second year (the 2006 scheme) and the Agency has not yet paid all those claimants who were underpaid in the first year, nor recovered the sums from those farmers who were overpaid. As a consequence, the Agency was not able to administer the 2006 single payment scheme in a fully cost-effective manner.

Until the Agency is able to routinely meet the 30 June deadline each year and is confident that it can process payments within an acceptable tolerance of error, there is a risk that it will incur financial corrections from the European Commission and farmers may not have complete confidence in the Agency's administration of the scheme.

Source: National Audit Office

2.20 In 2006 Structural Measures provided funding for four interlinked areas of European Union policy: regional policy; employment and social policy; rural development; and fisheries. Expenditure came 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);[28] and the Financial Instrument for Fisheries Guidance (FIFG). The funding for 2006 was allocated according to three main objectives (85 per cent of Community funding of Structural Measures was spent on these 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.
- Objective 3: supporting the adaptation and modernisation of policies and systems of education, training and employment.

2.21 The remainder of the funding was distributed through: the Cohesion Fund (nine per cent), 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; Community initiatives (five per cent); and other activity (one per cent).

2.22 Structural Fund programmes vary enormously in size and complexity. Moreover, 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. 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.

2.23 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 4** shows how these arrangements work in the United Kingdom.

2.24 A new feature for the 2007–2013 Financial Framework is the introduction of an *Audit Authority* which will have responsibility for verifying the effective functioning of the management and control systems in the Member State. For example, under current proposals, the ERDF programmes will be audited by the Department for Communities and Local Government Internal Audit function.

The Court's overall findings on Structural Measures

2.25 The Court found that the reimbursement of expenditure for Structural Measures is subject to material error; for the 2000-2006 Financial Framework, 44 per cent of the 177 reimbursements tested were affected by error, and the Court reported that at least 12 per cent[29] of the total amount reimbursed to Structural Measures projects should not have been. The 12 per cent error was calculated using results from the 177 sampled projects which were selected from between 18 and 20 programmes (for the 2000–2006 Financial Framework there were 545 operational programmes in total).

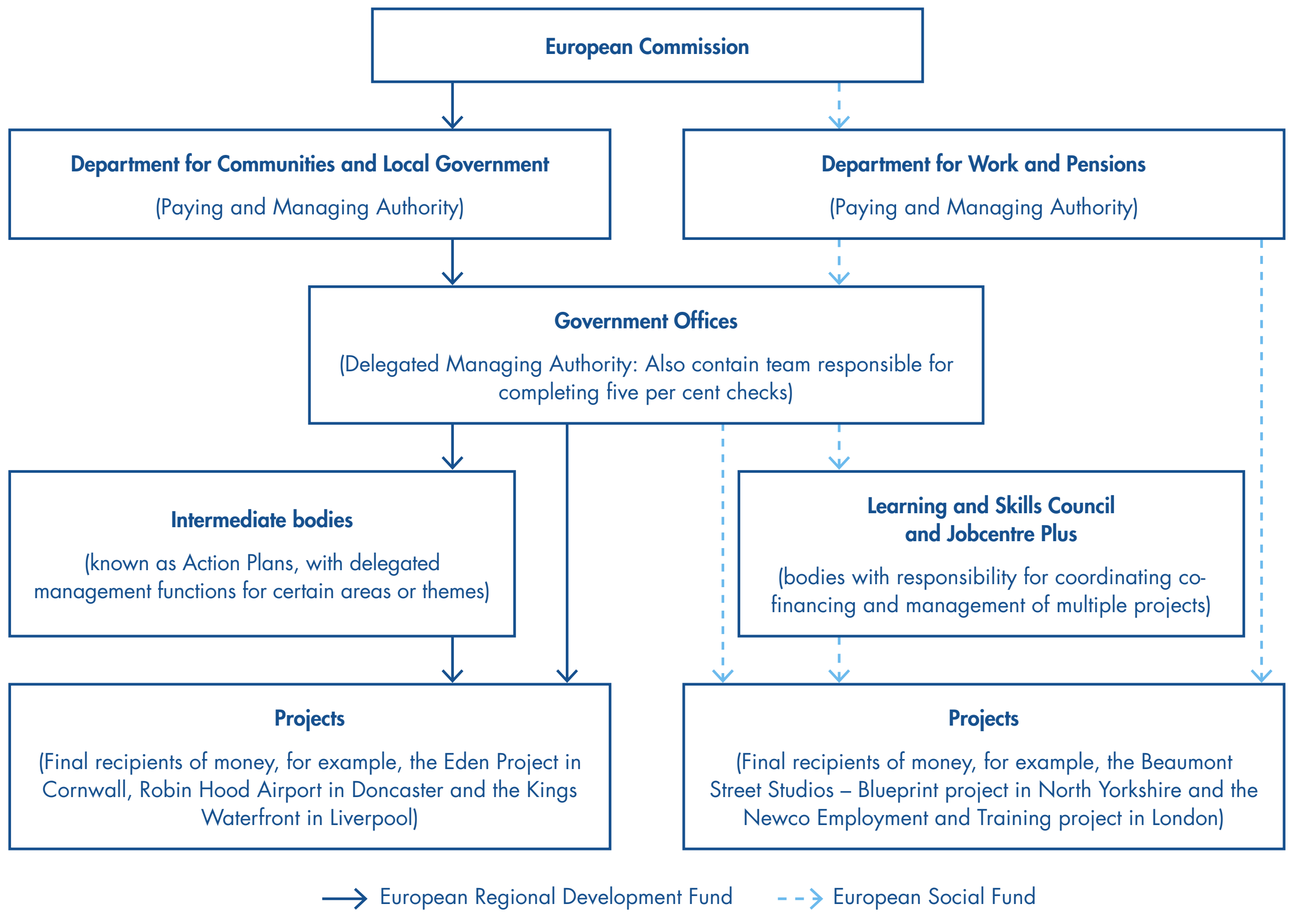
2.26 The underlying cause of over-reimbursements varied between the four funds. The most frequent causes of incorrect reimbursements were:

- the application of incorrect grant rates;
- inclusion of costs which are not reimbursable (such as recoverable value added tax);
- the award of a contract or of additional work without compliance with European or national public procurement rules; and
- the absence of necessary documentation to support the calculation of overheads or the apportionment of staff costs (for the 2007-2013 Financial Framework the use of flat rates for indirect expenditure, such as overheads, will be allowed).

2.27 The Court found that 13 out of 19 national control systems tested were 'ineffective overall' with the remaining six classified as only 'moderately effective'. **Figure 5 on page 18** shows the systems tested and the Court's findings. The main weaknesses identified were:

- Managing Authority – insufficient on-the-spot checks of expenditure and failure to identify that cost statements were not supported by appropriate evidence;
- Paying Authority – failure to identify that the Managing Authority had not carried out sufficient day-to-day checks; and

4 Responsibilities for managing Structural Measures in the United Kingdom – 2000–2006



Source: National Audit Office

- Audit Body (the organisation responsible for ex-post checking of a five per cent sample of project operations which, in the United Kingdom, is conducted by the relevant departments – see Figure 4) – failure to carry out sufficient checks of an appropriate quality on the expenditure of the programmes.

2.28 The Commission considers that the findings presented by the Court only show the situation during one particular year in the Financial Framework. The Commission observe that a large proportion of errors are likely to be addressed throughout the seven year Framework (in particular, through the continuing audit work of national and Commission audit bodies). It also considers that it has put in place effective systems to carry out its supervisory role although it accepts that it is necessary to provide better evidence of financial corrections by Member States.

2.29 The Court noted that the Commission does not receive adequate and reliable information from Member States concerning corrections made at the level of final beneficiaries. In its view, the information is incomplete as it does not show the full extent of corrections made or the extent to which recoveries related to expenditure made in 2006. The Commission added a new action to its Action Plan (see paragraph 3.7 in Part Three) to analyse the various systems used in recoveries. This new measure was introduced in March 2007 and will take some time to implement fully. The Commission aims to improve the quality and reliability of its figures on recoveries for its 2007 annual accounts. It has drawn the attention of Member States to the shortcomings of the information they provide and intends to take action if reliable information is not forthcoming from Member States.

5 Categorisation of control systems

Programme	Assessments of the functioning of: Managing Authority	Paying Authority	Audit Body[1]	Winding-up Body[2]	**Control system is:**
EAGGF – Sachsen-Anhalt	🟢	🟡	🟢	🟢	Moderately effective
EAGGF – Poland	🔴	🔴	🔴	🟡	Ineffective
EAGGF – Spain	🔴	🔴	🟢	🟡	Ineffective
ESF – Objective 3 – Germany – North Rhine-Westphalia	🟡	🟢	🟢	🟡	Moderately effective
ESF – Objective 3 – Germany – Lower Saxony	🔴	🟡	🟢	🟢	Ineffective
ESF – Objective 3 – France –Midi Pyrénées	🔴	🟡	🔴	🟢	Ineffective
ESF – Objective 3 – France –Nord-Pas de Calais	🟡	🟢	🟡	🟢	Moderately effective
ESF – Objective 1 – Education measures – Slovenia	🔴	🔴	🔴	🟡	Ineffective
ESF – Objective 1 – Germany – Thüringen	🟡	🟢	🟡	🟢	Moderately effective
ESF – Objective 1 – Fomento del empleo – Spain	🔴	🟡	🔴	🟡	Ineffective
ESF – Objective 3 – UK – Scotland	🔴	🔴	🟡	🟢	**Ineffective**
ERDF – UK – Merseyside	🔴	🔴	🟡	🟡	**Ineffective**
ERDF – Italy – Campania	🟡	🔴	🟢	🟢	Ineffective
ERDF – Spain – Pais Vasco	🔴	🔴	🟢	🟢	Ineffective
ERDF – Greece – Peloponnesus	🟡	🟡	🟡	🟡	Moderately effective
ERDF – Portugal – Accessibility and transport	🟡	🟡	🟢	🟢	Moderately effective
ERDF – Interreg – Austria/Hungary	🔴	🔴	🟢	🟢	Ineffective
ERDF – Spain – Valencia	🔴	🔴	🟡	🟢	Ineffective
CF – Spain – 7 projects	🟡	🔴	🟡	🟡	Ineffective

Legend:
- Satisfactory 🟢
- Partially satisfactory 🟡
- Unsatisfactory 🔴

Source: Data from the European Court of Auditors' Annual Report concerning the financial year 2006

NOTES

1 See paragraph 2.27.

2 This is the organisation responsible for validating the final declaration of the project expenditure.

2.30 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 considers that it has put in place effective systems to carry out its supervisory role within the multi-year Financial Frameworks although it recognises that improvements are required in its documentation of financial corrections.

2.31 The Commission formally adopted measures in February 2008 to strengthen its supervisory role of Structural expenditure. These measures are intended to:

- encourage a more risk-based approach to auditing managing bodies;
- give deadlines for remedial procedures;
- provide for follow-up of individual errors found by the Court; and
- promote a rigorous and effective closure of 2000-2006 programmes.

The position in the United Kingdom

2.32 As noted in paragraphs 1.5 and 1.8 the Court's work provides an overall conclusion for the European Union. Its Report, however, draws upon audit findings from individual Member States. This section looks at those findings in the United Kingdom within Structural Measures.

2.33 For ERDF expenditure in the 2000-2006 period, the Court carried out testing in Merseyside and found that the Managing Authority and Paying Authority controls were unsatisfactory and the Audit Body and Winding-up Body controls were only partially satisfactory. The Department for Communities and Local Government accepted that there was some ineligible expenditure, usually because of a lack of a sufficient audit trail (the Department noted that the requirements for retention of documents for some 13 years is onerous for small organisations) and some weaknesses in tender procedures. The Department for Communities and Local Government viewed the implementing bodies' failure to understand the Regulations and National Rules as a key reason for error by the United Kingdom. Where findings were accepted the Department is seeking to improve processes. Other findings have not been accepted and discussions between the Department and the Commission are ongoing.

2.34 Each Director-General within the Commission is required to prepare an Annual Activity Report – a management report on performance, culminating in a declaration on the assurance which can be taken from the internal controls. If a Director-General considers there are material internal control weaknesses, he will qualify his declaration and issue reservations on the level of assurance he can offer. As part of the Directorate General, Regional, 2006 Annual Activity Report, the Commission gave an adverse opinion on the functioning of the systems for ERDF programmes in six English regions and two in Scotland (one URBAN[30] programme in Scotland also received an adverse opinion and no opinion was given for one URBAN programme in the United Kingdom because of scope limitations – limitations in the coverage of audit evidence). The adverse opinions arose because of system weaknesses, such as concerns over the monitoring visits carried out by the Government Offices. There were also differences in the interpretation of the Regulations. These issues were initially identified in 2004 and 2005 during Commission visits to the United Kingdom.

2.35 The Commission carried out further work in the United Kingdom during 2006 and concluded that, although progress had been made, it was still impossible to ensure that the systems were functioning effectively to prevent and detect errors and irregularities. The Commission therefore decided to formally suspend the remaining payments to six English regions in April 2007 until it could be confirmed that the control systems were working effectively. As a result of improvements made, the Commission has since lifted the suspensions on all except the North West Objective 2 and URBAN programmes.

2.36 The Commission has confirmed a decision to impose a financial correction of some €25 million (£17 million) on the United Kingdom. This will result in a loss to Exchequer funds because Scheme payments that could have been eligible to be funded by monies from the Commission will be funded instead by Parliamentary Supply. The Department for Communities and Local Government has confirmed that where grant recipients have made claims for ineligible expenditure they will be expected to repay those amounts.

Closure arrangements

2.37 The Court noted that at the end of 2006, some €131.6 billion (£89.8 billion)[31] of commitments outstanding from the 2000-2006 Financial Framework were yet to be paid (an increase of 11 per cent on 2005). Some €93 billion (£63.4 billion) of the outstanding commitment at the end of 2006 related to Structural Measures (over 2.5 years' expenditure at the 2006 spending rate). Beneficiaries of the funds have until the end of 2008[32] to make payments or risk 'de-commitment'. Expenditure being de-committed means that the Commission cannot reimburse the Member State for any money spent outside the agreed period. This may result in an under-spend for the Commission and a decrease in income for the Member States.

2.38 Although the 2000-2006 Financial Framework has now finished and the 2007-2013 Framework is in progress, payments to final beneficiaries of Structural Funds from the 2000-2006 Framework will continue until 2008. 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 will be essential if the Commission is to reduce errors and thereby increase the chances of obtaining a positive Statement of Assurance. The Court recommended that this risk should be addressed by the Commission and the Member States. The Commission suggests that a build-up of outstanding commitments over a given Financial Framework is a consequence of a system where commitments are made within the period but payments can continue beyond the end of the period.

iii Fraud and irregularity, and the work of OLAF

2.39 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.[33] If a project in receipt of Structural Funding, for example, does not receive the agreed amount of additional funding from national sources (called co-financing), the monies 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.[34] A situation, for example, where a farmer deliberately falsified records of land areas in order to claim additional payments could constitute fraud.

2.40 The European Anti-Fraud Office is known as OLAF.[35] OLAF's role is to fight fraud, corruption, and any other illegal activity (including misconduct) that has financial consequences for the European Union. It is part of the Commission, but is autonomous in its investigative role. 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 2006

2.41 Member States are required to notify the Commission of irregularities, including possible frauds, which are detrimental to the European Union's financial interests. In 2006, Member States notified the Commission of 12,092 irregularities, with a total value of €1,155.32 million (£788 million) of which some €323 million (£220 million) was estimated suspected fraud (some 0.3 per cent of the budget). The total number of irregularities reported to the Commission, decreased by 7.3 per cent in 2006, but the total value of reported irregularities increased by some 10 per cent. This increase follows an increase of 4.4 per cent between 2004 and 2005. The United Kingdom, reported 1,416 irregularities (including possible fraud), an increase over 2005 of 14 per cent by number and 27 per cent by value. The reasons for these changes are not clearly understood. The figures are analysed further at Appendix 4.

2.42 OLAF's statistical assessment of irregularities is influenced by the timeliness and accuracy of the Member States' reporting. OLAF has noted that the recording practices of the national administrations vary and that data communicated by Member States is sometimes incomplete. Furthermore, the distinction between suspected fraud and other irregularities is not consistent as Member States do not always have the same definition of criminal risk and a significant proportion of reports do not distinguish between suspected fraud and irregularity.

2.43 The Commission works with Member States to improve the notification system for irregularities, in particular to clarify the concepts of fraud and irregularity. For the reasons outlined in paragraph 2.42, however, OLAF cautions that its figures should be interpreted with caution; it would be particularly inappropriate to draw conclusions about the geographical distribution of fraud or on the efficiency of the services which contribute to the protection of financial interests.

PART THREE

Developments in financial management and accountability

3.1 This Part examines initiatives by the Commission and Member States to improve the financial management of European Union funds, in particular:

i the fundamental review of the European Union budget;

ii progress in implementing the Commission's Action Plan;

iii annual summaries;

iv the preparation of national statements/national declarations by a number of Member States (including the United Kingdom);

v Treaty changes; and

vi developments within the Court.

i The fundamental review of the European Union budget

3.2 In May 2006, the European Parliament, the Council and the Commission agreed that the Commission should undertake a fundamental review of the European Union budget, both of expenditure (including the Common Agricultural Policy) and of resources (including the United Kingdom abatement), to report in 2008-2009.

3.3 The Commission state that "the budget review is an opportunity for a thorough assessment of the European Union budget and its financing, free from the constraints of a negotiation on a financial framework". The review will:

- look at the long-term, to see how the budget can be shaped to serve European Union policies and to meet the challenges of the decades ahead;
- set out the structure and direction of the European Union's future spending priorities, assessing what offers the best added value and most effective results;
- examine how the budget works and whether it should be managed differently – how to get the right balance between continuity and responding to new challenges; and
- look at the best way of providing the resources necessary to fund European Union policies.

3.4 The Commission began the review by launching a consultation process with all interested stakeholders. Submissions for this consultation were to be provided by the 15 April 2008.

3.5 In a report to Parliament in May 2007[36] HM Treasury stated that, in responding to the consultation, the United Kingdom will "emphasise that the principle of sound financial management must be to the fore in the Commission's approach. But must also ask: what is the role for the European Union in any given policy area? and does it necessarily require spending?" HM Treasury further commented that "with 40 per cent of the total European Commission Budget still being spent on the Common Agricultural Policy, and with more than 60 per cent of Structural and Cohesion Fund expenditure still being directed to rich Member States, the United Kingdom will continue to argue that this is hardly a Budget designed to meet the challenges of the 21st Century".

ii Progress in implementing the Commission's Action Plan towards an Integrated Internal Control Framework

3.6 In January 2005 the Commission made it one of its strategic objectives for 2005-2009 to strive for a positive Statement of Assurance. In June 2005 it published "A Roadmap to an Integrated Internal Control Framework" which set out proposals for strengthening financial management based on its assessment of where existing internal controls fell short of those recommended by the Court.

3.7 Subsequently, in January 2006, the Commission published its "*Action Plan* towards an Integrated Internal Control Framework"[37], 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.

These are outlined under the four headings below.

3.8 Although successful completion of the Action Plan will lead to improvements in controls, it does not guarantee a positive Statement of Assurance. The Court, in its Report, notes that the "Commission's timetable for its action plan appears to be optimistic" and points out that "most of the actions concerned are likely to have a real impact on the functioning of the supervisory and control systems of the Commission only in the medium/long term."[38]

3.9 On 27 February 2008 the Commission published its final report on the implementation of the Action Plan. It identified that most of the actions are complete but warns that the impact on the rates of errors will only become measurable over time. Impact indicators are defined which will form the basis of a further evaluation of the Action Plan as at 31 December 2008; the Commission will prepare a further report on its success in early 2009.

The costs and benefits of existing controls

3.10 The Action Plan set an objective of demonstrating that controls for the management of European Union funds are cost-effective in reducing the risk of error. The Commission decided to do this, for each policy area, by measuring the costs of the existing controls and comparing these to the resultant level of error.

3.11 In October 2007[39] the Commission outlined progress on its first estimate of the costs of controls in four policy areas: the Common Agricultural Policy; the European Regional Development Fund (ERDF); the Environment Policy area; and Research. The exercise estimated that costs of control – both the Member States' and the Commission – for the Guarantee Section of EAGGF[40], for example, was €2,018 million (£1,376 million) – about 4.15 per cent of expenditure. For ERDF, the figure was some 3.55 per cent of expenditure.[41] The Commission hope to use this information, once the estimates are complete, to identify areas where control mechanisms can be made more cost effective. A Commission communication on this issue is expected in October 2008.

Remedying sector specific gaps

3.12 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 Measures. In the 2006 Action Plan 'Contracts of Confidence' are identified as one method of improving controls over Structural Measures expenditure.

3.13 Contracts of Confidence are a mechanism which allows the Commission to take a more risk-based approach to its compliance audits. As some 76 per cent of expenditure is made at the Member State level the Commission perform a series of audits each year to ensure compliance with European legislation in the management of funds. Where a Member State, or region, demonstrates the effective functioning of the controls system and, in particular, that the work of the appointed local audit body can be relied upon, the Commission offers it a Contract of Confidence. In return for signing the Contract the Member State or region benefits from reduced scrutiny from the Commission.

3.14 To date, six Contracts of Confidence have been signed with Austria, Denmark, Estonia, Portugal, Slovenia and Wales. The Commission has informed us that other Member States/Regions have also expressed an interest in this initiative.

Simplification

3.15 The Action Plan identified that irregularities are more likely to occur in areas where difficulties are encountered by beneficiaries in applying eligibility criteria. 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.[42] To address this problem the Action Plan recommended simplifying the regulatory framework and developing an overarching legal framework regarding internal controls.

3.16 In relation to Common Agricultural Policy expenditure, the introduction of the Single Payment Scheme has resulted in some simplification although, as can be seen from Appendix 3, the United Kingdom has implemented three separate Single Payment Scheme models. The difficulties in paying claims at the Rural Payments Agency in England are, in part, due to the complexity of the Schemes in their early stages (see 2.14). Further simplification is also taking place through the ongoing reform of the European Union sugar sector.

3.17 In relation to Structural Measures, the Commission has agreed one set of detailed rules for Structural Funds and the Cohesion Fund for the 2007–2013 Financial Framework replacing the nine in force for the previous period. 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 Framework national eligibility rules – set at national level only – will now apply, rather than the two sets of rules – one for projects co-financed with the Community and one for nationally-funded projects – that applied in the previous period. Although the new programmes are now in operation, the long lead time required for closing programmes from the previous period means that it will take some time before the full benefits from this simplification can be realised.

Management declarations and deriving greater assurance from audit

The following two sections cover the assurances which might be offered by Member States.

iii Annual summaries

3.18 A recent development in the management of European Union funds is the legislated requirement, from February 2008, for Member States to produce an annual summary of the available audits and declarations in relation to Structural Measures and the European Fisheries Fund. Unlike expenditure on the Common Agricultural Policy, expenditure on Structural Measures funds several policy areas and is made through a large number of smaller schemes administered by a greater number of paying and managing authorities. The purpose of these summaries is to increase the transparency surrounding these underlying transactions.

3.19 Member States can choose whether they wish to provide a statement alongside the summary which will include: a view on the level of assurance which can be taken on the underlying control systems; and the views of an independent audit of the data usually conducted by the Supreme Audit Institution. The United Kingdom, in line with most Member States, has chosen not to provide such a statement, instead relying on the statement accompanying its National Declaration (discussed further in the following section). The Commission hopes that these summaries and statements will provide information for use in the annual activity report produced by each Directorate General within the Commission, and an additional level of assurance.

iv National Declarations

3.20 In November 2006 the Economic Secretary to HM Treasury announced that the Government intends to prepare and lay before Parliament an annual consolidated statement on the United Kingdom's use of *all* European Union funds (sometimes referred to as a National Declaration). The proposal is intended to improve financial management of European Union funds in the United Kingdom and could, in addition, provide the Court and the Commission with a source of assurance.

3.21 In 2006 The United Kingdom was responsible for the expenditure of some €8.1 billion (£5.5 billion)[43] of funds originating from the European Union. This is a significant amount of money, but, as it is accounted for in the United Kingdom within large departmental accounts, it can be difficult to obtain an overview of European Union income and expenditure relating to the United Kingdom. Structural Measures expenditure is, for example, accounted for within a number of organisations including: the Department for Work and Pensions; the Department for Communities and Local Government; and other government bodies in England, Scotland, Wales and Northern Ireland.

3.22 Unlike obligatory Annual Summaries which are enshrined in legislation[44], National Declarations are being produced by Member States at their discretion for the benefit of their Parliaments. Two countries, the Netherlands[45] and Denmark[46], have already produced statements; these are outlined in the boxes below. In addition, Portugal and Sweden have both expressed an intention to explore some form of enhanced national reporting on European Union funds. In December 2007 the heads of the Supreme Audit Institutions of the European Member States discussed improvements to the accountability for European Union funds and the idea of National Declarations. A further Seminar, specifically to exchange views and experiences on National Declarations was agreed, in principle, for Spring 2008.

3.23 The European Parliament Committee on Budgetary Control, within its report on discharge of the 2006 budget, strongly supports the introduction of national declarations and welcomed the initiative taken by some Member States to approve the adoption of a national declaration on the management of Community funding.[47]

The Danish European Union Member State declaration

- The National Audit Office of Denmark presented a statement on the audit of European Union funds in Denmark in 2006 to its Committee of Public Accounts in November 2007.
- Denmark made a net contribution of some €0.7 billion (£0.5 billion) to the European Union in 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.
- In the auditor's opinion, the 2006 accounts of the European Union areas give a true and fair view of European Union income and expenditure and year end balances, except with regards to the settlement of customs duties and agricultural levies where the preliminary opinion is that the settlements are not true and fair.
- For the legality and regularity of underlying transactions; the auditor is of the opinion that, taken as a whole, the transactions underlying the 2006 accounts for European Union income, expenditure and year end balances are legal, regular and in compliance with the provisions laid down by the Commission and the Council of the European Union, with the exception of customs duties and agricultural levies, where the transactions consisting of information provided by enterprises may be incorrect.

Source: Audit of EU funds in Denmark, Rigsrevisionen

The Dutch European Union Member State declaration

- The Dutch government is implementing its national declaration in phases starting with expenditure on the Common Agricultural Policy in 2006 and extending to cover Structural Funds and the collection and remittance of Traditional Own Resources in the future.
- The Netherlands made a net contribution of some €4 billion (£2.7 billion) to the European Union in 2006.
- The declaration is to be an annual statement on both the quality of financial management systems and the legality and regularity of transactions at final beneficiary level.
- The 2006 declaration includes statements on the functioning of the systems and the legality and regularity of payments under the Common Agricultural Policy.
- The auditors note that the 2006 declaration provides a sound assessment of the operation of the systems in place in the Netherlands for agricultural assistance from the Common Agricultural Policy[1] and the measures in those systems to manage and control expenditure and revenue.
- For the legality and regularity of underlying transactions; the auditor is of the opinion that the 2006 declaration provides a sound assessment of the Common Agricultural Policy expenditure[1] and revenue down to the level of the Paying Agencies. With regard to the final beneficiaries' compliance with the aid conditions, a reservation was raised in relation to cross-compliance for expenditure on the Common Agricultural Policy farmers must comply with a number of requirements regarding the environment, food safety and animal welfare. Non-compliance with these requirements can lead to a cut in aid.
- The declaration also notes that the Netherlands must transfer approximately €6.2 million (£4.2 million) to the Commission in 2007 in connection with long-outstanding balances. A further reservation was raised in relation to these long outstanding receivables.

NOTE

1 European Agricultural Guidance and Guarantee Fund – Guarantee section.

Source: Report on the Dutch EU Member State declaration 2006, Algeriere Rekenkamer

v The Reform Treaty

3.24 The European Union Reform Treaty (or Lisbon Treaty)[48] was signed in December 2007 by the 27 heads of state or government and contains a number of changes relevant to the Community budget and financial management. If the Treaty is ratified, the four principal changes related to the budgetary process will be:

- *Multi-year budgeting:* For the last two decades Financial Frameworks have been the basis of budgetary planning in the European Union but the Maastricht Treaty made no reference to these multi-year procedures. The Reform Treaty inserts a new article which provides that the Council will adopt, with the consent of the European Parliament, financial frameworks covering at least five years. This is intended to ensure that expenditure develops in an orderly manner and within the limits of the European Union's resources. The annual budget which is subsequently set must be consistent with the Financial Framework.
- *Budget adoption:* The current procedure for adoption of the annual budget provides for two 'readings' by the Council and two 'readings' by the European Parliament of successive drafts of the budget. Different rules apply to the powers of these two institutions in respect of different categories of expenditure. The Reform Treaty simplifies these provisions in two respects: there will be only a single 'reading' of the budget by each of Council and Parliament, with any differences of opinion between the institutions sorted out in a conciliation committee; and no distinction is made between different categories of expenditure.
- *Budget management:* The Treaty establishing the European Community currently makes the Commission responsible for budgetary management. In a separate sentence, it requires the Member States to cooperate with the Commission in observing the principle of sound financial management. The Reform Treaty makes a potentially significant change stating: 'The Commission shall implement the budget in cooperation with the Member States'. This change recognises the fact that responsibility for day-to-day management of around 76 per cent of the budget lies with the Member States.
- *Budget Discharge:* The Reform Treaty introduces a new requirement for the Commission to submit to the Council and the European Parliament 'an evaluation report on the Union's finances based on the results achieved', taking account of comments made by the Parliament and Council during the budgetary discharge procedure. It is not clear how the Commission will implement this provision.

vi Developments within the Court

3.25 A peer review of the Court's organisation and methods is under way, involving senior staff from the Supreme Audit Institutions of Austria, Canada, Norway and Portugal. It is due to report its findings in 2008-2009.

APPENDIX ONE

Study methods

1 For each of the last thirteen 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 types of expenditure and the Court's opinion on the 2006 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 Auditors' Annual report concerning the financial year 2006 http://eca.europa.eu/portal/pls/portal/docs/1/479520.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 2006 http://ec.europa.eu/anti_fraud/reports/commission/2006/en.pdf and its Annex http://ec.europa.eu/anti_fraud/reports/commission/2006/stat_en.pdf.
- OLAF's Operational Activity Report for the period 1 Jan 2006 to 31 December 2006 http://ec.europa.eu/atwork/synthesis/aar/doc/olaf_aar.pdf.
- The Annual Activity Reports of various Directors-General of the Commission, in particular the Directors-General for: Agriculture and Rural Development; Regional Policy; and the Budget http://ec.europa.eu/atwork/synthesis/aar/index_en.htm.
- The Commission's report on internal audits carried out during the year http://ec.europa.eu/dgs/internal_audit/docs/86-4-2006_en_com-280-final.pdf and its annex http://ec.europa.eu/dgs/internal_audit/docs/86-4-annex_en_sec708.pdf.
- The annual Synthesis Report of the main policy achievements http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0067:FIN:EN:PDF and the annual Synthesis Report on management achievements http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0274:FIN:EN:PDF.
- The European Parliament's Discharge Report on the European Union general budget for the financial year 2005, http://www.europarl.europa.eu/comparl/cont/adopt/discharge/2005/default_en.htm.
- The European Parliament's Draft Discharge Report on the European Union general budget for the financial year 2006, http://www.europarl.europa.eu/comparl/cont/adopt/discharge/2006/commission_en.htm.

2 In addition, we examined subsequent developments 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 2006 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;
  - DG Budget – the Directorate-General for the Budget; and
  - OLAF – the European Union's Anti-Fraud Office
- Foreign and Commonwealth Office; and
- Her Majesty's Treasury.

APPENDIX TWO

The European Union's budgetary process

1 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 Framework – sometimes called the Financial Perspective – (see box below), which sets out the budgetary priorities for that period. The European Union budget is not allowed to be in deficit.

What is a Financial Framework?

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

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

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

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

The current Framework was established in 2006 and covers the period 2007–2013. Previous cycles covered the1988–1992, 1993–1999 and 2000–2006 periods.

The annual budgetary procedure determines the level of expenditure for a specific year, by activity within each heading and for allocating appropriations between the various budget headings.

Source: National Audit Office and the European Commission

2 The budgetary process until 2008 was as follows: 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 is adopted by qualified majority, by 31 July. Parliament conducts its first reading in October, and may propose amendments and modifications to the draft budget. These are then reviewed again by the Council, before Parliament reviews and adopts the final budget, which is signed into law by the President of the Parliament. 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. The Reform Treaty would simplify these provisions in two respects: there will be only a single 'reading' of the budget by Council and Parliament, with any differences of opinion between the institutions sorted out in a conciliation committee; and no distinction is made between different categories of expenditure.

3 Once the budget is adopted, it is implemented by the Commission, which distributes funds to Institutions and Member States. Some 76 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.

6 The five institutions of the European Union

The European Parliament

- 785 elected members.
- Has extensive legislative powers, jointly with the Council.
- One of the two main legislative authorities.
- An arm of the Community's budgetary authority.
- Administrative spend: €1.4 billion (£1.0 billion).

The Council of the European Union

- One Minister for each Member State.
- Senior legislative body of the Community.
- An arm of the Community's budgetary authority.
- Administrative spend: €585 million (£399 million).

The European Commission

- One Commissioner from each Member State.
- Proposes and executes Community policies and ensures each Member State meets its Treaty obligations.
- Implements the budget.
- Administrative spend: €4.2 billion (£2.9 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: €238 million (£162 million).

The European Court of Auditors

- One member from each Member State, After the accession of Romania and Bulgaria in January 2007 the Court comprised 27 Members.
- External auditor of the accounts of all revenue and expenditure of the Community.
- It is independent of the other European Institutions and the governments of Member States.
- 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.
- Each Member is appointed for a term of six years.
- Administrative spend: €99 million (£68 million).

Source: National Audit Office summary of data from the European Court of Auditors' Annual Report concerning the financial year 2006

NOTE

Total expenditure on European Institutions was €6.7 billion (£4.6 billion). The five institutions listed above account for some €6.5 billion (£4.4 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).

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, draft disclosure of accounts decision, and a motion for a resolution. By 30 April, Parliament votes on the decisions and motion. The Commission is obliged to take follow-up action on the conclusions reached and recommendations made by Parliament and the Council.

5 The main sources of funding for the budget are a contribution based on Member States' gross national income, a Value Added Tax-based contribution and customs duties on a range of commodities imported from non-Member States. These income categories and the main expenditure programmes are described in the table on the next page.

6 The European Union budget for 2006 was the last under the 2000-2006 Financial Framework, the main objective of which was to ensure the successful integration of new Member States. The 2006 budget also began, as part of a longer term effort, channelling European Union funds towards projects aimed at generating sustainable growth and creating new jobs across the European Union. **Figure 7 and Figure 8** show the receipts and payments positions, respectively, for 2006.

7 European Union: Sources of receipts in 2006

Source of receipt	Value (€ billion)	Percentage
Gross National Income-based own resources	70.1	65
Value Added Tax-based own resources	17.2	16
Traditional own resources	15.0	14
Surplus carried forward from 2005	2.5	2
Miscellaneous revenue	3.6	3
	108.4	100

Source: Data from the European Court of Auditors' Annual Report for the financial year 2006

8 European Union: Breakdown of expenditure (payments) for 2006

Type of expenditure	Value (€ billion)	Percentage
Common Agricultural Policy	49.8	46.7
Structural Measures	32.4	30.4
Internal Policies	9.0	8.4
Administration	6.7	6.3
External Action	5.2	4.9
Pre-accession Aid	2.3	2.2
Compensation	1.1	1.0
Reserves	0.1	0.1
	106.6	100.0

Source: Data from the European Court of Auditors' Annual Report for the financial year 2006

The main sources of income and expenditure

Source of income

- **Traditional own resources** – consisting of customs duties, including those on agricultural products, on a range of commodities imported from non-Member States and sugar levies charged on the production of sugar to recover part of the cost of subsidising the export of surplus Community sugar into the world market.
- **Value added tax (VAT)-based contributions** – based on a uniform rate of 0.3 per cent – at June 2007 (calculated by the Commission and not exceeding one per cent), applied to the VAT base which must not, for any Member State, exceed 0.5 per cent of its Gross National Income.
- **Gross national income (GNI)-based contributions** – calculated according to the Member States' Gross National Income. The rate of this resource is whatever is required, given all other revenue, to balance the Budget.
- Other revenue and the surplus brought forward from 2005.

Expenditure programmes

- **Common Agricultural Policy**, schemes to support farmers and agricultural markets, and rural development.
- **Structural Measures**, programmes to promote structural adjustment in under-developed regions, supporting economic and social conversion 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

APPENDIX THREE

The Single Payment Scheme

1 The Single Payment Scheme was introduced by the Member States between 2005 and 2007 as part of reforms of the Common Agricultural Policy. It replaced 11 different farmer subsidies based on agricultural production with one single subsidy based on land area. This single subsidy is independent of the volume of production, and is made provided farmers meet certain criteria concerning: environmental standards; and health and safety; and have kept their land in good agricultural and environmental condition. The changes were made, by the European Union, to remove the incentive for over-production and to simplify the application of the Common Agricultural Policy.

2 The decoupling of aid from production is the latest phase in reforms encouraging farmers to make production decisions based on market returns rather than subsidies. In making these changes the aim is to increase the competitiveness of European Union agricultural products and enhance its position in multilateral trade negotiations.

3 In order to qualify under the Single Payment Scheme farmers must first obtain 'entitlements'. National authorities opt for one of the payment models **(see Figure 9)** provided for under European Union legislation and calculate the number and value of each farmer's entitlements. Farmers then receive payment as long as each 'entitlement' allocated to them is matched by a hectare of eligible land and other eligibility rules are met. Figure 9 shows the Member States that implemented the Single Payment Scheme in 2006 and the models they applied.

9 Single Payment Scheme models adopted by Member State audited by the Court

Member State	Model applied
Austria	Historic
Belgium	Historic
Denmark	Hybrid dynamic
Germany	Hybrid dynamic
Ireland	Historic
Italy	Historic
Luxembourg	Hybrid static
Portugal	Historic
Sweden	Hybrid static
United Kingdom	
England	Hybrid dynamic
Scotland	Historic
Wales	Historic
Northern Ireland	Hybrid static

Source: National Audit Office summary of data from the Department for Environment, Food and Rural Affairs

Single Payment Scheme Models and the allocation of entitlements

4 **Entitlements.** Ownership of entitlements gives farmers the right to claim payments from the Commission (via the Paying Agencies) in respect of the land they farm. One entitlement, together with one hectare of land declared by the farmer and kept in good agricultural and environmental condition, gives rise to a payment under the Single Payment Scheme.

5 The number and value of entitlements to be allocated to each farmer is calculated by identifying a *reference amount* and then dividing this amount by the number of hectares the farmer is allowed to claim against. The reference amount and number of hectares used to calculate a farmer's entitlements are determined in accordance with the model applied by the Member State. There are three basic models for determining the reference amount. The reference period for all models is 2000 to 2002.

6 For the historic model, the value of each entitlement is calculated by dividing the reference amount by the number of hectares which gave rise to this amount in the reference years. For example, for the Static **Historic** Rate the reference amount is based on the average direct payment receipts of each farmer within the reference period, under the previous subsidy schemes.

7 For the **flat rate (regional) model**, the reference amount is based upon the subsidy receipts for the whole region rather than by claimant and the value of each entitlement is calculated by dividing the reference amount by the number of eligible hectares declared in the region in the first year of the Single Payment Scheme. This model was not applied by any Member States in 2006.

8 For the **hybrid models**, the value of each entitlement is calculated using a mix of the basic and flat rate calculations. The following hybrid models were applied in 2006:

- **Static Hybrid Rate.** The reference amount is based partly on the average direct payment receipts of each farmer within the reference period, and partly on a flat rate per hectare of land.
- **Dynamic Hybrid Rate.** As with the Static Hybrid Rate, the reference amount is based partly on claimants average subsidy receipts, if any, in the reference period, and partly on a flat rate per hectare. Over time, the historic rate proportion declines until payments are wholly based on a flat rate. For example in 2006, 90 per cent of the English financial ceiling was used to fund the 'historic' element of entitlement values and 10 per cent to fund the flat rate element in year one of the scheme, and the weighting transfers to the flat rate in incremental steps of five per cent to 15 per cent each year.

APPENDIX FOUR

Cases of irregularity, including possible fraud, notified to the Commission by Member States in 2005 and 2006

10 Cases of irregularity, including possible fraud, notified to the Commission by Member States in 2005 and 2006

Category of expenditure	2005 Total number of cases	2005 Total amount € million	2005 Amount of suspected fraud € million	2006 Total number of cases	2006 Total Amount € million	2006 Amount of suspected fraud € million	Percentage Change Total number of cases %	Percentage Change Total Amount %
Structural Measures	3,570	601	205	3,216	703	158	–9.9	+17.0
Traditional Own Resources	5,943	328	105	5,243	353	134	–11.8	+7.6
Common Agricultural Policy	3,193	102	22	3,249	87	30	+1.8	–14.7
Pre-accession funds	338	17	1	384	12	2	+13.6	–26.0
Total	**13,044**	**1,048**	**332**	**12,092**	**1,155**	**323**	**–7.3**	**+10.2**

Source: Data from OLAF's Protection of the European Communities' financial interests – Fight against fraud – Annual Report 2006

NOTES

1 The 2005 figures are restated as Member States often notify OLAF of irregularities (including suspected fraud) some time after the irregularity has occurred.

2 Figures do not cast correctly due to rounding.

1 The most marked difference from 2005 is Structural Measures where the value of reported irregularities increased by 17 per cent despite a decrease of just under 10 per cent in the number of cases. As in previous years, the European Regional Development Fund and European Social Fund account for the most irregularities. Reported irregularities also increased significantly by value while decreasing in number in Traditional Own Resources.

2 Member States are required to report where they suspect that irregularities have arisen as a result of fraud. Suspicion of fraud case numbers have decreased for the Common Agricultural Policy but the value has increased. The opposite is the case for Structural Measures. For Traditional Own Resources, both the number of cases and the value have increased. The reasons for these changes are not known.

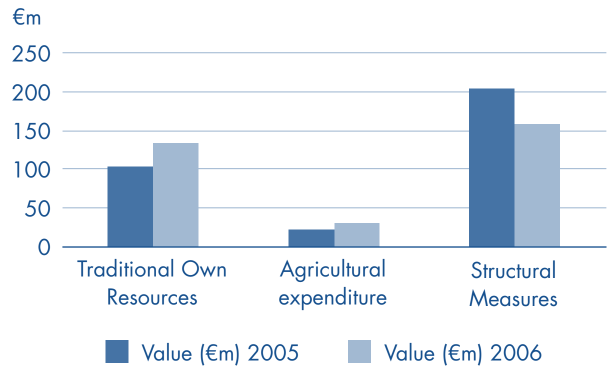
3 OLAF also receives information regarding suspicions of fraud from other sources, such as the Commission and whistleblowers. In 2006 OLAF received a total of 721 such reports of suspected fraud (a similar number to 2005).

4 **The position in the United Kingdom:** In 2006, the United Kingdom reported 1,416 irregularities (including possible fraud) to OLAF, an increase of 14 per cent on 2005. This was the fourth highest number of reported irregularities, behind Spain (1,668 cases), Germany (1,665 cases) and The Netherlands (1,596 cases). The value of irregularities reported by the United Kingdom was €125 million (£85.3 million), 27 per cent more than in 2005. This was the fourth highest figure in the European Union, behind Italy, Spain and Greece. These data are dependent on the timeliness, completeness and quality of reporting by Member States, and should be treated with caution; for example, OLAF consider that it is possible some Member States are under-reporting irregularities; as such it is inappropriate to make comparisons between Member States based on these data.

5 The increase in reported irregularities in the United Kingdom arose in Traditional Own Resources for both cases and amount; OLAF considers this could be due to improved reporting compliance. For Structural Measures, the number of reported irregularities decreased by 10 per cent but the value increased by 17 per cent, this is due to an increased reporting threshold.

6 **Fraud investigations:** In 2006, OLAF opened 195 new cases, including cases for which OLAF monitors the investigations carried out by the authorities in Member States. This is a fall of around ten per cent compared with 2005. Fifty-one of these cases were in the United Kingdom. This was the fourth highest total behind Italy (71 cases), Belgium (70 cases)[50] and Germany (68 cases). The figures for the United Kingdom are markedly higher than for 2005 (a 31 per cent increase). OLAF closed 216 cases, leaving 430 cases outstanding at the end of 2006. Of the 216 cases that were closed, 132 were closed with a follow-up recommendation (nearly the same as 2005). The bulk of follow-up work concerns financial recovery and judicial activities (follow-up activity can also be administrative, legislative or disciplinary). Financial recovery from closed follow-up actions decreased in 2006 at €114 million (£78 million) in comparison to €204 million (£139 million) in 2005.

11 Value of suspected fraud by major policy area



Source: National Audit Office analysis of data from OLAF's "Protection of the financial interests of the Communities – Fight against fraud – Annual report, 2006"

APPENDIX FIVE

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

Recommendation	Progress in implementation
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 qualified its opinion on the European Union's accounts for thirteen years in succession. The Court's opinion on the 2006 account provided a clear opinion for revenue, administrative expenditure and pre-accession strategy with the exception of the SAPARD programme. The other four areas received qualified opinions, although the Court noted that in relation to expenditure under the Common Agricultural Policy, the IACS system, in particular in respect of the Single Payment Scheme, where properly implemented was effective in limiting the risk of irregular payments. 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 nine members, two of which are external appointments.	The Court's most recent Annual Report notes a strengthening of the financial reporting framework and accounting systems. The implementation of accruals-based accounting in 2005 was consolidated in 2006. The Court's Report observes that the Commission has noted, since 2005, issues in the IT accounting systems applied by the 19 Directorates General. See paragraphs 1.12 to 1.17 of the Court's Report.

Recommendation	Progress in implementation
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.	For the first time the Court makes use of a 'traffic light assessment' of Commission performance concerning the legality and regularity of underlying transactions for the key policy areas. This assessment includes an appraisal of the functioning of supervisory and control systems and the error range. This offers a clear indication of the Court's assessment of performance. This is examined in Part 1 of this report.
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.	Simplification is one of the themes identified in the Commission's 'Action Plan towards an Integrated Internal Control Framework' (the Action Plan). With the introduction of the Single Payment Scheme (SPS), the Commission has simplified the Common Agricultural Policy whilst removing the incentive for over-production. The SPS replaced 11 previous schemes based on subsidies for production with one single subsidy based on land farmed. This issue is discussed further in Part 2 of this report. The new Financial Framework presents an opportunity for continued simplification by the Court.
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 Roadmap, 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. In February 2008 the Commission implemented a plan to strengthen its supervisory role for Structural Measures under shared management to address the recommendations of the Court's 2006 report. The Commission will report progress quarterly.
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 are developing their own national statement of assurance. Her Majesty's Treasury announced that the Government intend to prepare and lay before Parliament an annual consolidated statement on the United Kingdom's use of European Union funds (this is sometimes referred to as a National Declaration). 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 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 at Appendix 6.

Recommendation	Progress in implementation
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 undergoing a peer review by senior staff from the Supreme Audit Institutions of Austria, Canada, Norway and Portugal.
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 in 2006, 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. This issue is covered further in Part 2 of this report at paragraphs 2.42 and 2.43.
11 The United Kingdom Government should utilise the occasion of the Kingdom Presidency to improve accountability in the European Union. Specifically, it should: ■ 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; ■ 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; and ■ 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; ■ 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 ■ 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; and 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 report covering the 2004 programme period.[1]

NOTE

1 *Financial Management in the European Union*, HC 999, 2005-2006.

APPENDIX SIX

Special Reports published by the European Court of Auditors in 2007

Special Report 1/2007	The implementation of the mid-term processes on the Structural Funds 2000-2006.
Special Report 2/2007	The Institutions' expenditure on buildings.
Special Report 3/2007	The management of the European Refugee Fund (2000-2004).
Special Report 4/2007	Physical and substation checks on export refund consignments.
Special Report 5/2007	The Commission's management of the CARDS programme.
Special Report 6/2007	Effectiveness of technical assistance in developing the capacity of government in beneficiary states.
Special Report 7/2007	Control, inspection and sanction systems relating to the rules on conservation of the Community fish resource.
Special Report 8/2007	Administrative cooperation in the field of value added tax.
Special Report 9/2007	Evaluating the European Union Research and Technological Development (RTD) framework programmes – could the Commission's approach be improved?

ENDNOTES

1 This, and all figures in this report, has been converted at the 2006 average exchange rate of €1=£0.68205. The use of a constant exchange rate aids comparisons between different periods, however, sterling figures which do not relate to 2006 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 Comprising payments of €12.4 billion (£8.5 million), after deducting an abatement of €5.2 billion (£3.5 billion), less receipts of €8.1 billion (£5.5 billion).

3 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.

4 This is specified in Article 248 (1) of the Treaty establishing the European Community.

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

6 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 Directorate-General. Twenty-four agencies are also consolidated.

7 Which provides financing for a wide range of measures for structural adjustment of agriculture and rural development in accession countries. It is often referred to as SAPARD.

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

9 In 2006, the Common Agricultural Policy was delivered through the European Agricultural Guidance and Guarantee Fund (EAGGF). From 2007, new regulations established a European Agricultural Guarantee Fund (EAGF) and a European Agricultural Fund for Rural Development (EAFRD) to replace the EAGGF.

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

11 Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom.

12 Bulgaria, The Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Poland, Romania and Slovakia.

13 Arable Area Payments Scheme, Beef Special Premium, Extensification Payment Scheme, Sheep Annual Premium Scheme, Suckler Cow Premium Scheme, Slaughter Premium Scheme, Veal Calf Slaughter Premium Scheme, Dairy Premium, Dairy Additional Payments, Hops Income Aid, and the Seed Production Aid.

14 €7.7 billion (£5.3 billion) from the EAGGF Guarantee fund and some €3.6 billion (£2.5 billion) from the EAGGF Guidance fund.

15 The European Court of Auditors' annual report 2006; Commission response paragraph 5.44.

16 The European Court of Auditors' annual report 2006; Commission response paragraph 5.21.

17 The Court report notes a common reason for this as farmers leasing land who did not renew the lease on part of its land, therefore maintaining *entitlement* but losing *hectares*.

18 Wales and Scotland applied this type of consolidation only in the first year of SPS whereas it continues in Austria and Ireland. In 2005, more than 200,000 hectares were consolidated in this way. The impact is estimated at €60 million (£41 million) per year.

19 The production, rearing of animals or growing of agricultural products.

20 In the United Kingdom, the number of applications increased by two-thirds to 116,500 in 2005.

21 Report on discharge in respect of the implementation of the European Union general budget for the financial year 2006.

22 The Commission requires Member States to create a national reserve by ring fencing up to three per cent of the agricultural budget in any one year; this is designed to cover expenditure which cannot be planned, such as grants of entitlement to new entrants to farming. Entitlements unused for three years are transferred to national reserves.

23 Under the beef special premium and the slaughter premium schemes.

24 *The Delays in Administering the 2005 Single Payment Scheme in England*, HC 1631 2005-2006.

25 *A progress update in resolving the difficulties in administering the Single Payment Scheme in England*, HC 10 2007-2008.

26 The Single Payment Scheme Regulation (Regulation (EC) No 1782/2003) sets a payments deadline of 30 June in the following year. Subject to a four per cent tolerance, Regulation (EC) No 883/2006 sets out that European Funding is progressively reduced until SPS payments made more than four months after the deadline are wholly funded by the Member State (in this case the United Kingdom Exchequer).

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

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

29 The error rate was calculated using a two tail test of which 12 per cent was the lower limit (the Court were 95 per cent confident that the actual percentage error is at, or higher than, 12 per cent).

30 Urban II is the Community Initiative of the European Regional Development Fund (ERDF) for sustainable development in the troubled urban districts of the European Union for the period 2000-2006. As a follow-up to Urban I in 1994-1999, Urban II aims more precisely to promote the design and implementation of innovative models of development for the economic and social regeneration of troubled urban areas. It will also strengthen information and experience-sharing on sustainable urban development in the European Union.

31 Commitments can be carried for more than one year therefore commitments at a point in time may be higher than the annual budget for commitments. Outstanding commitments for the Structural Funds (but not the Cohesion Fund) are subject to the year n+2 rule, which requires commitments to be cancelled if no corresponding payments have been made by the end of the second year following the year the commitment was made. Member States are warned of the risk of cancellation with the aim of focussing attention where implementation is falling behind.

32 The Commission can make payments to Member States up to the closure of the operational programmes, the claims for which have to be made to the Commission by March 2010. However, these are based on payments made by the Member States to the final beneficiaries up to the end of 2008.

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

34 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).

35 From the French, Office européen de lutte anti-fraude.

36 European Community Finances Statement on the 2007 EC Budget and measures to counter fraud and financial mismanagement. http://www.hm-treasury.gov.uk/media/2/8/ecbudget220507a.pdf.

37 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.

38 The European Court of Auditor's Report, paragraph 2.21.

39 Conference on risk of error in Community programmes, 9 October 2007. http://ec.europa.eu/budget/library/documents/implement_control/conf_risk_1007/cost_benefits_pp_risk_en.pdf.

40 In 2006, the Common Agricultural Policy was delivered through the European Agricultural Guidance and Guarantee Fund (EAGGF). From 2007, new regulations established a European Agricultural Guarantee Fund (EAGF) and a European Agricultural Fund for Rural Development (EAFRD) to replace the EAGGF.

41 Only four Member States participated in this part of the survey (Hungary, the United Kingdom (Wales), Portugal and Germany (North Rhine-Westphalia)).

42 Financial Management of the European Union, Committee of Public Accounts, Eighteenth Report, Session 2004-2005, HC 498.

43 According to the data in the Commission's computerised accounting system ABAC.

44 Article 53b(3) of the Financial Regulation provides: "Member States shall produce an annual summary at the appropriate national level of the available audits and declarations".

45 Report on the Dutch EU Member State declaration 2006 http://www.rekenkamer.nl/cgi-bin/as.cgi/0282000/c/start/file=/9282400/modulesf/hm4egxqh.

46 Audit of EU Funds in Denmark http://www.rigsrevisionen.dk/media(454,1033)/Audit_of_EU_funds_2006.pdf.

47 Draft report on discharge in respect of the implementation of the European Union general budget for the financial year 2006.

48 The Treaty of Lisbon amending the Treaty Establishing the European Union and the Treaty Establishing the European Community, including the Protocols and Annexes, and Final Act with Declarations Lisbon, 13 December 2007. http://www.fco.gov.uk/Files/kfile/TREATY%20FINAL%20TEXT.pdf.

49 Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia joined on 1 May 2004. Romania and Bulgaria joined in January 2007.

50 A proportionally higher occurrence of cases is to be expected in Belgium in proportion to its size, population and receipts from the EC budget given that it is the seat of the largest European Institutions.

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