National Audit Office

Financial Management in the European Union

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 349 Session 2008-2009 | 27 March 2009

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Tim Burr
Comptroller and Auditor General
National Audit Office

23 March 2009

The National Audit Office study team consisted of:

John Hardman, Simon Reason and Sean Titley, under the direction of Peter Gray

This report can be found on the National Audit Office web site at www.nao.org.uk

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

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SUMMARY

1 In 2007, expenditure by the European Union budget totalled €114.0 billion and revenue was €117.6 billion. In that year, the United Kingdom made a gross contribution of €13.4 billion to the European Union. Its net contribution was €6.1 billion, the largest after Germany following an abatement of €5.2 billion.

2 This report follows our practice in recent years of updating the United Kingdom Parliament on the efforts being made by the European Commission (the Commission), working with Member States, to strengthen the financial management of the European Union. It draws upon the audit findings of the European Court of Auditors (the Court); information from the European Anti-Fraud Office (OLAF); the results of our own audit findings in the United Kingdom on the use of European Community money; and a review of the various initiatives underway to strengthen financial management.

3 This report covers:

- the 2007 Budget and the Court of Auditors' audit opinion on the 2007 financial statements (Part 1);
- performance on the main expenditure areas and reported incidence of fraud and irregularity (Part 2); and
- the initiatives to improve financial management and accountability (Part 3).

Findings

4 In November 2008, the Court published its report on the Commission's implementation of the 2007 budget. For the first time the Court provided a positive Statement of Assurance, without qualification, on the *reliability* of the accounts. In reaching this conclusion the Court sought assurance that all revenue, expenditure, assets and liabilities had been recorded and that the annual accounts faithfully reflected the Community's financial position at the year-end.

5 On the second element of its Statement of Assurance, however, and for the fourteenth successive year, the Court did not provide a positive Statement of Assurance on the *legality* and *regularity* of most categories of European Union expenditure. It found that the 'Administrative and other expenditure' and 'Economic and financial affairs' expenditure were legal and regular. But for the main areas of expenditure, Cohesion (formerly known as *Structural Measures*) and *Agriculture*, it reported a material level of error. The Court treats as material an error in excess of two per cent of total expenditure in that policy area.

Agriculture expenditure

6 The estimated overall level of error reported by the Court on agricultural expenditure of between two and five per cent was not significantly different from the previous year. The estimated error rate for the European Agricultural Guarantee Fund (EAGF), which accounted for some 80 per cent of *Agriculture* spending in 2007, was slightly below materiality. The increasing use of the Single Payment Scheme, across Member States, and the increasing application of the Integrated Administration and Control System, which links payment to registered parcels of land, were important factors reducing the error rate. But the Court found a significant level of error in expenditure on rural development under the European Agricultural Fund for Rural Development, which led the Court to conclude that expenditure on Agriculture as a whole was affected by a material level of error.

7 In its report on 2007 the Court raised a number of concerns about the application of the Single Payment Scheme within the United Kingdom. As with previous years many of these issues appear to have arisen because the United Kingdom's interpretations of European regulations differed from those of the Court during the implementation of the new scheme.

8 The National Audit Office has reported separately on the delays and errors in payment that accompanied the introduction of the Single Payment Scheme in England, and the action being taken to address these delays. The Department for Environment, Food and Rural Affairs included provisions totalling some £320 million in its accounts for 2007-08 (a reduction from £348 million for 2006-07) as an estimate for potential financial corrections arising from disallowed payments under the Single Payment Scheme for 2005 and 2006 and other, smaller, schemes administered by the Rural Payments Agency and Devolved Administrations. Since publication of the Department's 2007-08 accounts part of this provision has crystallised. The Commission, in July 2008, issued a financial correction of £54.9 million for irregularities in administering the 2004 Arable Area Payments Scheme.

9 The Regulations for funding the Single Payment Scheme stipulates that reimbursement to Member States by the Commission shall be reduced on a sliding scale for payments made to claimants after the annual payment deadline. The Rural Payments Agency made late payments after the 2005 Scheme deadline resulting in a reduction in reimbursement of some £63 million.[1] This £63 million was therefore paid from Exchequer funds and resulted in a loss of that amount for the United Kingdom taxpayer. This figure is in addition to the provision outlined in paragraph 7.

Cohesion Expenditure (formerly known as Structural Measures)

10 Expenditure on Cohesion, which includes the European Regional Development Fund and European Social Fund, continues to be the biggest source of error in the European Union budget. The Court concluded that expenditure on Cohesion projects was subject to material error, and reported that at least 11 per cent should not have been reimbursed by the Commission in 2007. Errors were mainly due to inclusion of ineligible costs, over-declaration of money spent, or failure to respect procurement rules.

11 The Court tested a sample of 16 national supervisory and control systems to assess how effectively they functioned. It reported that three were 'not effective', 11 only 'partially effective' and the remaining two were classified as 'effective'. One of the partially effective supervisory systems was in Northern Ireland. The European Commission considers these findings to be an improvement on the sample reviewed in 2006, when the Court assessed the majority of systems as 'ineffective'.

1 Department for Environment, Food and Rural Affairs Resource Account for the 2006-07 financial year. HC 585, 12 November 2007.

12 The Court noted that at the end of 2007 there were some €138.6 billion of Cohesion Policy commitments outstanding (unused commitments carried forward to meet future spending) from the 2000-2006 financial period which is referred to as a Financial Framework. During that period Cohesion policy expenditure was made through five distinct funds - four 'structural' funds and one 'cohesion' fund. Some €84 billion of the outstanding commitment related to the structural funds (over 2.3 years' expenditure at the 2007 spending rate). Although the 2007-2013 Framework is in progress, payments to beneficiaries of structural funds from the 2000-2006 Framework will continue until 2009 and for the Cohesion Fund until 2010. Setting up new programmes while others are running down requires officials to work to different sets of rules drawn up for different time periods.

13 In the United Kingdom the Department for Communities and Local Government, which is responsible for expenditure on the European Regional Development Fund, included a provision of £72.9 million in its accounts for 2007-08 to cover potential ineligible grant payments which may be subject to financial corrections by the Commission.

14 Cohesion projects in Member States are co-financed by the European Union Budget. The other co-financer varies and could be the Member State itself or other public, private or third sector organisations. In the current economic climate the availability of private sector financing is reducing. This will create challenges for the continued delivery of Cohesion projects in the United Kingdom.

Financial Corrections

15 The Commission has stated that it will take tougher action to suspend payments and make financial corrections, across all programmes, where Member States fall below standards. Financial corrections across all expenditure areas and all Member States led to the recovery of €843 million in 2008 compared with €287 million for 2007. The Commission forecasts that a further €1.5 billion of corrections will be finalised by March 2009. The Commission does not publish a comprehensive breakdown of corrections by Member State.

Irregularity and fraud

16 It is important to distinguish between irregularity and fraud. 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. Fraud is an irregularity that is committed intentionally and constitutes a criminal act that only the courts can determine as such.

17 Data from the European Anti-Fraud Office (OLAF) showed that, on a like-for-like basis, the number of irregularities reported by Member States to the Commission, including possible fraud, decreased from 12,565 in 2006 to 11,033 in 2007 (some 12 per cent) but the total value of reported irregularities increased by some 20 per cent to €1,392 million. The drop in the number of cases reported was due in part to a higher reporting threshold. The increase in total value was due to the reporting of a small number of very large irregularities. The United Kingdom reported 1,666 irregularities (including possible fraud), an increase over 2006 of 18 per cent by number and 125 per cent by value. The increase was due to more extensive control checks carried out in the Cohesion expenditure area.

18 OLAF continued to observe that its estimates of irregularity and fraud depended upon the quality of information reported by Member States and should be treated with caution (particularly comparisons across Member States). It reported that the distinction between suspected fraud and other irregularities was not consistent, as Member States did not always have the same definition of criminal risk, and a significant proportion of reports did not distinguish between irregularity and suspected fraud.

Efforts to improve financial management

19 In January 2005, the European Commission made it a strategic objective to strive for a positive Statement of Assurance from the Court. It published an Action Plan in January 2006. It reported in February 2009 that the implementation of the Plan was complete.

20 The Commission's Action Plan identified a need to simplify the regulatory framework governing expenditure. 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. The Commission has simplified some areas. In Agriculture, for example, the Single Payment Scheme, based on the area of land farmed, has replaced 11 production-based subsidy schemes. The Commission made efforts to simplify Cohesion programmes throughout 2008 and has indicated it will propose further measures in 2009 on the basis of recommendations from a joint Commission and Member State working group.

21 The fundamental review of the European Union budget, currently under way, offers an opportunity to consider how financial management can be further strengthened. In response to the consultation process, the Court proposed key principles that it considered should guide the Commission in designing the eligibility, governance and management arrangements for Community spending: clarity of objectives, simplification, transparency and accountability, and realism. On the last of these the Court believed that some expenditure programmes had been set up in a way that made it difficult to ensure that the conditions for spending were met. In its summary of the points raised during the consultation, published in November 2008, the Commission highlighted a desire amongst consultees for: increased transparency of the European Union budget; simplification of the budget; strengthening the responsibilities of Member States, which manage around 80 per cent of the budget; and more budget flexibility to allow a quick response to changing needs.

22 In December 2008, the Commission published a paper addressed to the European Parliament, the Council of the European Union and the Court on what should constitute a tolerable risk of error in spending European Union funds. The Commission suggested that the risk of error would inevitably vary by expenditure area, and that it might be appropriate for the threshold which defines the material level of error for the legality and regularity of underlying transactions to vary also. It argued that reducing error in some expenditure areas could carry a disproportionate cost. It concluded that the European Parliament and the Council of the European Union, as budgetary authority, could set a threshold for the auditors to consider in different policy areas taking into account political imperatives, benefits of a policy, inherent risk, potential for further simplification and the additional cost associated with reducing error rates. The Commission has invited the other European Institutions to respond to the paper.

23 Some Member States are taking steps to increase the transparency with which they have used European monies. In July 2008, the Treasury published the first annual consolidated statement of European Union expenditure in the United Kingdom. The statement brings together expenditure from across government departments and other public bodies, and the Devolved Administrations. The Netherlands and Denmark have also produced their own form of statements and Sweden plans to publish its first statement in April 2009.

Conclusion on financial management

24 Initiatives implemented in recent years by the European Commission and Member States to improve the financial management of European monies have started to produce beneficial effects. According to the Court's report for 2007 the error rate for agriculture expenditure, for example, was only just above the level at which the Court considered it material.

25 But the Court's finding that at least 11 per cent of cohesion expenditure should not have been reimbursed indicates that substantial progress is still needed to improve performance in this area. Work has started on this, with some simplification of the rules for the 2007-2013 Financial Framework, but the progress needed is likely to take some years yet and requires continued simplification of these still complex programmes. The current European Budget Review and the work on the 2014-2020 Financial Framework due to start soon offer an opportunity to simplify the rules governing this expenditure whilst defining closely the intended outcomes.

Recommendations

i **The European Court of Auditors, and the United Kingdom Committee of Public Accounts, have highlighted the inherent complexity of some European programmes as a contributory factor leading to error**. The Treasury, working with the other United Kingdom departments, should take the opportunity afforded by the current European Budget Review and forthcoming discussions over the shape of the 2014-2020 programmes to press for simplification during deliberation over future policy objectives.

ii **The current financial climate could increase the risk that Cohesion projects funded jointly by European and private money are held up by, or cancelled, due to lack of private funding**. The United Kingdom paying authorities, in conjunction with Treasury, should monitor the implementation rate of the 2007-2013 Cohesion programmes, establish the extent to which planned projects are likely to be dependent on private funding and have in place a plan to mitigate any risks if such funding is not forthcoming.

iii **While the National Audit Office has previously reported on a range of issues related to the implementation of the Single Payment Scheme in England, the Court raised a number of concerns about the application of the detailed regulations. As with previous years, many of these issues appear to have arisen from differing interpretations of European regulations by the United Kingdom authorities, the Commission and the Court.** The United Kingdom authorities have worked with the Commission to seek agreement on the interpretation of regulations. But they should extend this work to include, where possible, the Court to achieve greater clarity and agreement on the interpretation of the 2007-2013 Financial Framework regulations.

iv **The Commission does not publish an easily accessible summary of the corrections it imposes each year broken down by Member State**. This information would be useful to national Parliaments in judging the quality of administration of European Union funds in Member States. The Treasury should encourage the Commission to bring together and publish information on the financial corrections it makes across all policy areas, and to break this information down by Member State.

v **OLAF continues to report that the reliability of published information on fraud and irregularity is reliant on the quality of information submitted by Member States and should be treated with caution**. The Treasury should press OLAF and other Member States to develop a consistent arrangement for reporting and recording irregularity and fraud across the European Union. The Treasury should encourage OLAF to state alongside its published figures where it has concerns about the quality and timeliness of the information submitted.

vi **There is a risk that, in launching the Cohesion programmes under the 2007-2013 Financial Framework, the prompt and efficient closure of the 2000-2006 programmes in the United Kingdom is not given sufficient priority**. The United Kingdom departments responsible for managing the residual 2000-2006 programmes should have appropriate project management arrangements to close the programmes as quickly as possible, including effective arrangements for clearing outstanding irregularities. The aim should be to minimise the risk of error, and allow administrative resources to be focused on bringing programmes in the 2007-2013 Framework into operation.

vii **Some Member States, including the United Kingdom, have taken forward initiatives to improve the quality of information they produce for their national parliaments on their use of European Union monies**. The Treasury should take every opportunity to encourage greater transparency in the use of European Union funds across Member States, for example, by encouraging debate at the Council of the European Union on the experiences of Member States with the different approaches developed so far.

PART ONE

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

1.1 This Part summarises the main conclusions of the European Court of Auditors' (the Court) Statement of Assurance on the consolidated financial statements for the European Communities for the year ended 31 December 2007.

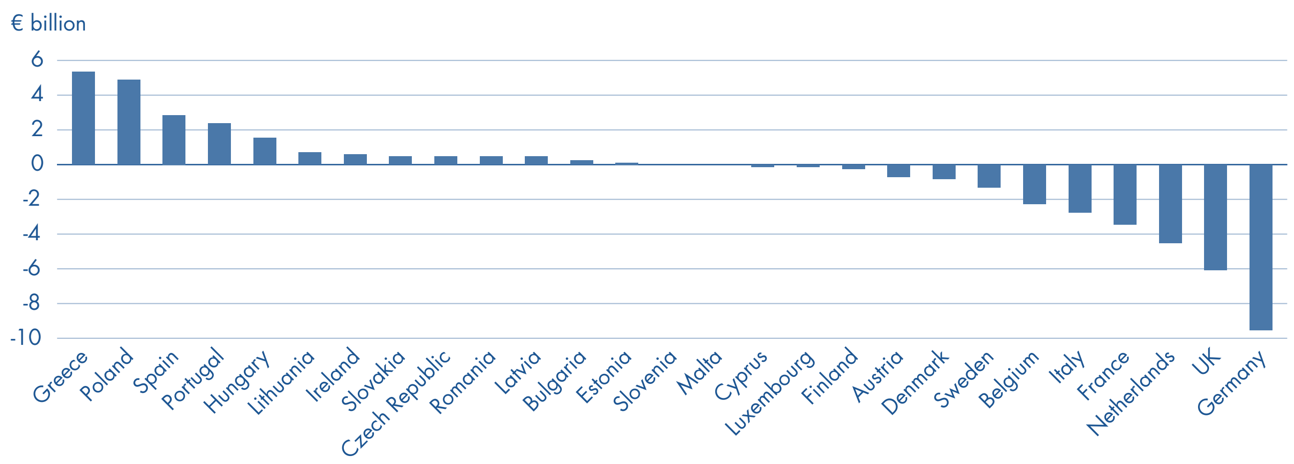
The European Union budget

1.2 The 2007 financial year covered by the Court's report marked the start of a new Financial Framework (see Appendix 3) for the period 2007-2013. This Framework sets out the budgetary priorities, agreed between the European Parliament, the Council of the European Union and the Commission, for each seven year period. The 2000-2006 Framework has ended, but existing projects and related expenditure within it are ongoing and will not be completed until 2010.

1.3 In 2007 the final budget for payments was €113.9 billion (£77.9 billion)[2], a 6.1 per cent increase on the final budget in 2006. In 2007 actual payments totalled €114.0 billion (£78.0 billion), a 6.9 per cent increase on 2006 and revenue was €117.6 billion (£80.4 billion), an 8.5 per cent increase on 2006. Background to the 2007 budget and more details of the European Union's budgetary process are provided at Appendix 3.

1.4 The United Kingdom made a gross contribution of €13.4 billion (£9.2 billion) to the budget of the European Union in 2007. Its net contribution was €6.1 billion (£4.2 billion)[3], the highest after Germany, and compares with €4.3 billion (£2.9 billion) in 2006. Member States' net contributions are shown in **Figure 1**.

1 Net Receipts/Payments for 2007 (€ billion)



Source: Data from the European Court of Auditors' Annual Report for the financial year 2007

2 This, and all figures in this report, has been converted at the 2007 average exchange rate of €1 = £0.684. The use of a constant exchange rate aids comparisons between different periods.

3 This figure comprises a calculated payment to the European budget of €18.6 billion less the abatement of €5.2 billion resulting in an actual contribution to the budget of €13.4 billion. Receipts from the European budget totalled €7.3 billion resulting in a net contribution of €6.1 billion.

1.5 The United Kingdom's net contribution to the total budget reflected an abatement of €5.2 billion (£3.6 billion). In December 2005, whilst under the United Kingdom Presidency, 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, in 2004 prices, 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.

The Court's Statement of Assurance on 2007 accounts

1.6 The Court published its report on the implementation by the European Commission (the Commission) of the 2007 budget in November 2008. For the first time the Court provided a positive Statement of Assurance, without qualification, on the *reliability* of the accounts, but for the fourteenth successive year the Court did not provide a positive Statement of Assurance on the *legality* and *regularity* of most European Union expenditure. To assess *reliability* the Court aims to obtain reasonable assurance that all account items are properly recorded and that the accounts faithfully reflect the financial position at the end of the year. To assess *legality* and *regularity* the Court checks whether transactions conform to applicable laws and regulations, and whether they are covered by sufficient budgetary appropriations. For an overview of the Court's methodology and detailed definitions of reliability, legality and regularity, see Appendix 3.

1.7 On the *reliability* of the accounts, the Court concluded that they give a fair presentation, in all material respects, of the financial position of the European Union and the results of their operations and cash flows. The Court judged that the qualifications expressed in its previous year's report on the 2006 accounts, which partly arose from the challenges of introducing accruals accounting in 2005, were no longer necessary.

1.8 The Court's assessment on the *legality* and *regularity* of the transactions underlying the accounts was as follows:

- Revenue, commitments and payments for 'Administrative and other expenditure' and 'Economic and financial affairs' were free from material error (the Court defines a material error as above two per cent of expenditure). For Agriculture expenditure the Court confirmed that the Integrated Administration and Control System (IACS)[4] continues to be effective in limiting the risk of irregular expenditure if it is properly implemented and if accurate and reliable data are introduced in support of Single Payment Scheme (SPS) payments.
- The Court identified five areas of expenditure, however, which were materially affected by errors: Agriculture and Natural Resources; Cohesion; Research, Energy and Transport; External Aid, Development and Enlargement; and Education and Citizenship.

The Court's findings on the *legality* and *regularity* of underlying transactions in each of the expenditure areas is shown in **Figure 2**.

1.9 Part 2 examines the Court's findings on the two most significant policy areas: 'Agriculture and Natural Resources' (which encompasses the Common Agricultural Policy); and 'Cohesion' (previously called Structural Measures). These two policy areas together represented over 80 per cent of European Union expenditure in 2007 **(Figure 3)**.

4 The Integrated Administration and Control System (IACS) comprises a system for identifying parcels of agricultural land and animals and recording them to a database which forms the basis for eligibility checks.

2 The European Court of Auditors' specific assessments concerning legality and regularity of underlying transactions

Specific assessments of the 2007 Statement of Assurance Annual Report	Functioning of supervisory and control systems	Errors found through substantive testing
Agriculture and Natural Resources	🟡 [2]	🟡 [3]
Cohesion	🟡	🔴
Administrative and Other Expenditure	🟢	🟢
External Aid, Development and Enlargement	🟡	🟡
Research, Energy and Transport	🟡	🟡
Education and Citizenship	🟡	🟡
Economic and Financial Affairs	🟢	🟢
Revenue[1]	🟢	🟢

Functioning of supervisory and control systems

🟢 Effective 🟡 Partially effective[4] 🔴 Not effective

Error range[5]

🟢 Less than 2% (below materiality threshold) 🟡 Between 2% and 5% 🔴 Greater than 5%

Source: The European Court of Auditors' Annual Report for the financial year 2007

NOTES

1 See scope limitations in paragraphs 4.4 and 4.9 on page 84 of the Court's report for more information.

2 The Court concludes that Integrated administration and control system continues to be effective in limiting the risk of irregular expenditure where properly implemented and if accurate and reliable data is introduced to support single payment scheme payments based upon allocated entitlements.

3 Rural development accounts for a disproportionately large part of the overall error rate: for European Agricultural Guarantee Fund expenditure the Court estimates the value of error to be slightly below two per cent.

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

5 The error range cannot be interpreted as a confidence interval (in a statistical sense). It is the Court's division of the scale of error rates into three intervals.

3 European Union expenditure in 2007

Expenditure area	Payments (€ million)	Share of total expenditure (%)	Cumulative total (%)
Agriculture and Natural Resources	51,044	44.8	44.8
Cohesion	42,015	36.9	81.7
Administrative and Other Expenditure	8,230	7.2	88.9
External Aid, Development and Enlargement	6,199	5.4	94.3
Research, Energy and Transport	4,484	3.9	98.3
Education and Citizenship	1,453	1.3	99.5
Economic and Financial Affairs	490	0.4	100.0
Revenue	38	0.03	100.0
Total	**113,953**	**100.0**	**100.0**

Source: European Commission Accounts

PART TWO

Performance on the main expenditure areas

i Agriculture and Natural Resources

2.1 In 2007, expenditure on the Agriculture and Natural Resources (Agriculture) policy area was €51 billion (£35 billion), compared to €50 billion (£34 billion) in 2006. This element represented 45 per cent (the largest component) of Community expenditure in 2007 (47 per cent in 2006).

2.2 In 2006, the Common Agricultural Policy was delivered through the European Agricultural Guidance and Guarantee Fund (EAGGF). From 2007, new regulations established two new funds to replace EAGGF. These two funds comprise the majority of the Agriculture and Natural Resources policy area:

- *The European Agricultural Guarantee Fund* (some 80 per cent of the total expenditure area in 2007) – which provides support for the agricultural sector through direct aid and intervention measures (primarily through the Single Payment Scheme); and
- *The European Agricultural Fund for Rural Development* (some 12 per cent of the total expenditure area in 2007) – which encourages rural development, such as investment in farm holdings and infrastructure in rural areas as well as schemes to encourage farmers to manage their land in an environmentally-friendly way.

Appendix 4 provides details on the Single Payment Scheme and the wider financial support for Agriculture.

The Court's overall findings on Agriculture

2.3 Overall, the estimated level of error reported by the Court on Agricultural expenditure was not significantly different from the previous year. The estimated error rate for the European Agricultural Guarantee Fund was slightly below the two per cent level at which the Court defines it material. The Court found, however, a significant error level on expenditure on rural development under the European Agricultural Fund for Rural Development.

2.4 The Court tested 196 transactions from across the Agriculture and Natural Resources policy area and found that 61 were affected by error, of which it classified 40 as 'serious'. This estimated error for the policy area as a whole fell into the two per cent to five per cent range.

On the European Agricultural Guarantee Fund:

2.5 The operation and expansion of the Single Payment Scheme and the Integrated Administration and Control System, which links payments to registered parcels of land, were important factors in reducing the rate of error within European Agricultural Guarantee Fund expenditure. The Single Payment Scheme is the principal agricultural subsidy scheme covering 55 per cent (27 per cent in 2006) of total expenditure in the policy area. It introduced one single subsidy based on land farmed to replace eleven previous schemes based on subsidies for production. Originally implemented by ten Member States in 2005, the Single Payment Scheme has now been adopted by a further seven.

2.6 To obtain assurance over the *legality* and *regularity* of payments made in 2007 from the European Agricultural Guarantee Fund, the Court audited the reliability of the supervisory and control systems applicable to Single Payment Scheme claims in selected paying agencies from nine Member States. It found that where properly implemented and supported by accurate and reliable data, the Integrated Administration and Control System was effective in limiting the risk of irregular expenditure within the Single Payments Scheme.

2.7 The Court also audited a sample of underlying transactions and found that some 20 per cent of the Single Payment Scheme transactions sampled revealed incorrect payment, a limited number of which had a high financial impact. The overall financial impact of this error was some 0.83 per cent of the expenditure concerned.

2.8 To improve the reliability of payments made under the Single Payments Scheme the Court identified a number of urgent issues to be addressed:

- improving the identification, registration and management of entitlements;
- eliminating from the database ineligible areas and beneficiaries and ensuring up-to-date information on land parcels; and
- clarifying and simplifying the rules underpinning the measures, in particular the use of the national reserve.

On the European Agricultural Fund for Rural Development:

2.9 Expenditure on rural development has increased from some €11.3 billion (£7.7 billion) in new commitments in 2006, to €12 billion (£8.2 billion) in 2007, and a planned €13 billion (£8.9 billion) in 2008. Just over a fifth of Agriculture expenditure was devoted to rural development in 2007.

2.10 The Court's audit found that expenditure on rural development was particularly prone to errors. Payments under these schemes depend on respecting (often complex) conditions, such as observance of good farming practices. This complexity, along with imprecise definitions in national legislation on some eligibility conditions, made it difficult for national authorities to verify the farmers' compliance with the relevant requirements.

The principal weaknesses detected by the Court in Rural Development expenditure:

- insufficient checks on the validity of the bids submitted under private procurement;
- lack of cross-checks to validate the number of animals declared by a farmer;
- inadequate verification of the eligible area under agri-environment measures;
- lack of systematic verification as to whether the agri-environment commitments fulfil requirements;
- inconclusive and poorly documented administrative and on-the-spot controls;
- inadequate consideration of risk factors stipulated in EU legislation;
- inadequate verification of the existence of private co-financing; and
- inadequate audit trail for projects receiving interest rate subsidies.

Source: European Court of Auditors' 2007 Report, pages 116 and 117

The position in the United Kingdom

2.11 Although the Court's report draws upon findings from audit work in individual Member States it does not seek to provide an opinion on a country by country basis. It is therefore not possible to compare performance in the United Kingdom to other Member States. This section reports, however, on specific findings related to the operation of the Agriculture and Natural Resources area in the United Kingdom.

2.12 The National Audit Office reported in October 2006[5] and again in December 2007[6] on the difficulties in administering the Single Payment Scheme in England, notably the delays experienced by claimants in receiving monies from the Scheme (see Appendix 4). We concluded that the delays were caused 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. Our reports noted improvements in the administration of the Single Payment Scheme in the United Kingdom, but also observed that until the Rural Payments Agency (the designated paying agency) is able to meet the annual payment deadline routinely, 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 Commission.

5 *The Delays in Administering the 2005 Single Payment Scheme in England*, HC 1631 2005-06.
6 *A progress update in resolving the difficulties in administering the Single Payment Scheme in England*, HC 10 2007-08.

2.13 In its report on 2007, the Court raised a number of concerns about the application of the Single Payment Scheme within the United Kingdom. As with previous years many of these issues appear to have arisen because the United Kingdom's interpretations of European regulations differed from those of the Court during the implementation of the new scheme. The Court, the Commission and Member States need to achieve greater clarity in the interpretation of often complex scheme regulations. The issues raised in respect of 2007 are summarised in the box below.

2.14 These issues could lead to the Commission starting proceedings against the United Kingdom to recover any expenditure which does not conform to the applicable legislation.

2.15 The Department for Environment, Food and Rural Affairs included provisions totalling some £320 million in its 2007-08 accounts (£348 million in 2006-07) as an estimate for potential financial corrections (see Appendix 7) arising from disallowed payments under the Single Payment Scheme for 2005 and 2006; and under other schemes administered by the Rural Payments Agency and Devolved Administrations. Since publication of the Department's 2007-08 accounts part of this provision has crystallised; the Commission, in July 2008, imposed a financial correction of some £54.9 million for irregularities in administering the 2004 Arable Area Payments Scheme. The level of any further financial correction is not yet known with certainty, and the process of calculation and settlement with the Commission may take several years to conclude.

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

Erroneous calculation of entitlements: The Court found various Member States had failed to apply correctly certain key elements of the system related to the establishment and management of the entitlements which are incorporated into the Integrated Administration and Control System (IACS) – see Appendix 4 for an overview of entitlements and IACS. The Court considered that the systems for calculating the entitlements were only 'partially effective' and that they did not provide reasonable assurance that the annual Single Payment Scheme payments based upon the allocated entitlements were correct.

In the United Kingdom (England) the four entitlements audited were erroneously calculated because of failure to take account of changes in land parcels. But these errors did not have a significant impact on 2007 payments because England applied the dynamic model (see Appendix 4 for further information). Unless corrected these errors would, however, result in significant under or over payments in future years.

Late claim penalties applied incorrectly: A one per cent per working day penalty should be applied by the Paying Agency to applications received from claimants after the scheme closing date. The Court found that the United Kingdom (England) applied late claim penalties incorrectly. The Rural Payments Agency observed that the Commission agreed a claim receipt deadline extension and the Agency applied late claim penalties from the date of that, extended, deadline; the Court reported that this was incorrect, its interpretation of the rule is that for all applications received after the extended deadline the one per cent per working day penalty should have applied from the date of the original application deadline.

Two payments on the same parcel of land: The Court found that in the United Kingdom (England) Single Payment Scheme entitlements were allocated, and aid was paid, to landlords who leased out their land for most of the year, rather than the farmer leasing the land. The United Kingdom authorities considered that, depending on the terms of the letting agreement, landlords may in some circumstances qualify for payments. 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 explained that "if the landlord bears the economic risk of the farming activity, it is not excluded to consider him exercising an agricultural activity". The Commission therefore considered that there were cases where one party could be eligible for the Single Payment Scheme and another party eligible for rural development payments on the same parcel of land.

Lack of assurance over eligibility of surfaces: As the Single Payment Scheme is based on the area of land kept in good agricultural and environmental condition rather than the level of production, a key control is in determining the eligibility of the land being claimed. Information on the eligibility of land surfaces is recorded in the Land Parcel Identification System (LPIS). The Court believed that the use of computerised information techniques for the Geographic Information System (GIS), the graphical layer of the LPIS, such as up-to-date aerial or spatial orthoimagery (a type of digital photography of the land), was important to ensure this information was accurate.

As the United Kingdom (England) did not use aerial or spatial imagery to populate the LPIS, the Court reported that the administrative controls did not provide assurance that European aid was paid out correctly. In response the Commission and the United Kingdom Government have both stated that the use of orthoimagery is not legally required. The Court has confirmed that resulting errors would not have a material effect on aid payments.

Effectiveness of IACS monitoring elements: The Court assessed the effectiveness of the IACS monitoring elements which provided the basis for checks of the area and eligibility of land parcels declared by farmers under the Single Payment Scheme in the United Kingdom (England) and found:

- Administrative procedures and controls to ensure correct payment – Not effective
- Risk analysis and selection procedures for inspections – Partially effective
- Inspection methodology, quality control and reporting of individual results – Effective
- Preparation and reliability of statistics on inspections and results – Not effective

Source: The European Court of Auditors' Annual Report for the financial year 2007

2.16 The Regulations for funding the Single Payment Scheme stipulates that reimbursement by the Commission shall be reduced on a sliding scale for payments made after the payment deadline. The Rural Payments Agency made late payments after the 2005 Scheme deadline resulting in a reduction in reimbursement of some £63 million.[7] This £63 million was therefore paid from Exchequer funds and resulted in a loss of that amount for the United Kingdom taxpayer. This figure is in addition to the provision outlined in paragraph 2.15.

2.17 In December 2008 the Commission confirmed a decision to impose a financial correction on the United Kingdom of £22.2 million in relation to weaknesses in the control systems of the Fruit and Vegetables Producers' Scheme which formed part of the Common Agricultural Policy. The Rural Payments Agency anticipating this correction had made a related accrual in its 2007-08 accounts.

2.18 The Department for Environment, Food and Rural Affairs also included in its accounts for 2007-08 a £4 million (£7 million in 2006-07) contingent liability for payments that have still to be made for the 2005 Scheme but will not be reimbursed by the Commission. As and when residual payments are made the cost will be met from United Kingdom funds.

ii Cohesion Policy

2.19 In 2007, expenditure on Cohesion policies (known as Structural Measures during the 2000-2006 Financial Framework) totalled €42 billion (£28.7 billion), or 37 per cent (the second largest component) of the European Union's budget. Projects are designed to reduce disparities in the level of development between regions.

2.20 This part of the budget covered four interlinked areas of European Union policy: regional policy (64 per cent of Cohesion expenditure); employment and social affairs (27 per cent); rural development (8 per cent); and maritime affairs and fisheries (less than one per cent). The monies were provided through four *structural funds* and one *cohesion fund*. The *structural funds* were the European Regional Development Fund (ERDF); the European Social Fund (ESF); the European Agricultural Guidance and Guarantee Fund, Guidance section (EAGGF-Guidance)[8]; and the Financial Instrument for Fisheries Guidance (FIFG).

2.21 Because of the nature of the projects, such as investment in infrastructure, funding for the Cohesion policy area usually covers several years. It is common for this funding to start in one Financial Framework period and not complete until the next. 2007 was the first year of a new Financial Framework (2007-2013). At the time of the Court's audit no programme expenditure had been declared for reimbursement. The Court's audit work, therefore, covered payments for 2000-2006 projects and programmes. Appendix 5 looks in detail at the changes in this policy area between the Financial Frameworks.

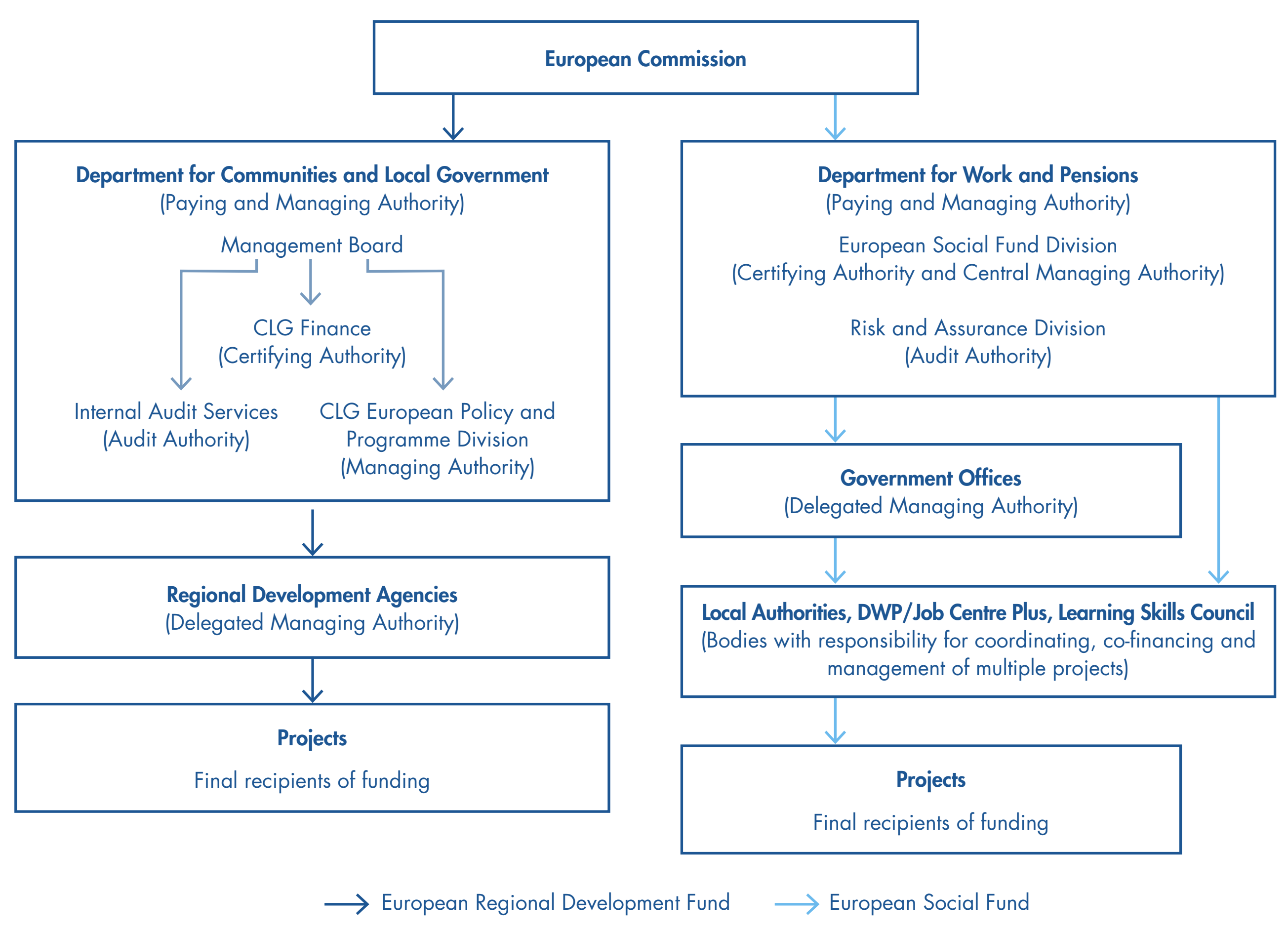
2.22 Cohesion Policy programmes vary greatly in size and complexity. For the 2000-2006 Financial Framework there were 545 operational programmes ranging in value from under €500,000 to over €8 billion. Project expenditure within each programme can range from a few hundred Euros to an individual recipient, to several hundred million Euros for a major infrastructure project. Responsibility for managing these funds is shared between the Commission and Member States, who are responsible for ensuring project costs are correctly reported and 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 implemented by 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 certifies the expenditure made by the Managing Authority and submits applications for reimbursement to the Commission. Intermediary bodies may act on behalf of either Paying or Managing Authority in dealing with the final beneficiaries of the funding. **Figure 4 overleaf** shows how these arrangements work in England for the two largest Cohesion Policy Funds.

2.24 A feature for the 2007-2013 Financial Framework is the introduction of an *Audit Authority* which will be responsible for verifying the effective functioning of the management and control systems in the Member States. For example, under current proposals, the Department for Communities and Local Government Internal Audit function will audit the European Regional Development Fund programmes.

7 *Department for Environment, Food and Rural Affairs Resource Account for the 2006-07 financial year* HC 585, 12 November 2007.
8 The EAGGF Guidance Fund contributes to the structural reform of the agricultural sector and the development of rural areas.

4 Responsibilities for managing the two largest Cohesion Policy in England – 2007-2013



The Court's overall findings on Cohesion Policy

2.25 The Court found that the reimbursement of Cohesion Policy expenditure is subject to material error for the 2000-2006 Financial Framework, and that the supervisory and controls systems in the Member States and the Commission are only 'partially effective'. It reported that 54 per cent of the 180 reimbursements tested were affected by *legality* and *regularity* errors and that at least 11 per cent[9] of the total amount reimbursed to Cohesion projects should not have been.

On the underlying transactions

2.26 The underlying cause of incorrect reimbursements varied between the funds. The most frequent causes of incorrect reimbursements from the European Regional Development Fund were eligibility errors arising from inclusion of costs which should not have been reimbursed because of their nature and serious failures to respect procurement rules. For the European Social Fund the most common errors were lack of evidence that the overheads or staff costs were relevant to the project; overestimation of staff costs or overheads; and inclusion of ineligible costs (eligibility errors).

9 This figure is calculated using results from 176 sampled projects selected from 16 operational programmes (for the 2000-2006 Financial Framework there were 545 operational programmes in total). The error rate was calculated using a two tail test of which 11 per cent was the lower limit (the Court were 95 per cent confident that the actual percentage error is at, or higher than, 11 per cent).

On the control systems

2.27 The Court tested a sample of 16 Member State's national supervisory and control systems to assess how effectively they functioned. It reported that three were 'not effective', 11 only 'partially effective' and the remaining two were classified as 'effective'. **Figure 5** shows the systems tested and the Court's findings. The main weaknesses identified were:

- Managing Authorities – insufficient day-to-day checks of whether expenditure had actually occurred, failure to identify expenditure declarations not supported by appropriate evidence and failure to identify weaknesses in tender procedures;
- Paying Authorities – failure to identify when Managing Authorities had not carried out adequate day-to-day checks; and
- Audit Authorities – failure to carry out sufficient checks to obtain assurance on the effective functioning of the control systems.

2.28 The Commission regards the Court's findings to be a significant improvement from 2006 when the Court's sample assessed 13 out of 19 systems as 'ineffective'. The Court changed its assessment recording between the two years, the assessment 'not effective' used in 2008 is comparable to the 2007 finding 'ineffective'. It also does not extrapolate the findings of its sample across all supervisory and control systems. The Commission believes a large proportion of errors would be addressed through checks carried out by Member States and Commission services between the year audited by the Court and the final closure of the programme, rather than in a single year in which the Court audits.

5 Assessment of Supervisory and Control Systems

Programme	Key Internal Control: Managing Authority	Paying Authority	Audit +Body	Winding-up +Body	Overall Assessment
EAGGF – Portugal	Partially effective	Effective	Effective	Effective	Partially effective
EAGGF – Spain	Not effective	Not effective	Partially effective	Effective	Not effective
ESF – Denmark – obj. 3	Effective	Effective	Effective	Effective	Effective
ESF – Greece – Health	Effective	Effective	Effective	Effective	Effective
ESF – Italy – Campania	Partially effective	Partially effective	Effective	Effective	Partially effective
ESF – Portugal – Norte	Not effective	Not effective	Partially effective	Effective	Not effective
ESF – Spain – Entrepreneurial Initiative	Not effective	Not effective	Not effective	Effective	Not effective
ERDF – Spain – Competitivity	Partially effective	Partially effective	Partially effective	Effective	Partially effective
ERDF – Czech Republic – Industry and Enterprise	Partially effective	Partially effective	Partially effective	Effective	Partially effective
ERDF – Germany – Mecklenburg Vorpommern – obj. 1	Partially effective	Partially effective	Not effective	Effective	Partially effective
ERDF – Greece – Information Society	Partially effective	Partially effective	Partially effective	Partially effective	Partially effective
ERDF – France – Martinique	Partially effective	Effective	Effective	Effective	Partially effective
ERDF – UK (Northern Ireland) – PEACE II	Partially effective	Partially effective	Partially effective	Partially effective	Partially effective
ERDF – Italy – Research	Partially effective	Partially effective	Partially effective	Effective	Partially effective
ERDF – Czech Republic – Infrastructure	Partially effective	Partially effective	Partially effective	Effective	Partially effective
ERDF – Slovakia – Basic Infrastructure	Partially effective	Effective	Partially effective	Effective	Partially effective

Effective   Partially effective   Not effective

Source: The European Court of Auditors' Annual Report for the financial year 2007

2.29 The Court recommends:

- errors are prevented in the early stages of a project through working with the project promoters and ensuring that the first level controls are functioning effectively;
- the project rules, subject to governing regulations, are simplified where possible;
- the Commission makes maximum use of the work of the audit authorities in the Member States; and
- the Commission makes effective use of the corrective instruments at its disposal including, for example payment suspension, financial corrections and recoveries.

The Commission's Response

2.30 In response the Commission has noted that it now has in place an action plan to strengthen its supervision of national controls on Cohesion Policy expenditure and, in line with this plan, has taken steps to increase the impact of its audit work through speeding up suspension of payments and financial corrections. For the period 2007-2013 it will make use of a new procedure allowing it to interrupt payments to Member States for a six month period while identified *legality* and *regularity* issues are addressed.

2.31 The Commission's strategy for the 2007-2013 period is to review the work of the audit authorities in the Member States in order to be able to conclude whether it can rely on their work. Where it has a positive conclusion it will not need to duplicate their work by carrying out its own audits at the level of beneficiaries.

The position in the United Kingdom

2.32 As observed in paragraph 2.11 the Court does not seek to offer an audit opinion on a country by country basis. As part of its audit on the Cohesion area the Court carried out testing in Northern Ireland on the PEACE II project. This project aimed to support progress towards a peaceful and stable society and promote reconciliation. It found that the Managing Authority, Paying Authority, Audit Body and Winding-up Body controls were only 'partially effective'. In addition the Commission Directorate-General responsible for Employment, Social Affairs and Equal Opportunities, in his 2007 Annual Activity Report[10], gave an adverse opinion on the functioning of the monitoring systems for European Social Fund programmes tested in the United Kingdom (Scotland).

2.33 From April 2007, in the light of performance in 2005 and 2006, the Commission suspended reimbursements to England for European Regional Development Fund expenditure. Following improvements, suspensions were lifted in the second half of 2007 and in 2008, without financial penalty, on all areas with the exception of North West Objective 2 and URBAN programmes, for which a financial correction of €24.8 million (valued at £19.8 million by the Department) was applied. The Commission also carried out audits on the closure of the 1994-1999 Financial Framework. In England, European Regional Development Fund programmes in two regions, the North West and North East, were subject to scrutiny and the extent of any financial correction is yet to be determined by the Commission.

2.34 In the United Kingdom the Department for Communities and Local Government has included in its 2007-08 Resource Account a provision of £72.9 million to cover potential ineligible grant payments in England which might be the subject of Commission financial corrections. In addition to this provision it also includes contingent liabilities to cover other possible issues related to the European Regional Development Fund. The provision and contingent liabilities are covered in detail at Appendix 7.

2.35 There are no provisions in the Department for Work and Pensions' 2007-08 accounts for possible Commission financial corrections against the management of the European Social Fund programmes. It observes that "a liability could arise in 2009 at the closure of the 2000-2006 European Social Fund (ESF) programme when the Audit Authority is required to produce a closure statement for each ESF programme. There is a risk that any adverse opinions might result in the European Commission imposing financial corrections. At present there is uncertainty as to the amount of any potential liability and therefore a provision cannot be justified at this stage."

2.36 The Department for Work and Pensions has, however, made a provision in its 2007-08 accounts of £25.9 million against money provided to beneficiaries that the United Kingdom authorities have identified should not have been, and which now looks unlikely to be recoverable from those beneficiaries (see Appendix 7). This provision is included in the accounts but not separately disclosed.

10 Each Directorate-General is required to publish an Annual Activity Report covering policy results, management and internal control systems, reservations, and a declaration of assurance.

Closure arrangements

2.37 The Court noted that at the end of 2007 there were some €138.6 billion (£94.9 billion) of Cohesion commitments outstanding (unused commitments carried forward to meet future spending) from the 2000-2006 Financial Framework. Some €84 billion (£57.5 billion) of these commitments related to the Structural Funds (over 2.3 years' of payments at the 2007 rate), and some €18.1 billion (£12.4 billion) concerned the Cohesion Fund.

2.38 Final beneficiaries had until the 31 December 2008 to spend the 2000-2006 Financial Framework funds allocated to them. Expenditure incurred after this date is not eligible for European Union co-financing. Member States will continue to make reimbursements to final beneficiaries for eligible expenditure until 2009 for Structural Funds and 2010 for the Cohesion Fund. Member States subsequently have until 31 March 2010 to claim reimbursements from the Commission. The Commission will not reimburse claims submitted after this date, and costs will be met by the Member State.

2.39 Setting up new programmes while others are in the process of closing requires officials to work to different sets of rules drawn up for different time periods. Prompt and efficient closure of the 2000-2006 programmes is needed if the Commission is to reduce errors and thereby increase the chances of obtaining a positive Statement of Assurance. The Court recommended that the closure of the 2000-2006 Financial Framework should not be delayed. In preparation for closure the Commission issued guidelines in 2006 and hosted closure seminars in Member States. The Commission is also carrying out audits of Member States' preparations for closure as part of its Action Plan.

2.40 The current difficult economic climate could pose a challenge to getting Cohesion projects for the 2007-2013 Financial Framework up and running. Cohesion projects in Member States are co-financed by the European Union Budget. The other co-financier varies and could be the Member State itself or other public, private or third sector organisations. In the current economic climate the availability of private sector financing is reducing. This will create challenges for the continued delivery of Cohesion projects in the United Kingdom.

iii Fraud and irregularity, and the work of OLAF

2.41 The European Anti-Fraud Office is known as OLAF[11]. The role of OLAF 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.

2.42 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. If a project in receipt of Cohesion monies, 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.

Irregularities and suspected fraud reported in 2007

2.43 Member States are required to notify the Commission of irregularities, including possible frauds, which are detrimental to the European Union's financial interests. In 2007, Member States notified the Commission of 11,033 irregularities[12] with a total value of €1,392 million (£953 million) of which some €297 million (£203 million) was estimated as suspected fraud (just under 0.3 per cent of the budget). The total number of irregularities reported to the Commission, decreased on a like-for-like basis by 12.2 per cent in 2007, but the total value of reported irregularities increased by some 20.3 per cent. The primary reason for a fall in the number of reported irregularities was an increase in the reporting threshold for Agriculture, from €4,000 to €10,000 effective from 1 January 2007. The increase in the value of reported irregularities was because of a small number of high value Agricultural expenditure irregularities.

11 From the French, Office Européen de Lutte Anti-Fraude.
12 This figure excludes an additional 411 *Direct Expenditure* irregularities valued at €33 million which Commission departments reported to OLAF.

2.44 The United Kingdom, reported 1,666 irregularities (including possible fraud), an increase over 2006 of 18 per cent by number and 125 per cent by value. The increase is due to more extensive control checks carried out in the Cohesion expenditure area. A complete analysis of the value of suspected fraud reported by each Member State is not published. Reported irregularities are analysed further at Appendix 6.

2.45 OLAF's statistical assessment of irregularities is influenced by the timeliness and accuracy of the Member States' reporting. OLAF has noted, for some years, 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. OLAF warns that its figures should therefore be interpreted with caution, and that no conclusion can be drawn about the geographical distribution of fraud.

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 it looks at:

i the fundamental review of the European Union budget;

ii progress in implementing the Commission's Action Plan;

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

iv tolerable risk.

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 2008-09.

3.3 The Commission stated 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 objectives of the review are to:

- 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 United Kingdom Government's contribution[13] advocated a re-orientation of the budget towards building a prosperous Europe within a strong global economy; addressing the challenges of climate change; and ensuring security, stability and poverty reduction. It suggested this re-orientation should be in the context of a shift away from Agricultural support, and that Cohesion Policy should be better focused on the less prosperous Member States. It emphasised the need for sound financial management, including the highest standards of financial control and independent audit, and greater focus on delivery of outcomes in programme design and evaluation.

3.5 The European Court of Auditors' put forward key principles to be used when designing eligibility, governance and management arrangements for Community spending:

- *Clarity of objectives* – The Court's audits revealed a lack of clarity in the objectives of some spending programmes. Examples can be found in the Court's Special Reports (see Appendix 8).
- *Simplification* – The Court focused particularly on eligibility criteria, practicality and avoiding unnecessary complexity in legislation.
- *Realism* – The Court has found that some expenditure programmes are set up in a way which makes it difficult, or impossible, to ensure that the conditions for spending are met, and that it is better to set up schemes that run with relative ease than to attempt to compensate for complex eligibility requirements by complex governance and management arrangements.

13 'Global Europe: Vision for a 21st Century Europe', Treasury, June 2008.

- *Transparency and Accountability* – Lack of transparency makes evaluation and 'follow-up' harder and inhibits the general public's ability to hold decision makers accountable.

3.6 The stakeholder consultation closed in June 2008. The Commission summarised, during a closing conference in November 2008, the views expressed by contributors among which were the following:[14]

- *Agriculture*: Agriculture spending requires reform; the Common Agricultural Policy (CAP) should be maintained but with new common goals; and rural development objectives should fall under the Cohesion Policy expenditure area, not Agriculture.
- *Cohesion Policy*: Expenditure should concentrate on the less developed Member States and regions; policy should focus on economic convergence; and policy should extend to respond to global challenges.
- *Delivery*: the European Union budget requires increased transparency; the budget structure should be simplified; the responsibilities of Member States, which manage over 80 per cent of the budget, should be strengthened; and more budget flexibility is required to respond immediately to changing needs.

3.7 The views expressed during the consultation will be an important input into the current Commission's review to be presented by the end of 2009. The planning of the Financial Framework from 2014 onwards must be completed by July 2011 and is therefore a task for the new Commission, expected to be appointed in the latter half of 2009.

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

3.8 In January 2005 the Commission made it a strategic objective for 2005-09 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 in 2004.

3.9 In January 2006, the Commission published its '*Action Plan* towards an Integrated Internal Control Framework'[15], 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.

3.10 The Commission published an Action Plan Impact Report in February 2009.[16] The Commission reported that implementation of its Action Plan was well advanced. Although successful implementation of the actions should lead to improvements in controls, it does not guarantee a positive Statement of Assurance. The sections below review the four themes covered in the Action Plan.

The costs and benefits of existing controls

3.11 The Action Plan set an objective of putting in place controls for the management of European Union funds that are cost-effective in reducing the risk of error. The Commission has since measured the costs of controls and has compared these to the resultant level of error in each policy area. This exercise prompted a recent paper from the Commission on the tolerable level of risk – see paragraphs 3.23 to 3.25.

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 Cohesion policies. In its February 2009 Impact Report the Commission observed that it continued to implement the core elements of the Action Plan in line with its gap assessment, and believed its activities are leading to improved performance in its supervisory and control systems (see paragraph 2.27 and 2.28).

14 'Reforming the Budget, Changing Europe', a conference by the European Commission, November 2008. The Commission has made available all the consultation contributions and prepared a formal consultation report; both are available on its website at ec.europa.eu.
15 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, European Commission, January 2006.
16 Communication from The Commission to the European Parliament, the Council and the European Court of Auditors – Impact Report on the Commission Action Plan towards an Integrated Internal Control Framework COM (2009) 43, European Commission, February 2009.

3.13 One method of improving controls in Cohesion expenditure identified in 2006 was 'Contracts of Confidence'. These contracts are a mechanism which allows the Commission to take a more risk-based approach to its compliance audits. Where a Member State, or region, demonstrates the effective functioning of its control system, and in particular that the work of the appointed local audit body can be relied upon, the Commission offers a Contract of Confidence. In return for signing the Contract the Member State or region benefits from reduced scrutiny from the Commission. At 4 February 2009 seven such Contracts had been signed. The Commission has also published new guidance for managing and certifying authorities on managing the risk of error in Cohesion programmes.

3.14 As a response to issues identified since the publication of the Action Plan in February 2008 the Commission put in place a specific plan to manage the risks relating to Cohesion policies. This plan sets out 37 actions to be completed by 2009 and is based on a two-pronged strategy:

- helping Member States to do a better job of checking the eligibility of project expenditure before they submit payment claims to the Commission; and
- tougher measures to suspend payments and make financial corrections where Member States fall below standards.

3.15 In February 2009 the Commission reported that some 28 of the 37 actions were completed including all those related to improved reporting, guidance notes, training seminars, and streamlined internal procedures for financial corrections.

3.16 One evidence source cited by the Commission as an indicator of the efficacy of its control systems is the level of financial corrections imposed. To date seven Commission decisions have been taken to suspend payments on 2000-2006 programmes – two in Italy, two for interregional programmes, and one each for the United Kingdom (in Scotland), Bulgaria, and Luxembourg, and there are some 20 more forecast. Financial correction actions have led to the recovery of some €843 million (£577 million) since the start of 2008 (compared with €287 million (£197 million) for 2007). Some €216 million (£148 million) of this total resulted from 21 *formal* correction decisions taken by the Commission; the balance was accepted by the Member States concerned before a formal correction decision was applied by the Commission. A further €1.5 billion (£1 billion) of financial corrections are forecast, across all policy areas not just Cohesion, to be finalised by the end of March 2009. Corrections are not fines: they are decisions to recover European Union taxpayers' money, where it has been wrongly claimed and paid out to beneficiaries. The Commission does not publish a comprehensive breakdown of corrections by Member State; further information on financial corrections can be found at Appendix 7.

Simplification

3.17 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.[17] To address this problem the Action Plan sought to simplify the regulatory framework underpinning the 2007-2013 Financial Framework. The Commission's 2009 Impact Report gave examples of where simplification had occurred in different policy areas including the Single Payment Scheme in Agriculture (discussed in Part 2 of this report and at Appendix 4) however, it observed that simplification for the 2007-2013 Financial Framework was not as extensive as it hoped.

Management declarations and deriving greater assurance from audit

3.18 The Commission, in February 2009 reported a high level of compliance with the legislated requirement (from February 2008) for Member States to produce an annual summary of the available audits and declarations in relation to Cohesion Policy and the European Fisheries Fund. It reported, however, that the quality of the optional additional analysis in most summaries could be improved.

3.19 The following section on National Declarations covers developments with the additional assurance which might be offered by Member States.

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

iii National Declarations

3.20 In November 2006 the Economic Secretary to the Treasury announced that the Government intended to prepare and lay before Parliament an annual consolidated statement on the United Kingdom's use of 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.

3.21 In July 2008, the Treasury laid before the United Kingdom Parliament the first annual consolidated statement, including an audit opinion from the National Audit Office. The Statement consisted of an expenditure account, a balance sheet and a cash flow statement for the year ended 31 March 2007. It was based on information received from the managing authorities in England, Northern Ireland, Scotland and Wales and covers receipts from the Commission in each of the main expenditure areas. This was the first time in the United Kingdom that European Union money, accounted for by a variety of departments and public bodies plus the Devolved Administrations, had been brought together in one statement.

3.22 In addition to the United Kingdom, the Netherlands and Denmark have also produced statements while Sweden plans to publish its first statement in April 2009. Each country has adopted approaches to meet their own national requirements. Other Member States are considering whether to take forward this initiative. These national initiatives are aimed at improving the financial management of European Union funds at Member State level by increasing the transparency with which European Union funds are used, thereby enhancing accountability.

iv Tolerable risk

3.23 The Commission published a paper, in December 2008, addressed to the European Parliament, the European Council and the Court, on the tolerable risk of error.[18] This paper, under the Action Plan referred to in paragraph 3.9, sought to encourage debate on the concept.

3.24 The paper takes as its basis the view that auditors define a *materiality* threshold for error. If spending breaches this threshold it is irregular and a negative audit opinion may be given. For the Court a level of error over two per cent is used as the *materiality* threshold for the *legality* and *regularity* of transactions. The Commission suggests that the risk of error differs by expenditure area and argues that it may, therefore, be appropriate for the *materiality* threshold to vary also. Depending on the level of *materiality*, there is a cost associated with the level of controls required in order to reduce error below the threshold. The Commission estimated the cost of the control systems for two areas of European expenditure (the European Regional Development Fund and Rural Development) and compared these estimates with the error rates identified by the Court. Taking the cost of improving the effectiveness of these control systems into account it suggests, for example, that as a first indication a tolerable rate of error on an annual basis for the Cohesion policy area may lie around 5 per cent.

3.25 The Commission's paper concludes that the budgetary authority (the European Parliament and the Council of the European Union) could set a different error threshold for different policy areas, having taken account of the political imperatives, the benefits of a policy (also non-financial), the inherent risk, the potential for further simplification and the additional cost associated with reducing error rates through more controls. The practical effect, in audit terms, would be to vary the threshold in some expenditure areas below which a positive opinion would be given.

18 http://ec.europa.eu/budget/library/sound_fin_mgt/com_2008_866_tolerable_risk.pdf

APPENDIX ONE

The Committee of Public Accounts' report: subsequent developments

In 2005 the Committee of Public Accounts reported[19] on the Financial Management of the European Union. It made a series of recommendations to improve the management and accountability of the European Union Budget. This appendix provides an update on subsequent developments.

Original conclusion	Developments to-date
1 "Historically, accountability and audit arrangements of the European Union have been characterised by inertia among the Institutions. Since the Committee's last visit [1999], 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. In general, since the Committee's 2005 visit, the Commission has implemented its Action Plan on an Integrated Control Framework, see paragraphs 3.8 to 3.10. Most significantly the Commission has committed to a fundamental budget review – outlined in paragraphs 3.2 to 3.7. Member States have also played a role – outlined in paragraphs 3.20 to 3.22. The Court has identified specific progress in the Commission's supervisory and control systems, in particular the Annual Activity reports published by each Directorate-General within the Commission on the operation of controls within their overall responsibility – pages 45 to 50 of the Court's Report covering the 2007 financial year.
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."	For the first time, the Court gave a positive Statement of Assurance on the fair presentation of the European Communities financial position and the results of their operations and cash flows as of 31 December 2007. The Court, however, has now qualified its opinion on the *legality* and/or *regularity* of the underlying transactions for fourteen years in succession. The Court provided a clear opinion on the revenue, commitments and payments for 'Administrative and Other Expenditure' and 'Economic and Financial Affairs'. The other five areas received qualified opinions, although the Court noted that in relation to expenditure under 'Agriculture and Natural Resources', the Integrated Administration and Control System was effective in limiting the risk of irregular payments. This is examined further in Part 2 of this report.

19 Financial Management of the European Union, Eighteenth Report of Session 2004-05, HC 498.

Original conclusion	Developments to-date
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 Commission continues to make progress in improving financial management. As paragraph 1.7 observes the accruals accounting system introduced in 2005 has helped the Commission achieve a positive statement on the *reliability* of the accounts. In particular, in Agriculture, the implementation of the Single Payment Scheme (see paragraph 2.5) and the Integrated Administration and Control System has led to improvement (see paragraph 1.8).
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 second consecutive year the Court has provided a 'traffic light' assessment of Commission performance regarding the *legality* and *regularity* of underlying transactions for the main expenditure 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. It is, however, not the Court's intention to give an opinion or report for individual Member States. Where observations have been made by the Court as part of its programme of audit visits to Member States, these are disclosed in the annual report, for example those demonstrated in Figure 5. Issues relating to the United Kingdom have been examined in Part 2 of this report. As outlined in paragraphs 3.20 to 3.22 some countries have developed National Declarations which draw together, for national parliaments, the European monies spent within their jurisdiction. Where produced this provides greater transparency to European expenditure.
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'. With the introduction of the Single Payment Scheme the Commission has consolidated many Common Agricultural Policy production-based schemes with one area-based scheme. It should be noted that simplification, in the sense of making scheme rules less prescriptive, can lead to a wider variation in interpretation of regulations across Member States and beneficiaries. An opportunity to achieve further simplification will come with the design of programmes for the 2014-2020 Financial Framework.
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 Roadmap intended to achieve this objective. The Roadmap 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 (paragraphs 3.8 to 3.10). 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. It observed that in the five years to 2008 the Commission increased the number and coverage of audits in this expenditure area and used the findings to suspend interim payments and adopt financial correction decisions. The plan outlines 37 actions in ten areas including, 'Preventative actions for closure of 2000-2006 programmes and projects' and 'Actions to improve primary controls at national level'. In February 2009 the Commission reported 28 of the 37 Structural Measures actions had been completed.

Original conclusion	Developments to-date
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 European Union budget now covers seven expenditure areas and encompasses 27 Member States. Some Member States are developing their own national Statement of Assurance.
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."	The Court publishes a series of Special Reports throughout the year. The number it publishes has risen from five in 2005 to 11 in 2008. The Court's most recent Special Reports are listed at Appendix 8.
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 underwent a peer review by senior staff from the Supreme Audit Institutions of Austria, Canada, Norway and Portugal. The objective of this was to assess the design and operation of the Court's Audit Management Framework. The findings of this were published on 9 December 2008. The main conclusions of this peer review were that: ■ The Court conducts its work with independence and objectivity; ■ The Court's audit reports are based on sufficient and appropriate audit evidence, as required by International Auditing Standards; and ■ The stakeholders interviewed have a high level of confidence in the Court's reports and generally consider them to be fair, factual and objective. The peer review noted that the Court is an organisation in transition that has taken, and continues to take, actions to address areas of improvement. It outlined challenges and opportunities for the future, including: ■ Developing a culture which emphasises the Court as a single audit institution; ■ Enhancing quality assurance and quality control activities to ensure that the interpretation and application of its audit policies and practices are consistent; and ■ Developing risk based audit strategies to optimise the use of resources.
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 European Anti-Fraud Office (OLAF), but they do so on an inconsistent basis. OLAF's current work on a methodology to distinguish between irregularity and intentional fraud is clearly a priority."	This is still an ongoing area of concern for the OLAF and the Commission, as outlined in paragraph 2.45. The 2007 Commission report on *The protection of the European Communities' financial interests and the fight against fraud* notes that the practices of the national administrations still vary, though improvements have been achieved due to the efforts made to harmonise their approaches.

Original conclusion	Developments to-date
10 *continued*	It was noted that data communicated by Member States is sometimes incomplete. Furthermore, the distinction between 'suspected frauds' and other irregularities is not consistent as Member States do not always have the same definition of criminal risk. A significant proportion of communications received by the Commission do not distinguish between suspected fraud and irregularity. Figures on reported irregularities and suspected fraud continue to carry the caveat that they should be interpreted with caution and that it would be inappropriate to draw simple conclusions about the geographical distribution of fraud or on the efficiency of the services which contribute to the protection of financial interests.
11 "The United Kingdom Government should utilise the occasion of the United Kingdom Presidency to improve accountability in the European Union. Specifically, it should:	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 expenditure year.[20]
a As a top priority, press for the simplification of the rules and regulations of the Common Agricultural Policy and Structural Measures to reduce the scope for fraud and error so as to increase the prospects of achieving a positive Statement of Assurance.	Whilst some simplification has been achieved in the rules and regulations governing the 2007-2013 Financial Framework, there is potential for further progress to be made in this area.
b Support, and encourage other Member States to support, the development of the Roadmap for a positive Statement of Assurance. In particular, attention should be focused on: ■ identifying the reasons the Court is unable to provide a positive Statement of Assurance on the *legality* and *regularity* of the underlying transactions; ■ the action the Commission and National Authorities need to take in each of the areas which are a cause for concern, with a specific focus on the major areas of European Union spending, support for Agriculture through the Common Agricultural 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.	The Court has reported on each expenditure area using the traffic light system to identify which areas are materially free from error of *legality* and/or *regularity* (see Figure 2). This provides a more transparent assessment of the areas where more attention is required in order to gain an overall positive Statement of Assurance. The Court has also set out recommendations on specific issues within each expenditure area which require attention as a priority. This is largely based on addressing the errors identified during audit testing which have had the most significant impact on the audit opinion, both by value and frequency of error. Under the 2007-2013 Financial Framework there is potential for National Authorities to enter into 'Contracts of Confidence' with the Commission. The value of these is yet to be seen.
c Encourage, with other Member States and the Commission, an increased focus on value for money work in the Court given the importance of ensuring the effective use of Community funds; and **d** Support OLAF's efforts to obtain a clearer picture of the scale of irregularity, including fraud, by: ■ encouraging Member States to: i) fulfil their obligation to protect Community Funds as they protect National Funds; (ii) deter crime against European interests by identifying those responsible and applying effective penalties and sanctions; ■ setting a good example to the other Member States by complying with OLAF's guideline for reporting irregularities; and ■ encouraging a programme of secondments to OLAF from a wide range of United Kingdom institutions, including the police force."	The practices of the national administrations in reporting irregularities and suspected frauds still vary. This limits the effectiveness of the Commissions and OLAF's efforts in tackling fraud. Though improvements have been achieved thanks to the efforts made to harmonise the approach, the data communicated by Member States is sometimes incomplete. Furthermore, the distinction between 'suspected frauds' and other irregularities is not consistent as Member States do not always have the same definition of criminal risk. A significant proportion of communications received by the Commission do not distinguish between suspected fraud and irregularity.

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

APPENDIX TWO

Study methods

1 For each of the last fourteen 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 2007 accounts, examine the progress in addressing the recommendations made in the Committee of Public Accounts' 2005 report on financial management in the European Union, 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 2007 http://eca.europa.eu/portal/pls/portal/docs/1/1569525.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 2007 http://ec.europa.eu/anti_fraud/reports/commission/2006/en.pdf http://ec.europa.eu/anti_fraud/reports/commission/2007/en.pdf and its Annex http://ec.europa.eu/anti_fraud/reports/commission/2007/statistics_en.pdf
- OLAF's Operational Activity Report for the period 1 January 2007 to 31 December 2007 http://ec.europa.eu/anti_fraud/reports/olaf/2007/en.pdf
- The Annual Activity Reports of various Directors-General of the Commission, in particular the Directors-General for: Agriculture and Rural Development; Regional Policy; 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_2007_en.pdf and its Annex http://ec.europa.eu/dgs/internal_audit/docs/86_4_report2007_annex_en.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://ec.europa.eu/atwork/synthesis/doc/com_2008_338_en.pdf
- The Commission's Action Plan Impact Report http://ec.europa.eu/budget/library/documents/sound_fin_management/management_systems/com_2009_43_en.pdf
- The Commission's Structural Actions Action Plan Progress Report http://ec.europa.eu/budget/library/documents/sound_fin_management/management_systems/com_2009_42_en.pdf
- The European Parliament's Discharge Report on the European Union general budget for the financial year 2006 http://www.europarl.europa.eu/comparl/cont/adopt/discharge/2006/default_en.htm
- The European Parliament's Draft Discharge Report on the European Union general budget for the financial year 2007 http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-416.563+02+DOC+PDF+V0//EN

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 one.

3 Our work for this report is based primarily on a review of the Annual Reports concerning the financial year 2007 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
- Department for Communities and Local Government;
- Department for Environment, Food and Rural Affairs;
- The Rural Payments Agency;
- The Coordinating Body;
- Department for Work and Pensions; and
- Her Majesty's Treasury.

APPENDIX THREE

The European Union's budgetary process, and the European Court of Auditors' methodology

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 below), which sets out the budgetary priorities for that period. The European Union budget is not allowed to be in deficit.

Five institutions of the European Union

The European Parliament

785 members elected by the people of Europe

Shares responsibility for passing laws, in some policy areas, jointly with the Council

Shares responsibility for approving the EU annual budget jointly with the Council

Administrative spend: €1.3 billion (£0.9 billion)

The Council of the European Union

One Minister from each Member State attends from specialist policy area

Number of votes broadly reflects size of Member State populations

Shares responsibility for passing laws, in some policy areas, jointly with Parliament

Shares responsibility for approving the EU annual budget jointly with Parliament

Administrative spend: €558 million (£382 million)

The European Commission

Independent of national governments

One Commissioner from each Member State, nominated by national governments and approved by the European Parliament

Drafts proposals for new European laws, manages implementation of EU policies and EU spending and ensures Member States abide by European treaties and laws

Implements the budget

Administrative spend: €4.3 billion (£2.9 billion)

The European Court of Justice

One judge from each Member State

Ensures EU law is interpreted and applied consistently in all EU countries

Ensures EU Member States and institutions do what the law requires them to do

Administrative spend: €265 million (£181 million)

The European Court of Auditors

One member from each Member State

External auditor of the accounts of all revenue and expenditure of the Community

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

Administrative spend: €107 million (£73 million)

Source: European Union and European Court of Auditors' Annual Report concerning the financial year 2007

NOTE

Total expenditure on European Institutions was €6.8 billion (£4.6 billion). The five institutions listed above account for some €6.6 billion (£4.5 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).

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; a revision is made only in exceptional circumstances and within strict legal parameters.

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

2 The budgetary process is: at the end of April, or early May, the Commission adopts the preliminary draft budget, which is drawn together from input across each of the Commission's Directorate-Generals. This is submitted to the Council who examine and amend the figures and establish the draft budget before 31 July. The draft budget must be adopted by qualified majority (at least 255 votes out of 345, 29 of which are allocated to the United Kingdom). Parliament conducts its first reading in October, and may propose amendments and modifications to the draft budget. These proposals are reviewed by the Council, before Parliament further reviews and adopts the final budget, which is signed into law by the President of the Parliament.

3 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 is extended until the Council and Parliament come to an agreement.

4 The Commission may also propose amendments to the budget throughout the year, which may be adopted using the same procedures as the annual budget. This allows the Community to adjust the budget for developments during the year, such as unexpectedly high revenue or low expenditure.

5 The Reform Treaty would simplify these provisions in two respects: there would only be a single 'reading' of the budget by Council and Parliament, with any differences of opinion between the institutions resolved in a conciliation committee; and, no distinction will be made between different categories of expenditure.

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

7 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 Union 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.

8 The main sources of funding for the budget are a contribution based on Member States' Gross National Income, a contribution based on Value Added Tax and customs duties on a range of commodities imported from non-Member States. These income categories and the main expenditure programmes are described in **Figure 6**.

6 European Union: Sources of receipts in 2007

Source of receipt	Value (€ billion)	%
Gross National Income-based own resources	73.9	62.8
Value Added Tax-based own resources	19.4	16.5
Traditional own resources	16.6	14.1
Miscellaneous revenue	5.5	4.7
Surplus carried forward from 2006	2.1	1.8
Total	**117.6**	**100.0**

Source: European Court of Auditors' Annual Report for the financial year 2007

NOTE

Figures do not cast correctly due to rounding.

9 The European Union budget for 2007 was the first under the 2007-2013 Financial Framework, and the first for the enlarged European Union of 27 Member States. The key priority for the European Union remained growth and employment and the budget supported a new generation of programmes focusing on this area. The preservation and management of the Union's natural resources continued to receive considerable support. The Figure below shows the receipts position for 2007 while Figure 3 in Part one of this report shows the expenditure position.

The Court's audit methodology

10 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 2007 was based on two principal sources of evidence:

- An assessment of the operation of the supervisory and control systems applied in the collection and disbursement of funds from the European Union budget by European Union institutions, Member States, regions, third 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; and
- Checks based on representative statistical samples of underlying transactions relating to revenue and to expenditure, down to the level of the final beneficiary, aiming to provide direct evidence on the *legality* and *regularity* of payments.

7 The main sources of income and expenditure for the EU

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 calculated by the Commission and not exceeding 0.5 per cent, applied to the VAT base which must not, for any Member State, exceed 50 per cent of its Gross National Income.
- **Gross National Income (GNI) based contributions** – calculated as an equal percentage of each 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 2006.

Expenditure programmes

- **Agriculture and Natural Resources** – schemes to support farmers, agricultural markets, and rural development.
- **Cohesion** – 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.
- **Research, Energy and Transport** – research policy promotes the EU as an area of education, training, research and innovation. Energy and transport policies aim to support economic growth, safety and security of supply.
- **External Aid, Development and Enlargement** – including food aid, humanitarian and development aid. Payments offering assistance to pre-accession countries.
- **Education and Citizenship** – funding schemes to various thematic areas and types of projects such as grants to actions in favour of Citizenship or for mobility in the education and training sectors.
- **Economic and Financial Affairs** – programmes to promote research and development, increase competitiveness and provide macro-economic assistance.
- **Administrative and Other Expenditure** – this covers the expenditure of European Union institutions other than the Commission, pensions and European Schools.

Source: European Union, and European Court of Auditors' Annual Report for the financial year 2007

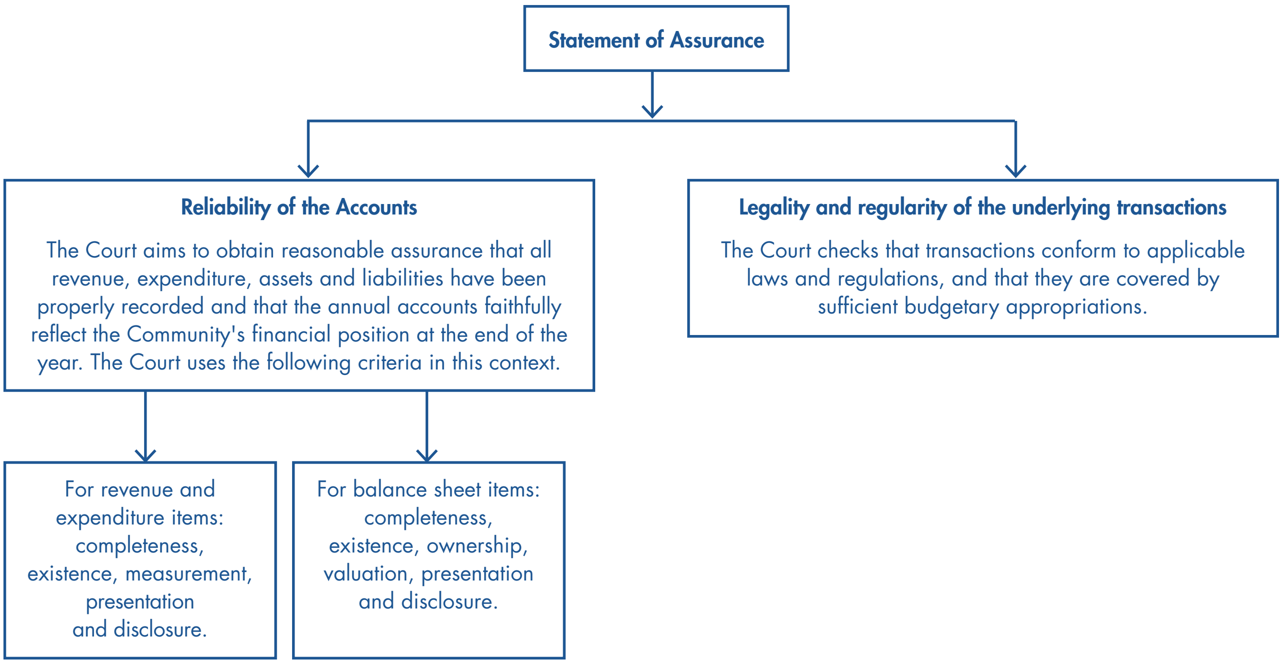
Figure 8 outlines what is meant by *reliability*, *legality*, and *regularity*.

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 their synthesis, stating whether the Commission has reasonable assurance that systems in place ensure the *legality/regularity* of the underlying transactions; and
- 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).

11 The Court's report for 2007 supplements its Statement of Assurance with specific assessments of the Community's major areas of income and expenditure,[21] as it has done in recent years. The Court also examined developments relating to qualifications in the 2005 and 2006 Statements of Assurance.

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



Source: European Court of Auditors

21 Agriculture and natural resources; Cohesion; Research, energy and transport; External aid, development and enlargement; Education and citizenship; Economic and financial affairs; Administrative and other expenditure.

APPENDIX FOUR

Financial support for agriculture: the Single Payment Scheme

1 The schemes under which Agricultural Policy direct aid payments were made in 2007 were:

- **The Single Payment Scheme** This is the principal agricultural subsidy scheme, put in place in 2005. It differs from historic schemes by breaking the link between subsidy and production, and focuses on promoting environmental good practice.
- **The Single Area Payment Scheme** Following the enlargement of the European Union in 2004 and 2007 to include twelve new Member States, ten[22] apply a simplified version of the Single Payment Scheme (SPS) called the Single Area Payment Scheme (SAPS). Under SAPS, a uniform amount within each Member State is paid for each hectare of eligible land. The Member States that currently apply SAPS are scheduled to apply SPS from 2012 onwards.
- **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. Under these schemes 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 depending on the approach adopted by the Member State concerned. The other aid schemes now only have a minor impact, relative to the two schemes above, on agricultural expenditure.

2 The Single Payment Scheme has been introduced by 17 Member States between 2005 and 2007 as part of reforms of the Common Agricultural Policy. It replaced most existing crop and livestock subsidy schemes with one single subsidy based on land area. This single subsidy is independent of the volume of production, and is paid provided farmers meet certain criteria concerning: environmental standards; 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.

3 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.

4 In order to qualify under the Single Payment Scheme farmers must first obtain 'entitlements'. National authorities opt for one of the payment models (see paragraphs 7-9 below) 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 overleaf** shows the Member States that implemented the Single Payment Scheme in 2007 and the models they applied.

Single Payment Scheme Models and the allocation of entitlements

5 **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.

22 Bulgaria, the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Poland, Romania and Slovakia (all but Slovenia and Malta who apply the Single Payment Scheme).

6 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.

7 Under the **Historic** model each farmer is granted entitlements based on the average amount of aid received and area farmed during the reference period.

8 Under the **Regional** model all entitlements of a region have the same flat-rate value and the farmer is allocated an entitlement for every eligible hectare declared in the first year of application.

9 Single Payment Scheme models applied by Member State in 2007

Member State	Model applied
Austria	Historic
Belgium	Historic
Denmark	Dynamic hybrid
Finland	Dynamic hybrid
France	Historic
Germany	Dynamic hybrid
Greece	Historic
Ireland	Historic
Italy	Historic
Luxembourg	Static hybrid
Malta	Regional
Netherlands	Historic
Portugal	Historic
Slovenia	Regional
Spain	Historic
Sweden	Static hybrid
United Kingdom	
England	Dynamic hybrid
Scotland	Historic
Wales	Historic
Northern Ireland	Static hybrid

Source: European Commission Directorate-General for Agriculture and Rural Development

9 The **Hybrid** model combines the historic element with a flat-rate amount and, if the **Dynamic Hybrid** is adopted by the Member State, the historic component decreases each year until it becomes a predominantly flat-rate system.

10 European Union 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 2007 there were 81 Paying Agencies across the 27 Member States, four 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. 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.

4 *Clearance of accounts through the Commission* (both annual financial clearance and multi-year conformity clearance).

Source: European Commission Directorate-General for Agriculture and Rural Development

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 2007 these were 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. For 2006 the six Paying Agencies in the United Kingdom were the Rural Payments Agency, 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.

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.

As new schemes are brought under IACS, the system is being progressively applied to an increasing proportion of EAGF expenditure (85 per cent in 2007).

Source: European Commission and European Court of Auditors

11 In 2007 the Court reported "the IACS inspection results reported to the Commission by Paying Agencies assess the *legality* and *regularity* of claims submitted by farmers and have been verified by the certifying bodies for the first time in 2007. However, the certifying bodies do not extend their work to final beneficiaries for the verification and validation of IACS statistics. Neither has the Commission verified the reliability of these statistics. Furthermore, the Court's analysis of the work of 28 certifying bodies for the purpose of such verifications, showed that two certifying bodies' assessment was negative and one was unable to assess the situation. The Court further found that reconciliations provided for by the relevant Commission guideline had either not been done, or not been done in the way foreseen or that information provided did not allow a conclusion to be drawn upon the adequacy of the work."

12 Outside of the Single Payment Scheme and Single Area Payment Schemes there are two further lines of subsidy for farmers:

- **Direct Coupled Payments** financed by the European Agriculture Guarantee Fund: with the introduction of the Single Payment Scheme most farmers are paid independently of the volume of actual production. Nevertheless, a small number of aid schemes remain or may be coupled to output in order to avoid abandonment of production. The amounts involved are declining as the SPS is extended to additional products and Member States.
- **Intervention measures** in agricultural markets financed by the European Agriculture Guarantee Fund: the principal measures are intervention storage and export refunds. Expenditure has declined sharply in recent years due to policy choices made in the context of the recent Common Agricultural Policy reforms and also because demand and market prices for agricultural products have increased.

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

APPENDIX FIVE

Structural Measures and Cohesion Policy

1 In the 2000-2006 Financial Framework **Cohesion** expenditure was referred to as Structural Measures policies and had three objectives:

Objective one: structural adjustment of regions whose development was lagging behind;

Objective two: economic and social conversion of areas facing structural difficulties; and

Objective three: modernisation of systems of education and employment.

2 Five funds were deployed to deliver these objectives; four *structural funds* and one *cohesion fund*:

Structural Funds

a The **European Regional Development Fund (ERDF)** which aims to strengthen economic and social cohesion in the European Union by correcting any imbalances that exist between regions, for example, in infrastructure.

b The **European Social Fund (ESF)** which sets out to improve employment and job opportunities in the European Union, for example, through combating discrimination.

c The **European Agricultural Guidance and Guarantee Fund – Guidance Section (EAGGF-Guidance)** which co-finances rural development projects.

d **The Financial Instrument for Fisheries Guidance (FIFG)** which co-finances measures towards a sustainable balance between fishery resources and their exploitation.

The Cohesion Fund

e The **Cohesion Fund**, directed at Members States whose Gross National Income per head is less than 90 per cent of the Community average, aims to reduce economic and social shortfalls whilst stabilising the economy.

3 For the 2007-2013 Financial Framework the Cohesion expenditure area encompasses three new broad policy objectives:

a **Convergence** seeks to bring the poorer Member States and regions up to the European average level by promoting 'growth-enhancing conditions'. This objective will receive some 81 per cent of Cohesion Policy Funds during the Framework.

b To strengthen **Regional Competitiveness and Employment** throughout Europe through innovation and entrepreneurship whilst protecting the environment and increasing employment through workforce training (16 per cent of Cohesion Policy Funds).

c **European Territorial Cooperation** aims to strengthen cross-border cooperation in cross-border areas (3 per cent of Cohesion Policy Funds).

4 The funds used to deliver these objectives have been rationalised down to the ERDF, ESF and Cohesion Funds. The funds applied to each objective for the 2007-2013 Financial Framework are shown in **Figure 10**.

10 Funds used to deliver the objectives of the Cohesion policy 2007-2013

Objective	Funds to deliver the objectives		
Convergence	ERDF	ESF	Cohesion Fund
Regional Competitiveness and Employment	ERDF	ESF	
European Territorial Cooperation	ERDF		

Source: European Commission

APPENDIX SIX

Cases of irregularity, including possible fraud, notified to the Commission in 2006 and 2007

1 Significant increases in irregular expenditure from 2006 were experienced in a number of areas:

- In Cohesion the value of reported irregularities increased by €125 million (18 per cent) with an increase of just under 20 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;
- In Agriculture the value of reported irregularities increased by €68 million (78 per cent) partly due to cases with a significant financial impact which arose or were discovered in previous years but were reported only in 2007. This increase in value was despite a decrease of 52 per cent in the number of cases due to the application from 1 January 2007 of a new Commission Regulation which raised from €4,000 to €10,000 the threshold above which Member States are required to report irregularities to the Commission; and
- Reported irregularities also increased significantly by value while decreasing in number in Pre-accession funds.

2 Statistics on expenditure directly managed by the Commission were reported for the first time in 2007. The financial impact of €33 million was notified by the teams responsible for external actions (€19.1 million) and internal policies (€13.9 million).

11 Cases of irregularity, including possible fraud, notified to the Commission in 2006 and 2007

Category of expenditure	2006[1] Total number of cases	2006[1] Total amount € million	2006[1] Amount of suspected fraud € million	2007 Total number of cases	2007 Total amount € million	2007 Amount of suspected fraud € million	Percentage Change Total number of cases %	Percentage Change Total amount %
Cohesion (Structural and Cohesion Funds)	3,216	703	158	3,832	828	141	+19.2	+17.8
Own Resources	5,705	353	134	5,321	377	107	-6.7	+6.8
Agriculture (EAGGF Guarantee Section)	3,249	87	30	1,548	155	45	-52.4	+78.2
Pre-accession funds	395	14	2	332	32	5	-16.0	+128.6
Direct expenditure[2]	–	–	–	411	33	18	–	–
Total	**12,565**	**1,157**	**324**	**11,444[2]**	**1,425**	**316**	**-8.9**	**+23.2**

Source: Data from OLAF's Protection of the European Communities' financial interests – Fight against fraud – Annual Report 2007

NOTES

1 The 2006 figures are restated as Member States often notify OLAF of irregularities (including suspected fraud) some time after the irregularity has occurred.

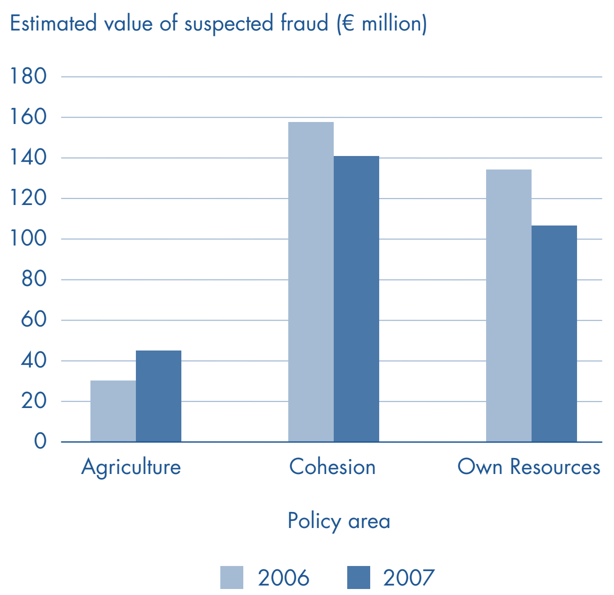
2 Figures for Direct expenditure are reported to OLAF by Commission departments. They are reported for the first time in 2007; to ensure we compare like for like they are removed from our year on year analysis.

3 Member States are required to report where they suspect that irregularities have arisen as a result of fraud. Suspicion of fraud case numbers, as reported by Member States, have increased to 105 (96 in 2006) for Agriculture as has the value of the financial impact to €45 million (€30 million in 2006). Suspicion of fraud cases have increased to 374 (241 in 2006) for Cohesion Policy while the value of the financial impact has fallen to €141 million (€158 million in 2006). For Traditional Own Resources, the proportion of irregularities categorised as frauds has remained constant with 2006 figures at 23 per cent though both the number of cases and the total financial impact of these cases decreased.

4 OLAF also receives information regarding suspicions of fraud from other sources, such as the Commission and whistleblowers. In 2007 OLAF received a total of 757 such reports of suspected fraud (an increase of some five per cent from 2006).

5 **The position in the United Kingdom**: In 2007, the United Kingdom reported 1,666 irregularities (including possible fraud) to OLAF, an increase of 18 per cent on 2006. This was highest number of reported irregularities, followed by Germany (1,504 cases), Spain (1,385 cases) and The Netherlands (1,262 cases). The value of irregularities reported by the United Kingdom was €281 million (£192 million), 125 per cent more than in 2006. This was the highest figure in the European Union, followed by Spain, Italy, and Germany. OLAF, on Cohesion Policy, observed that "2007 has been a special year for the number of irregularities and related irregular amounts reported by this country (the United Kingdom reported 502 irregularities in this expenditure area, and some €114 million (£78 million) on the European Regional Development Fund alone from 280 irregularities), as a result of extensive controls carried out."

12 Estimated financial impact of suspected fraud by major policy area



Source: Data from OLAF's Protection of the European Communities' financial interests – Fight against fraud – Annual Report 2007

6 These data are dependent on the timeliness, completeness and quality of reporting by Member States, and should be treated with caution; for example, OLAF considers 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.

7 The increase in reported irregularities in the United Kingdom arose in Cohesion Policy and Traditional Own Resources for both cases and amount. OLAF considers the increase in Structural Measures irregularities reported is partly as a result of extensive control checks carried out in the United Kingdom in 2007. In general OLAF have noted improved reporting compliance across Member States.

8 **Fraud investigations**: In 2007, OLAF opened 210 new cases, of which 48 were assisting national authorities in Member States. This is an increase of eight per cent in new cases opened compared with 2006. Thirty-two of these cases were in the United Kingdom. This was the ninth highest total. The figures for the United Kingdom are lower than for 2006 (a 37 per cent decrease). OLAF closed 232 cases, leaving 355 cases outstanding at the end of 2007 of which 21 relate to the United Kingdom. Of the 232 cases that were closed, 153 were closed with a follow-up recommendation (132 in 2006). 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 completed follow-up actions increased in 2007 to €203 million (£139 million) in comparison to €114 million (£78 million) in 2006.

APPENDIX SEVEN

Financial Corrections and Provisions – The United Kingdom position

Financial corrections

1 Legislation outlines how European funds should be spent. If this legislation is not adhered to this is an irregularity (see paragraph 2.42); the European Commission can refuse to fund projects and claw back any monies through a **financial correction**. The purpose of financial corrections is to restore a situation where all expenditure declared by a Member State is in line with the applicable national and Community rules and regulations.

2 Financial corrections can result from controls and audits at any level of the control system in the Member State or from audits by the Commission or the European Court of Auditors or OLAF. Where Member States make corrections for irregularities they are allowed to replace the disallowed expenditure with other eligible expenditure within the same programme in accordance with the legislation in force.

3 The Commission may take a formal decision to apply financial corrections to the Member State where the Member State has failed to make the required corrections, or where there are serious failings in the management and control system, which could lead to systemic irregularities. A financial correction applied by Commission decision involves a net reduction of the European Union funding of the programme concerned, which results 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. Government departments state that where grant recipients have made claims for ineligible expenditure, they will be expected to repay those amounts, thus recouping funds.

4 The Commission has the power to apply extrapolated or flat-rate corrections in certain cases where it is not possible or practicable to quantify the amount of irregular expenditure precisely, or when it would be disproportionate to cancel the expenditure in question entirely. Extrapolation is used when there are results of a representative sample of files available in relation to a systemic irregularity. Flat-rate corrections are applied in the case of individual breaches or systemic irregularities where the financial impact is not precisely quantifiable because it is subject to too many variables or diffuse in its effects.

Execution of financial corrections: withdrawals and recoveries

5 As we outline in the paragraphs above, action to execute financial corrections can be taken by Member States and by the Commission. In accordance with legislation, Member States may execute financial corrections in two ways. Either they:

- **withdraw** the expenditure affected from the programme immediately by deducting it from the next statement of expenditure submitted to the Commission, thereby immediately releasing the European Union funding for commitment to other operations; or they
- leave the expenditure for the time being in the programme pending the outcome of proceedings to **recover** the unduly paid amount from the beneficiaries. Recovery is effected either by obtaining repayment of the sums concerned or setting off the sums to be repaid against further payments due to the same beneficiary.

6 Member States are required to supply the Commission with data on financial corrections in the form of both the amounts withdrawn from co-financing and the amounts recovered. The two sets of data are distinct and complementary, as only expenditure withdrawn without waiting for the outcome of recovery proceedings[23] is included in withdrawals, and only expenditure which has not been withdrawn at the outset, but has been left in the declared expenditure until it is recovered, is included, once recovery has taken place, in recoveries. In addition, Member States are required to report the amounts awaiting recovery (subject to a recovery procedure but not yet recovered), or 'pending recoveries'. Information provided to the Commission by the United Kingdom on its financial corrections is shown in **Figure 13**.

Provisions and Contingent Liabilities

7 The following paragraphs refer to the contingent liabilities in the Resource Account of the Department for Communities and Local Government (DCLG).

8 In 2006-07 the Commission suspended payments to five of the nine UK regions resulting in a contingent liability of £62 million in 2006-07. Following detailed work by the Department to address the Commission concerns the majority of problems were addressed. In one region, the North West, problems persisted and the Commission levied a financial Correction of €24.8 million (valued at £19.8 million by the Department). This is accounted for in the 2007-08 account as an operating cost.

9 During 2007-08 the Commission reported on audit work including: the 1994-1999 Financial Framework ERDF expenditure in the North East and North West; further concerns about the 2000-2006 Framework; and aspects of two of the Interreg programmes. The total amount of grant at risk to the Department in respect of ERDF and Interreg is about £230 million. The Department, however, believes that many of the Commission's concerns will be overcome, but it outlines the following:

a In relation to the 1994-1999 Financial Framework in the North East and North West the Commission has concerns relating to some specific projects and it has extrapolated across the whole programme to reach a total potential disallowance. Having examined the projects in question the Department has acknowledged to the Commission that there are problems with the eligibility of some expenditure for grant, and the Department accepts that some £7 million of grant will be disallowed. Therefore this amount has been accrued in 2007-08. Of the remainder, the Department considers that it would be prudent to provide for £25.7 million in 2007-08 and raise a contingent liability for the remainder (£76 million).

b In relation to the 2000-2006 Framework, the Department assesses the total amount at risk to be about £104 million, but having examined the circumstances considers that only £1 million of payments in the North West are ineligible for grant. This amount has therefore been accrued in 2007-08. In addition it is considered that a further £41 million is at serious risk and therefore a provision has been raised for this amount. The remainder (£62 million) is disclosed as a contingent liability.

c There is also a further £17 million at risk on projects undertaken by Business Links and under the Interreg programme. The Department has significant concerns about some of this expenditure and has therefore raised a provision of just over £6 million. The remainder (£11 million) is disclosed as a contingent liability.

10 There is one further European related contingent liability in the Account due to possible administrative irregularities in respect of the ERDF programme, where approximately 50 per cent of the total irregularities value would not be recovered due to the insolvency of beneficiaries occurring. The liability is some £24.9 million and is based on the historical trend of the programme.

11 The above information on provisions and contingent liabilities is summarised in **Figure 14 on page 44**.

23 When a Member State opts for withdrawal of the irregular expenditure, it may still go on to recover the unduly paid sums from the beneficiary. Member States are obliged under the regulations to pursue recoveries wherever possible and appropriate (Article 38(1)(h) of Regulation 1260/1999 and Article 7(3) of Regulation 448/2001).

13 Financial Corrections reported to the Commission by the United Kingdom up to and including calendar year 2007

Programme	Withdrawals 2000-06 (€ 000)		Recoveries 2000-06 (€ 000)		Withdrawals 2007 only (€ 000)		Recoveries 2007 only (€ 000)		Pending Recoveries at the end of 2007 (€ 000)	
	Total Public Funding	EU contribution	Total Public Funding	EU contribution	Total Public Funding	EU contribution	Total Public Funding	EU contribution	Total Public Funding	EU contribution
ERDF	212,105	86,171	42,393	22,769	147,094	43,941	13,365	7,428	100,983	40,847
ESF	80,739	41,499	9,693	4,918	11,391	7,795	7,506	3,783	25,986	14,633
EAGGF	886	442	1,257	604	519	260	7	3	78,348	76,708
FIFG	701	572	68	78	595	469	11	32	711	727
TOTAL	**294,432**	**128,685**	**53,411**	**28,370**	**159,600**	**52,466**	**20,887**	**11,247**	**206,029**	**132,915**

Source: European Commission

NOTE

Figures do not cast correctly due to rounding.

ERDF – The European Regional Development Fund exists to promote regional development.
ESF – The European Social Fund exists to promote employment and economic and social cohesion.
EAGGF – The European Agriculture Guidance and Guarantee Fund exists to support agriculture and promote rural development.
FIFG – The Financial Instrument for Fisheries Guidance exists to support structural measures in fisheries and aquaculture.

14 Penalties imposed, provisions raised and contingent liabilities disclosed by the Department for Environment, Food and Rural Affairs and the Department for Communities and Local Government

Description	Department	Financial Penalty imposed by EC and/or accepted by Department 2007-08 £m	Provision[1] 2007-08 £m	Contingent Liability[2] 2007-08 £m
Possible obligations to repay EC funds in respect of the 1994-1999 ERDF programmes. The Commission has concerns relating to some specific projects and has extrapolated across the whole programme. The Department has acknowledged that there are problems with the eligibility of some expenditure.	DCLG	7.0	26	76
Possible financial corrections for irregularities with EC funds in respect of the administration of the 2000-2006 ERDF programmes.	DCLG	1	41	62
Possible financial corrections in relation to the Interreg programme and for ERDF projects undertaken by Business Links.	DCLG	–	6	11
Possible administrative irregularities in respect of the ERDF programme, where approximately 50 per cent of the total irregularities value would not be recovered due to the insolvency of beneficiaries.	DCLG	–	–	24.9
Financial correction imposed on grant payments made in the North West made by Government Offices	DCLG	19.8	–	–
Potential financial corrections arising from disallowed payments under the Single Payment Scheme for 2005 and 2006 and for other schemes administered by the Rural Payments Agency and Devolved Administrations.[3]	Defra	–	320	4
Disallowance for ineligible expenditure under the European Agriculture Guarantee Fund	Defra	0.6	–	–
Total		**28.4**	**393**	**177.9**

Source: National Audit Office analysis of departmental resource accounts

NOTES

1 A provision is a liability of uncertain timing or amount. An organisation should recognise a provision in its accounts when it is probable (i.e. more likely than not) that the liability will occur and a reliable estimate of the amount can be made.

2 A contingent liability is a potential liability which arises from past events but the existence of which will not be confirmed until the occurrence of a future event which is outside the control of the organisation. The potential value of contingent liabilities is not recognised in financial statements but should be disclosed.

3 From 2007-08 onwards Defra no longer create provisions for potential financial corrections due to new errors which occur in the Devolved Administrations. Devolved Administrations should create provisions for these in their own accounts. Provisions relating to Devolved Administrations existing at the start of 2007-08 remain in the Defra Resource Account.

APPENDIX EIGHT

Special Reports published by the European Court of Auditors in 2008

Special Report 1/2008	The procedures for the preliminary examination and evaluation of major investment projects for the 1994-1999 and 2000-2006 programming periods
Special Report 2/2008	Binding Tariff Information
Special Report 3/2008	The European Solidarity Fund: how rapid, efficient and flexible is it?
Special Report 4/2008	The implementation of milk quotas in the Member States which joined the European Union on 1 May 2004
Special Report 5/2008	The European Union's Agencies: Getting results
Special Report 6/2008	European Commission Rehabilitation Aid following the Tsunami and Hurricane Mitch
Special Report 7/2008	Intelligent Energy 2003-2006
Special Report 8/2008	Is cross compliance an effective policy?
Special Report 9/2008	The effectiveness of EU support in the area of freedom, security and justice for Belarus, Moldova and Ukraine
Special Report 10/2008	EC Development Assistance to Health Services in Sub-Saharan Africa
Special Report 11/2008	The management of the European Union support for the public storage operations of cereals
Special Report 12/2008	The Instrument for Structural Policies for pre-accession (ISPA), 2000-2006

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Financial Management in the European Union

A report by the Comptroller and Auditor General

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