Consolidated Statement on the Use of EU Funds in the UK for the year ended 31 March 2009

Report by the Comptroller and Auditor General

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Introduction

1. This report relates to the 2008-09 UK Consolidated Statement on the use of European Union (EU) Funds, and is the third annual statement produced by the Government. There is no statutory requirement to produce such a Consolidated Statement and it is therefore prepared on a voluntary basis, to help to detect weaknesses in controls and to promote sound management of EU funds. HM Treasury's Accounting Officer has overall responsibility for the preparation of this Statement. The arrangements for accounting for the use of EU funds are explained in the Commentary to the Statement. Funding from the EU and expenditure made from these funds are accounted for by the UK authorities who receive and include them in their audited statutory accounts. The Accounting Officers of these authorities are responsible for the recording and regularity of the underlying transactions.

2. I have audited this Statement to give my opinion on whether it presents a true and fair view and whether the underlying transactions conform to the authorities which govern them. In forming my opinion I have considered, in accordance with International Standards on Auditing, the results of specified audit procedures carried out by the auditors of the underlying statutory accounts. This report summarises the results of my audit.

The European legislative framework

3. The Treaty establishing the European Community provides the basic legal framework for the Budget of the EU. The Budget includes a number of separate funds, including the European Agricultural Guarantee Fund (EAGF), the European Agricultural Fund for Rural Development (EAFRD), the European Regional Development Fund (ERDF) and the European Social Fund (ESF). These are governed by secondary legislation made by the Council of the EU (the Council) and the European Commission (the Commission) which has overall responsibility for implementing the budget. The Council regulations and decisions define the eligibility criteria which final

beneficiaries have to meet to be entitled to EU funds. They also specify certain control processes which must be implemented by Member States. Within the Member States, national authorities are responsible for overseeing the implementation of EU funded schemes in accordance with EU legislation. This includes determining whether final beneficiaries have met the eligibility criteria before payment is made. The national authorities also have a financial reporting responsibility to the Commission.

4. If the UK authorities, in common with other Member States, fail to meet certain procedural and other requirements in EU regulations and decisions, the Commission may determine that conditions have not been met and levy a financial correction on the Member State. Where this occurs, the Commission makes a reduction in EU funding made to the Member State for expenditure on programmes. While my audit provides an opinion on the regularity of payments of EU funds by UK authorities to final beneficiaries, only the Commission is able to determine whether any financial correction is due. Any such shortfall in funding for UK expenditure is made good by the UK taxpayer. I consider that any expenditure met by the UK taxpayer in these circumstances is outside the intentions of Parliament and therefore irregular in the context of that part of my audit opinion.

5. These financial corrections are normally made some considerable time after the payments to final beneficiaries under the relevant programme. They normally result from inspections and audits by the EU authorities, sometimes as part of the formal closure of a scheme or multi-year programme. Hence, it can be several years before financial corrections are implemented. Paragraphs 28 to 33 set out the results of my audit of regularity.

The purpose of the Consolidated Statement

6. The purpose of the Consolidated Statement is clearly defined in the Economic Secretary's announcement to the House of Commons on 20 November 2006, where he stated that "*the Government intend…to prepare and lay before Parliament an annual consolidated statement on the UK's use of EU funds…which would be audited by the National Audit Office… These arrangements would enhance audit and Parliamentary scrutiny of our own use of EU funds, help detect any irregularities and thus improve financial management.*" The Consolidated Statement adds transparency by providing a single perspective on how the UK is managing EU funds and the liabilities that arise as a consequence – principally the probable future financial corrections that the UK expects the Commission to impose on the UK.

Responsibilities for the preparation of the Consolidated Statement and audit

7. HM Treasury's Accounting Officer has overall responsibility for the preparation of this Statement, which consolidates the EU funds accounted for by the individual central government authorities detailed at Note 2 to the Statement.

8. HM Treasury has taken steps in the production of this, the third annual Consolidated Statement, to further refine the definition of what is included in the Statement and what is not. As set out in the accounting policy in Note 1.3 to the accounts, the 2008-09 Statement now excludes transactions and balances from EU schemes where the UK authority is the final beneficiary, as these are managed by the Commission, not the UK government. The Statement should therefore only recognise transactions and balances from EU schemes where the UK government is in effect the managing authority on behalf of the EU and distributes the funds to others. This has required HM Treasury to restate some of the figures previously presented in the 2007-08 Consolidated Statement, following this refinement of its accounting policy.

9. HM Treasury has asked me to provide an audit opinion on this Consolidated Statement. My audit is designed to form a view on the truth and fairness of the financial statements and to conclude whether, in all material respects, the expenditure and funding have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. This includes checks on whether payments are for the correct amounts and paid to eligible beneficiaries who satisfy the scheme criteria. Where the conditions are not met, I consider the element of the transaction which is not in compliance with the regulations to be 'irregular'.

Progress in the preparation and audit of the Consolidated Statement

10. Significant progress has been made in the preparation and audit of this annual statement since 2006. There is now a clearer sense of what funds are classed as managed by the UK Government, as opposed to being managed by the Commission. Some good progress has been made in securing improved consistency of accounting policies across the component authorities. This has been most notable in relation to provisions for future liabilities, where there is now much greater commonality in determining when to raise a provision for potential future financial corrections and when to recognise that the provisions have crystallised into actual losses to the UK Exchequer.

11. The Consolidated Statement now reflects more fully the Statement that the Government originally envisaged. Nonetheless, there are material issues at the core of producing the Statement that HM Treasury and the UK authorities have still to resolve. I have therefore qualified my audit opinion on the 2008-09 Consolidated Statement. My comments on the potential for further improvements to the Consolidated Statement are discussed at paragraphs 34 to 38.

Qualified True and Fair Opinion arising from Disagreement on Consistency of Application of Accounting Policies, Disagreement on Accounting Policies for Foreign Currency Transactions and Limitations in Audit Scope

12. Under International Standards on Auditing (UK & Ireland), I am required to give my opinion on whether the Consolidated Statement presents a true and fair view of the use of EU funds in the UK. I have qualified my opinion for the reasons set out below.

Application of Accounting Policies

13. The accounting policies for EU funds are set out in HM Treasury's Financial Reporting Manual (FReM), which has been adopted by the UK government as the basis for producing its accounts. With the exception of Financial Reporting Standard 23 'The effects of changes in foreign exchange rate' (see paragraphs 15 to 18 below), authorities which received EU funding complied, in all material respects, with the FReM in producing their own financial statements and their interpretation of the guidance was within an acceptable range of professional judgement. For the purposes of this Consolidated Statement, however, accounting treatments and estimates have not always been consistent between Managing Authorities.

14. As a result of the inconsistent applications of accounting treatments and estimates, I have been unable to confirm that the debtors, creditors and related expenditure entries have been compiled on a consistent basis and are materially accurate.

Accounting Policy for Foreign Currency Transactions

15. I qualified my "true and fair" opinion on the 2008-09 financial statements of the Department for Environment, Food and Rural Affairs (DEFRA) and the Rural Payments Agency (RPA) over a disagreement about the accounting treatment for foreign exchange rate gains and losses.

16. Both DEFRA and the RPA are required to produce accounts in accordance with the FReM, which interprets UK General Accepted Accounting Practice for use in the public sector. The FReM requires entities to apply Financial Reporting Standard 23 'The effects of changes in foreign exchange rate' and Financial Reporting Standards 25, 26 and 29 relating to financial instruments in full from 2008-09 onwards.

17. The RPA has significant exposure to exchange rate risk as it pays out European Commission scheme funds (the most significant of which is the Single Payment Scheme) to English farmers in Sterling - but is reimbursed in Euros. To manage this risk, RPA uses a forward exchange contract to hedge its Single Payment Scheme-related Euro income.

18. I do not consider that the RPA's application of FRS 23 conformed to the Standard. In particular, the RPA did not apply the spot exchange rate on recognition of foreign currency transactions in respect of reimbursement from the Commission. The approach adopted by the RPA did not reflect the full volatility of exchange rates experienced in 2009. The effect of the RPA's treatment was to omit material gains/losses arising on retranslation of claims during the year. The full application of FRS 23 as stipulated in the Standard would have had a material impact on the valuation of the European Commission debtor, recognised foreign exchange gains in losses in scheme expenditure, and gains arising on the revaluation of the European Commission debtor. DEFRA and the RPA acknowledge that their 2008-09 accounts (and their figures included in this Consolidated Statement) did not comply in full with FRS 23.

Limitation in Audit Scope arising from unauditable balancing figures

19. The Consolidated Statement relies upon two balancing figures to complete the Balance Sheet ('Temporary UK Finding') and the Cash Flow Statement ('Receipts from the EU').

20. The Consolidated Statement is unusual in that it is not drawn up from a single ledger that supports the production of a trial balance, but from a series of returns made by component authorities. The Managing Authority returns are comprised of summary EU-related financial data extracted from the ledgers which support their statutory accounts.

21. Most Managing Authorities do not maintain EU-related debit and credit entries in a ledger separate from other activity. This introduces an inherent risk that the figures extracted from their accounting data are incomplete. To ensure that the Managing Authority returns balance, there is a built-in balancing figure in each one – Temporary UK Funding.

22. **Temporary UK Funding** in the Balance Sheet is intended to represent the amount of UK funds given to Managing Authorities to finance EU Scheme activities ahead of claiming and receiving funds from the European Commission. The underlying accounts and accounting records of the UK Managing Authorities do not, however, record the level of Temporary UK Funding. It is therefore not a figure for which I can draw specific assurance from the audits of the underlying statutory accounts.

23. If I could be assured that all of the other components of the Balance Sheet were materially correct, I could make the same judgement about Temporary UK Funding. I have not, however, been able to gain full assurance concerning the identification of debtor and creditor balances and related transactions between entities. I could therefore not verify the figure for Temporary UK Funding (£217,994,000 in the Balance Sheet).

24. **Receipts from the EU** is a figure that should be easily identifiable from the underlying statutory accounting data of the Managing Authorities, but the absence of a specific ledger for EU transactions means that HM Treasury has adjusted the receipts figure to make the Cash Flow Statement work. I have no assurance that this adjustment is a valid correction and I could therefore not verify £361,182,000 of the reported Receipts from the EU (£4,687,084,000 in the Cash Flow Statement).

25. I am content that, with the exception of adjustments which may have been required to the balance sheet, expenditure statement and cash flow statement as a result of the matters in paragraphs 13 to 24 above, the accounts present a true and fair view of the EU-funded activities of the UK central government.

Qualified True and Fair Opinion on 2007-08 figures

26. My audit opinion on the 2007-08 Consolidated Statement was qualified for reasons similar to, but not confined to, the reasons I have set out in respect of my opinion on the 2008-09 Statement. My opinion on the 2007-08 Statement highlighted that:

The financial statements are not based upon bookkeeping in a single ledger that supports the production of a trial balance. The process of data capture is vulnerable to the risks of inconsistencies among the UK government bodies involved.

As a result, there is uncertainty over the completeness and reliability of data concerning transactions and balances relating to the use of EU funds in the UK. In my opinion, accounting policies have not been consistently applied across the component entities in relation to the identification of debtor and creditor balances and related transactions between entities, the treatment of EU funding, the compilation of cash balances and the recognition of provisions for financial corrections.

Accordingly, these consolidated financial statements contain material misstatement, the quantification of which is dependent on professional judgement in the interpretation of those policies. As a direct consequence of the uncertainties surrounding the reliability of the balance sheet, I could not verify the figures for Temporary UK Funding (£182,839,000 in the balance sheet) or Other Receipts Direct from the EU (£108,530,000 in the cash flow statement).

27. The qualification of my opinion due to the inconsistent application of accounting policies was broader in 2007-08, since it also included the treatment of EU funding; the compilation of cash balances; and provisions for financial corrections. These qualification matters are unresolved, in that HM Treasury's subsequent restatements of the 2007-08 figures do not remove my concerns about the comparative figures - which are also disclosed as part of the 2008-09 Statement - being materially misstated. I am required by International Standard on Auditing (ISA) 710 to draw this matter to attention because it limits the understanding that can be gained by comparing the figures presented for the financial years 2008-09 and 2007-08.

Regularity of payments to final beneficiaries

28. My audit included the examination, on a test basis, of evidence that payments by UK government bodies to final beneficiaries in 2008-09, in all material respects, conformed with the authorities which govern them. As a result of the audit, I have been able to confirm that payments generally complied with these requirements. I noted a number of procedural and administrative matters which, whilst not providing evidence that payments to final beneficiaries were subject to material irregularity, give rise to the risk of the Commission imposing financial corrections in the future if it believes that its scheme regulations have not been followed.

Qualified Regularity Opinion

29. Where the Commission determines that its scheme regulations have not been complied with, it may propose a financial correction. The Commission makes an initial assessment of the consequences of the weaknesses found. It then discusses its findings with the UK authorities

before deciding on the actual level of the correction to be applied. The correction is then made by restricting the level of future funding made available to the UK, with the resulting cost being met by the UK taxpayer.

30. When the UK authorities become aware that a financial correction may be necessary, either from their own knowledge or from notification by the Commission, they provide for these amounts in their statutory accounts. Provisions for potential financial corrections of £601 million have been included in the 2008-09 Consolidated Statement. These provisions, relating predominantly to likely corrections by the Commission relating to expenditure and control systems up to 31 March 2009, represent a probable outflow of economic benefit but I do not consider these transactions to be irregular at that point. Once the Commission has determined the final correction, this represents a crystallised loss to UK funds which I then consider to be irregular.

31. During the financial year 2008-09, financial corrections relating to prior years totalling £137 million crystallised (**Table 1**), as a result of decisions confirmed by the Commission. Most of the £137 million disallowance loss that was confirmed in 2008-09 was incurred by DEFRA. I consider that these amounts are material in the context of the Consolidated Statement for 2008-09. I have qualified my regularity opinion on the Statement on the grounds that the loss to UK funds from these corrections falls outside of Parliament's intentions in relation to the proper administration of European funding.

32. A further £261 million of corrections has crystallised since the end of 2008-09 and prior to the Accounting Officer signing the Consolidated Statement (**Table 2**). Although these decisions occurred after the balance sheet date, they relate to conditions existing at that date and I consider these losses are also irregular in respect of my opinion on the Consolidated Statement for 2008-09. HM Treasury has provided further information on these corrections in the Commentary on the Consolidated Statement. The total of crystallised disallowances in 2008-09 and since that relate to events up to 31 March 2009 is therefore £398 million.

33. I also qualified my "regularity" opinion on the 2008-09 and 2009-10 DEFRA accounts because of the payment of material disallowance penalties imposed by the Commission.

Table 1: UK financial corrections confirmed by the Commission in 2008-09

Department	Amount £m	Funds affected
Department for Environment, Food and Rural Affairs	92	Agriculture and Natural Resources
Department for Communities and Local Government	24	European Regional Development Fund
Wales	12	European Regional Development Fund
Scotland	9	European Regional Development Fund
	137	

Table 2: UK financial corrections confirmed by the Commission since 31 March 2009

Department	Amount £m	Funds affected
Department for Environment, Food and Rural Affairs	161	Agriculture and Natural Resources (Single Payment Scheme)
Department for Environment, Food and Rural Affairs	32	Agriculture and Natural Resources (Other)
Northern Ireland	43[1]	Agriculture and Natural Resources (Single Payment Scheme)
Northern Ireland	25	European Regional Development Fund
	261	

Improving the Consolidated Statement

34. This Statement represents the third annual Consolidated Statement of the use of EU funds in the UK, compiled from pre-existing audited accounts for the 2008-09 financial year. In producing the Statement, HM Treasury has again made a number of significant adjustments to the data received from UK authorities.

35. HM Treasury continues to improve its processes for capturing data and preparing the Consolidated Statement and is working closely with the UK authorities to address the data quality and consistency issues highlighted in this report. In partnership with those authorities, HM Treasury is also developing its accounting guidance to help to improve the consistency of reporting of EU funding transactions across Central Government. This work should lead to continued improvements for future years.

[1] Plus an additional £11 million accounted for in DEFRA's Resource Accounts, dating back to SPS 2005, included in DEFRA figures shown.

36. The first two annual Statements have already led to increased scrutiny of the use of EU funds in the UK. The annual publication of this Statement will help to ensure that this continues. The audit of the Consolidated Statement should help to detect weaknesses in the UK's management of EU funds so that they may be addressed and so that management control systems may be improved.

37. The preparation of the 2008-09 Consolidated Statement has been subject to delay. Material financial corrections either proposed or confirmed by the Commission after the certification of the statutory accounts of Managing Authorities have been a major factor. When these announcements occur, they are significant post-balance sheet events that require adjustments to be made to the Consolidated Statement. In such circumstances, HM Treasury's Accounting Officer needs to have processes in place for the Accounting Officers of Managing Authorities to give their consent for HM Treasury to adjust figures that have been presented in the underlying statutory accounts and in the data returns to HM Treasury for the Statement.

38. The situation described gives rise to a risk of HM Treasury reporting matters to Parliament in the Consolidated Statement before the Managing Authorities do – for example, recognising disallowance provisions in the Statement that a Managing Authority would not report before publishing its statutory accounts for the following financial year. Securing agreement on the treatment of post-balance sheet events for the 2008-09 Consolidated Statement was not possible until the 2009-10 accounts of a key Managing Authority were completed and certified in August 2010. In my view, the resolution of this issue, enabling the HM Treasury Accounting Officer to make material adjustments to the figures within the Statement, is key to securing timelier completion and publication of the Consolidated Statement.

Conclusion

39. My audit work has identified a number of significant accounting and other issues which need to be addressed in order to ensure that the annual Consolidated Statement represents a true and fair view of the use of EU funds in the UK. HM Treasury has made further incremental improvements to its processes for preparing the annual Consolidated Statement and, with the agreement of the other UK authorities, is addressing the remaining issues through further work to align the detailed accounting policies and related accounting treatments across government.

40. The most important gain from the production of the Consolidated Statement has been the overview that it presents of the level of financial corrections imposed by the Commission. The confirmed losses totalling £398 million set out in this report and the provisions for further losses of £601 million detailed in Note 15 to the Statement represent huge past costs and potential future costs to

the taxpayer of implementing EU schemes in the UK. The Agriculture and Natural Resources schemes currently account for the bulk of the losses and provisions. In October 2009, I published "A Second Progress Update on the Administration of the Single Payment Scheme by the Rural Payments Agency" (HC 880, 2008-2009). That report set out my recommendations for addressing the major underlying problems leading to the costly administration of the scheme and the mounting financial corrections proposed by the Commission.

41. Note 15 to this 2008-09 Consolidated Statement shows that there is also a total of £221 million of provisions for other EU schemes – principally the European Regional Development Fund. This represents an increase of £113 million on the equivalent figure at 31 March 2008 and indicates that the issue of needing to improve controls over EU funds is one that extends beyond the administration of the Single Payment Scheme.

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