In accordance with the provisions of Article 248 (1) and (4) of the EC Treaty, Articles 143 and 181(2) of Council Regulation (EC, Euratom) No 1605/2002 on the Financial Regulation applicable to the general budget of the European Communities and Articles 116 and 135(2) of the Financial Regulation of 27 March 2003 applicable to the 9th European Development Fund, the Court of Auditors of the European Communities, at its meeting of 28 September 2005, adopted its

ANNUAL REPORTS

concerning the financial year 2004

The reports, together with the institutions' replies to the Court's observations, were transmitted to the authorities responsible for giving discharge and to the other institutions.
ANNUAL REPORT ON THE IMPLEMENTATION OF THE BUDGET

(2005/C 301/01)
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(1) The annexes related to the Annual Report on the Implementation of the Budget can be found at the end of this publication.
GENERAL INTRODUCTION

0.1. This document, covering the 2004 financial year, comprises the Court’s 28th Annual Report on the implementation of the general budget of the European Union, as well as its Annual Report in relation to the European Development Funds. The document follows the structure established for recent Annual Reports: the Statement of Assurance is presented in Chapter 1; key observations on budgetary management are given in Chapter 2; Chapters 3 to 9 cover revenue and activities financed from different parts of the budget, reflecting the headings of the financial perspective; while Chapter 10 covers financial instruments and banking activities. The replies of the Commission, or other EU Institutions where appropriate, are presented with the reports.

0.2. In relation to the Annual Report on the implementation of the general budget, the chapters covering revenue and the major areas of expenditure have the following main elements:

— detailed analyses and results of the audit work carried out in the context of the Statement of Assurance in the form of specific assessments,

— results of follow-up reviews of progress made on implementing recommendations of the Court and the Budgetary Authorities arising from previous audits,

— summaries of the Special Reports published by the Court since the last annual report.

0.3. The specific assessments are based on an evaluation of the operation of the principal supervisory and control systems governing revenue and each expenditure area, the results of the Court’s testing of underlying transactions, an assessment of the annual activity report and declarations of the Directors General, and the results of the work of other auditors where relevant. The Court’s overall appraisal of all these elements forms the basis for the Statement of Assurance set out in Chapter 1. In addition, the Annexes to Chapters 4 to 9 set out the elements used for monitoring and evaluating the financial management of the EU budget.

0.4. 2004 was marked by the accession of 10 new Member States on 1 May 2004, the biggest enlargement in the EU’s history. Reform of the Commission’s financial management continued to be consolidated, with 2004 being the first year when the budget was wholly decided and implemented under the activity based budgeting (ABB) format. This has resulted in a change in the way that financial information is presented, with details now being given in the budget by ABB policy area.

0.5. The Commission continued to prepare for the introduction of full accruals-based accounting, representing a fundamental reform in the way that the accounts are kept and financial information presented, for the 2005 financial year. Chapter 1 of this report (see paragraphs 1.21 to 1.45) gives the results of audit work undertaken on this ongoing process, particularly the key process of establishing opening balances. The Court’s work shows that further efforts are needed in order that the Commission may provide accurate accounting information for the 2005 year end.

0.6. Since the reform process was initiated in 2000, the Court has noted an improvement in the way in which the Commission organises itself and manages the EU budget. There have been improvements in the controls undertaken by the Commission on expenditure it manages directly. However, significant effort is still required, notably in those areas of the budget coming under shared management with Member States. It is of critical importance that the Commission and Member States work together to identify the weaknesses in the design and operation of schemes, and introduce appropriate remedial action.

0.7. In April 2004 the Court issued its Opinion No 2/2004 (1) on the ‘single audit’ model which included a proposal for a Community internal control framework. The Opinion was based on the experience gained by the Court in its audit work over a number of years, in particular the weaknesses identified in internal control systems at both European institution and Member State levels, which result in material incidences of error in underlying transactions over much of the budget. The Court proposes that current or new systems be developed and applied by the Commission and Member States in a coordinated manner and following common principles and standards. In addition, control systems should be designed to ensure an appropriate balance between the cost of controls, and the benefits they bring in terms of managing the risk of irregularity.

0.8. The Commission has reacted positively to the Court’s opinion, and in its Communication of June 2005 (2), proposes a roadmap to an integrated internal control framework. The Commission recognises that it is essential that the citizens of the Union have reasonable assurance that European public funds are managed in a legal and regular manner. Furthermore, clearly defined standards and objectives of internal control systems would provide an objective basis against which the Court could assess their design and operation when auditing them, thereby increasing the effectiveness of its work.

CHAPTER 1

The Statement of Assurance and supporting information

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THE COURT OF AUDITORS’ STATEMENT OF ASSURANCE

I. Pursuant to the provisions of Article 248 of the Treaty the Court has examined the ‘Consolidated reports on implementation of the budget and the consolidated financial statements’ of the European Communities for the financial year ended 31 December 2004 (1). It carried out its audit in accordance with its own audit policies and standards, which are based on international standards that have been adapted to the Community context. Through its audit, the Court has obtained a reasonable basis for the opinion expressed below. In the case of revenue, the scope of the Court’s audit work was limited. Firstly, VAT and GNI own resources are based on macroeconomic statistics for which the underlying data cannot be audited directly by the Court, and secondly, the audits of traditional own resources cannot cover the imports that have not been subject to customs supervision.

Reliability of the accounts

II. In the Court’s opinion, the ‘Consolidated reports on implementation of the budget and consolidated financial statements’ of the European Communities were drawn up in accordance with the provisions of the Financial Regulation of 25 June 2002 and with the accounting principles, rules and methods set out in the Annexes to the consolidated financial statements (2). Except for the effects of the observation in paragraph III, they faithfully reflect the revenue and expenditure of the Communities for the year and their financial position at the year-end.

III. In the absence of effective internal control procedures for miscellaneous revenue and advances, the Court cannot be certain that the transactions relating to the sundry debtors item have been correctly and completely recorded.

IV. Without calling into question the opinion expressed in paragraph II, the Court wishes to draw attention to the following:

(a) as has been the case in the past, the accounting system used to draw up the 2004 accounts was not designed to ensure that all assets and liabilities are recorded;

(b) following its action plan for the modernisation of the European Communities’ accounting system, the Commission has achieved significant progress towards introducing accrual-based accounting by 2005. However, adaptations and validations necessary to ensure the full implementation of the new accounting framework have been delayed.

Legality and regularity of the underlying transactions

V. On the basis of its audit results, the Court is of the opinion that in areas where the supervisory and control systems are implemented and allow for an adequate risk management, i.e. revenue, commitments, administrative expenditure and pre-accession strategy, the transactions underlying the consolidated annual accounts of the European Communities, taken as a whole, are legal and regular. Moreover, for common agricultural policy (CAP) expenditure the Court’s audit shows that, where properly applied, the integrated administration and control system (IACS) is an effective system to limit the risk of irregular expenditure.

VI. Without calling into question the opinion expressed in paragraph V, the Court emphasises that, in the area of pre-accession strategy, risks of varying degrees still exist at the level of implementing organisations in the candidate countries for all programmes and instruments.

(1) The ‘Consolidated reports on implementation of the budget and Consolidated financial statements’ make up Volume I of the annual accounts of the European Communities, financial year 2004.

(2) See Annex 1, Volume I, of the final accounts of the European Communities, financial year 2004.
VII. A greater effort is needed to effectively implement the supervisory and control systems and to address their weaknesses, so as to improve the handling of the attendant risks in the following areas, where payments are still materially affected by errors.

(a) In the case of CAP expenditure, the Court found recurrent evidence that expenditure which is not subject to IACS, or where IACS has been inadequately applied, poses greater risk because control systems are not as effective. Post-payment checks for CAP subsidies not covered by IACS do not provide reasonable assurance as to compliance with Community legislation. The Court concluded that CAP expenditure, viewed as a whole, was still materially affected by errors.

(b) In the case of structural measures, the Court again found weaknesses in the management and control systems which show the need, in varying degrees, for improvement in order to fully comply with the regulatory requirements for effective day-to-day management checks and/or independent sample checks of operations for the 2000 to 2006 programming period. For both programming periods (1994 to 1999 and 2000 to 2006), numerous errors of legality and regularity were detected in the expenditure included in the declarations leading to payments by the Commission.

(c) In the case of internal policies, despite the progress made in certain areas, the Court’s audit findings related to the supervisory and control systems and the underlying transactions do not provide sufficient assurance as regards the legality and regularity of payments. It is likely that the risk of errors will persist unless the legal framework is changed so as to simplify cost reimbursement systems and clarify the procedures and instructions governing the different programmes.

(d) In the case of external actions, the improvements of the Commission’s supervisory and control systems have not yet had an impact at implementing organisation level, where a relatively high number of errors at the level of payments in terms of frequency and financial impact were detected which were linked to the lack of a comprehensive approach to the supervision, control and audit of these organisations.

VIII. The Court notes the progress made by the Commission as regards the reform of its internal control system and the positive impact on the legality and regularity of the Commission’s internal management of expenditure. However, progress is still required in terms of operational effectiveness.

28 September 2005

Hubert WEBER
President

European Court of Auditors
12, rue Alcide De Gasperi, L-1615 Luxembourg
THE COURT’S OBSERVATIONS

INFORMATION IN SUPPORT OF THE STATEMENT OF ASSURANCE

Introduction

1.1. Pursuant to Article 248 of the EC Treaty, the Court of Auditors provides the European Parliament and the Council with a statement of assurance concerning the reliability of the accounts and the legality and regularity of the underlying transactions (the DAS). The Treaty also authorises the Court to supplement this statement with specific assessments of each major area of Community activity.

1.2. The aim of the work on the reliability of the accounts of the European Communities is to obtain sufficient evidence to conclude on the extent to which revenue, expenditure, assets and liabilities have been properly registered and that the annual accounts faithfully reflect the financial position at the end of the year (see paragraphs 1.6 to 1.45).

1.3. The aim of the work on the legality and regularity of the underlying transactions is to gather sufficient evidence, of a direct or indirect nature, to give an opinion on whether they are in accordance with the applicable regulations or contractual provisions, and have been correctly calculated (see paragraphs 1.46 to 1.86) (3).

1.4. Once again, the Court paid particular attention to the efforts made by the Commission to strengthen its internal control system and to the follow-up given to the action plans annexed to the annual activity reports and their Synthesis for the financial year 2003 (see paragraphs 1.54 to 1.86).

1.5. In addition, the Court provides indicators to monitor progress in improving internal controls both overall, and for each income and expenditure area (see Annexes to this Chapter and to Chapters 3 to 9).

Reliability of the accounts

1.6. The Court’s observations concern the final consolidated annual accounts for the financial year 2004 (4), as drawn up by the Commission in compliance with the provisions of the Financial Regulation of 25 June 2002 (5).

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(3) See the European Parliament resolution (EP 353,338, paragraph 35) and the Council recommendation (6850/05 BUDGET 5, page 8) on the 2003 discharge.

(4) The accounts comprise the ‘consolidated reports on the implementation of the budget’, covering the revenue and expenditure for the year, and the ‘consolidated financial statements’, covering the balance sheet setting out the assets and liabilities at the end of the year.

THE COURT'S OBSERVATIONS

1.7. Pending the complete implementation of the action plan on the modernisation of the accounting system as of the financial year 2005 (see paragraphs 1.21 to 1.45) and in the absence of a suitable accounting system, the preparation of the year-end financial statements was still, to a large extent, based on records outside the accounts. The information used for this was not always linked to the budgetary transactions from which they stem and the central accounting department was not always able to guarantee its accuracy or completeness (see paragraph 1.9).

1.8. Furthermore, in 2004 the accounting system still followed, to a large extent, cash-based accounting principles and did not make it possible to distinguish between capital and non-capital expenditure, between final payments and pre-financing, or even to determine the amount of debts and receivables. This affected the calculation of the economic outturn (see paragraphs 1.17 to 1.18 and also paragraphs 1.28 to 1.45).

1.9. The reservations contained in the declaration of the Director-General for Budgets (inadequate presentation of the assets and liabilities and of the financial position of the Communities and the EDF, and security issues (6) on the accounting system) are confirmed by the Court's findings. However, the efforts made by the Commission as part of the modernisation of the accounting system have already resulted in improvements in the quality of information provided.

1.10. Table 1.1 contains a follow-up of the reservation concerning the reliability of the accounts which was expressed in the Statement of Assurance for the 2003 financial year, as well as other points raised by the Court in that Annual Report which, according to the Commission, ought to be settled in the context of the modernisation of the Community accounting framework.

1.11. Despite the progress noted, in particular as regards the presentation of the annual accounts and the reduction in the number and scale of the reservations, the Court's audit identified problems, most of them already pointed out in previous reports (see paragraphs 1.12 to 1.20).

(6) See paragraph 1.18 of the Court's 2003 Annual Report.

THE COMMISSION'S REPLIES

1.7. The new accounting system was introduced in January 2005. The 2004 closure of accounts was made using the same rules and systems as the previous year, as provided for by both the Financial Regulation and the Commission Communication on the modernisation of the accounting system project in December 2002 (see COM(2002) 755 final of 17 December 2002).

1.8. The differentiation between capital and non-capital expenditure is one of the improvements arising from the introduction of the new accounting system. The 2005 opening balance sheet is currently being prepared using this distinction.

1.10. As in last year's replies, and as stated by the Court in its remark, the reservation of the Court in 2003 concerning revenues and advances is addressed by the introduction of the new accounting system in 2005. The new system will also address the other points raised in table 1.1.

1.11. As the Court has noted, progress has been made in the presentation of the annual accounts. However, many of the remarks the Court refers to can only be addressed with the introduction of accrual accounting and the new accounting system in 2005.
Table 1.1 — Follow-up to the reservation expressed in the 2003 Statement of Assurance as to the reliability of the accounts and the potential impact of the modernisation of the accounting system in respect of certain observations made in the 2003 Annual Report

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<tr>
<td>In the absence of effective internal control procedures for miscellaneous revenue and advances, the Court cannot be certain that the transactions relating to the sundry debtors item have been correctly and completely recorded.</td>
<td>The Commission continues to improve its methods of dealing with this area using the systems currently at its disposal (…)(for example, the regular reporting of overdue amounts since mid-2003.) However, (…) the major improvements in this area can only be made with the introduction of the new accounting system in 2005, in particular the accounting for pre-financing payments.</td>
<td>The Commission has pointed out that several measures have been undertaken. An aged balance of debts and recovery orders containing indicators on the dunning is sent quarterly to the authorising departments, there is closer cooperation with authorising departments during the recovery procedure and arrears interest on recovery orders is collected systematically. Likewise, the Commission is establishing an inventory of pre-financing operations and has indicated that adequate accounting procedures will be applied as from 2005. Nevertheless, the actions undertaken by end 2004 did not enable the Court to consider all the problems had been solved by that date (see paragraphs 1.17 to 1.19).</td>
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<td>Points potentially resolved within the framework of the modernisation of the Communities’ accounting system</td>
<td>Any future impact of the modernisation project on the Communities’ accounting framework</td>
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<td>In the absence of a suitable accounting system, the preparation of the year-end financial statements is to a large extent based on records outside the accounts and the evaluations used for this are not always linked to the corresponding budgetary transactions. The present accounting system does not make it possible to distinguish between capital and non-capital expenditure, between final payments and pre-financing or even to determine the amount of debts and receivables. The calculation of the economic outturn is thus adversely affected</td>
<td>The European Communities use cash accounting, as do most of the public sector organisations. The Commission is aware of the limitations of this approach, which is why it has undertaken the project for the modernisation of the accounting system and the move to accrual accounting. The Commission aims to comply with IPSAS standards by 2005. On 10 January 2005, the central accounting system was opened to use for the general budget. According to the Commission, the general accounting is now on a full accrual basis except for the external delegations and press offices outside the Commission’s headquarters, to which financial responsibilities have been deconcentrated and which will be progressively integrated into the central system as from 2005. The procedures for closing the 2005 accounts and for preparing the 2005 financial statements still need to be finalised.</td>
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<td>Certain problems related to the evaluation of the amounts shown in certain items of the balance sheet involve in particular sums held by financial intermediaries (recorded under sundry debtors), their actual utilisation rate and the amount of related interest, or again certain investments and loans against budgetary appropriations (ECIP, Eurotech Capital, Venture Consorti um and Joint Venture Programme for example).</td>
<td>The Commission has already done significant work in the area of the financial intermediaries. However, such problems can ultimately only be resolved with the introduction of the new accounting system in 2005. Currently the figures are established by a manual exercise and the Commission has continued to improve the procedures for recording interest. As part of the move to accrual-based accounting all open ECIP files are currently being revised. Considerable efforts have been made to record the financial intermediaries. Some of the questions have been dealt with in the accounting rules.</td>
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<td>Other weaknesses concerning the presentation of the accounts persist as regards certain items of agricultural expenditure and other advances not executed but shown as such, the presentation of approximate amounts having the characteristics of provisions, being shown like debts, and the accounting for pension rights, which neutralises the effect on the economic outturn.</td>
<td>Various points were dealt with within the framework of the transition to accrual accounting in 2005 and the Commission will only introduce changes for the 2005 accounts to avoid successive changes. The application of the accounting rules adopted by the Accounting Officer on 28 December 2004 is supposed to settle most of the points raised. According to the Commission, the current presentation of pensions in the balance sheet will, however, be maintained until an IPSAS standard has been issued on the subject.</td>
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<td>There is still no indication in the year-end accounts that some transactions are likely to be corrected at a later date by the Commission’s departments or by the Member States (see paragraph 1.1.2), nor any indication of the possible scale of such corrections. Furthermore, there are other uncertainties which may temporarily affect the accounts (see paragraph 1.1.3).</td>
<td>The annual accounts necessarily present financial information as known at the time of their closure. The reliability of this information will always be subject to the findings of audits underway at that time or undertaken subsequently. The account can only recognise the amounts to be recovered when the Commission adopts its decisions under clearance of accounts or similar procedures. The Commission is preparing rules for the accounting treatment of such recoveries, and for improving the explanatory notes to the annual accounts, as part of the modernisation of the accounting system. The situation remains unchanged for the 2004 accounts and is expected to be dealt with in the framework of the modernisation of the accounting system.</td>
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THE COURT’S OBSERVATIONS

Consolidated reports on implementation of the budget (revenue and expenditure)

Provisional components of the implementation of the budget

1.12. Despite the Court’s observation in its 2002 (7) and 2003 (8) Annual Reports, there continues to be no sufficient and precise indication in the explanatory notes to the year-end accounts that some transactions are likely to be corrected at a later date by the Commission’s departments or by the Member States (clearance of the EAGGF-Guarantee paying agencies’ accounts, adjustment of the provisional amounts in the case of the closure procedure for projects and programmes relating to Internal policies, External actions and Structural Funds). Additionally, the explanatory notes contain no indication of the possible scale of such corrections (e.g. the magnitude of the corrections made in previous financial years or the extent to which payments charged to the budget might be subject to future corrections).

1.12. An additional comment is included in the 2004 final accounts indicating that most of the payments made by the Commission during the year are provisional and subject to varying conditions. Following the modernisation of the accounting system, the Commission has new accounting rules in place for accounting methods of recoveries of amounts paid out, and this also covers the explanatory notes to the annual accounts. The effects of the new rules should be seen in the 2005 annual accounts.

For Structural Fund payments, it is difficult to predict the level of future corrections as it depends on the outcome of lengthy procedures in large numbers of individual cases.

Concerning agricultural spending, the annual accounts necessarily present financial information as known at the time of their closure. The reliability of this information will always be subject to the findings of audits underway at that time or undertaken subsequently. The accounts can only recognise the definitive amounts to be recovered when the Commission adopts its final decisions under clearance of accounts or similar procedures.

The Commission will analyse the possibility of improving information on the financial impact of corrections made concerning prior years.

1.13. Furthermore, there are other uncertainties which may temporarily affect the accounts, for example, 20 paying agencies, managing 11 000 million euro of agriculture funds, received a qualified or negative opinion on their accounts from the certifying bodies (see paragraph 4.19), and the Commission’s postponement of its financial clearance decision for the financial year 2004 of paying agency accounts representing 9 % of the expenditure declared for the financial year 2004, pending further information or the completion of certain audit work (see paragraph 4.20).

1.13. As stated in point 4.19, qualifications and negative opinions are restricted in the great majority of cases to particular issues and measures, concerning specific aspects of the activities of the 20 paying agencies concerned. The expenditure concerned is in general limited.

It should be emphasised that the postponement of the clearance of accounts decision does not cause any financial consequences for the Member States concerned, nor does it prejudice any exclusion of expenditure of Community financing. The Commission has already initiated a procedure to recover any material undue payments.

Expenditure booked against non-corresponding budget headings

1.14. According to the Accession Treaty (9), ISPA projects not fully implemented by the date of accession, shall be considered approved by the Regulation on the Cohesion Fund, while

1.14. According to the Financial Regulation, a payment can only be made against the budget heading on which the commitment was made. The heading title has now been changed to ‘closure of pre-accession aid

(7) Paragraphs 1.10 to 1.11.
(8) Paragraph 1.11.
payments made since that date (345.5 million euro) to the new Member States concerned, continue to be made against appropriations for pre-accession intervention. On the basis of the budgetary principle of transparency it would be appropriate to clarify the situation in the financial statements (10).

1.15. In the context of the common agricultural policy (11), the Member States have the possibility of reducing the payments due to farmers under certain aid schemes and using the funds withheld to finance additional rural development measures. According to this system (known as modulation), accounting entries have been made against a budget heading which will ultimately not be the one to which the concerned expenditure will be charged (165.2 million euro in 2004), and expenditure which has not yet been implemented (263 million euro at 31 December 2004) has been presented in the accounts as already having been effected (see paragraphs 1.13 and 1.14 of the 2002 and 1.10(a) of the 2003 Annual Report).

1.16. Reservations concerning the completeness and accuracy of the amounts due to the Commission in respect of the EAGGF-Guarantee debtors ledger (665.5 million euro net at 31 December 2004) have been expressed by several certifying bodies (see paragraph 1.25 of the 2002 and 1.10(d) of the 2003 Annual Report).

1.15. With regard to the entry into the accounts of 165.2 million euro in 2004, the accounting methods applied to the amounts withheld under Articles 3 and 4 of Regulation (EC) No 1259/1999 and Article 1 of Regulation (EC) No 1655/2004 are established in accordance with Article 1 of Commission Regulation (EC) No 1017/2001 (amending Article 2 of Regulation (EC) No 296/96).

With regard to the expenditure not yet implemented by the Member States (263 million euro in 2004), Member States can withhold part of the direct aid for farmers, on the basis of modulation and eco-conditionality, to be used during a specific period for measures accompanying rural development (under Articles 3 to 5 of Regulation (EC) No 1259/1999 and Articles 153(4) and 155 of Regulation (EC) No 1782/2003). The amounts withheld and not used must be reimbursed at the end of that period.

The current modulation system is being phased out and there are no plans to change the entry into the budgetary accounts during its last years. How it is treated in general accounts is under examination as part of the changeover to accrual accounting in 2005.

1.16. The provision for doubtful debts continues to be based on the best estimates of each paying agency involved, as in previous years. It is assumed that the paying agencies are in the best position to evaluate the chances of recoveries. The Commission has made several improvements to accounting arrangements for CAP debtors in recent years. These include requiring paying agencies to maintain debtors’ ledgers, and certifying bodies to check that these ledgers are complete. Certifying bodies for 86 of the 91 paying agencies were able to provide assurance that debtors’ ledgers were stated fairly.

Approximately one third of the amount mentioned by the Court is attributable to one paying agency, for which a reservation was made by the Certifying Body and for which the accounts were disjoined by the Commission.

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Sundry debtors

1.17. The recording of sundry debtors (4 139.8 million euro at 31 December 2004) continues to pose problems (12). Provisional payments are still entered as final expenditure and amounts to be recovered are not entered immediately. In the absence of adequate internal control procedures for miscellaneous revenue in the authorising officers’ departments, the Court cannot obtain assurance that the record of amounts receivable is complete and accurate.

1.18. Furthermore, in the absence of a suitable accounting system, the Court is unable to give assurance as to the accuracy and completeness of the amounts entered as held by financial intermediaries (13) totalling 1 313.6 million euro (14) at 31 December 2004 (see paragraph 1.27 of the 2002 and 1.10(f) of the 2003 Annual Report).

1.19. In addition, the basis on which the Commission recorded a value reduction of 29.6 million euro on advances for ECIP (13) (European Community Investment Partners) (51.5 million euro at 31 December 2004) was doubtful, because the constituent parts to which it applies were not yet fully identified, as the review of the open files has not been finalised (see paragraph 1.18 of the 2002 and 1.10(b) of the 2003 Annual Report).

Provision for pensions

1.20. The current presentation in the balance sheet of the provision for pensions (15) (26 008 million euro at 31 December 2004 according to an actuarial evaluation for staff (25 814 million euro) and for the Members of the Commission, the Judges and Advocates General of the Court of Justice as well as for the Members of the Court of Auditors (194 million euro)) and of the corresponding amount receivable from the Member States has the effect of neutralising the impact on the economic outturn, as it does not show the change during 2004 for the Community institutions’ pension liabilities (see paragraphs 1.31 to 1.32 of the 2002 and 1.10(h) of the 2003 Annual Report).

The Court’s Observations

1.17. As replied in previous years, the Commission accepts this remark of the Court, but states that the introduction of the new accounting system in 2005 addresses the problems raised.

1.18. The new system introduced in 2005 and based on accrual-accounting rules, will allow the Commission to better control the amounts of pre-financing (such as for financial intermediaries).

1.19. The review of the open files continued in 2005. The value of 51.5 million euro registered in the balance sheet at year-end 2004 corresponds to 41.2 million euro relating to pre-financing amounts (facility 2), and 10.3 million euro on accounts opened by the various financial institution partners of the ECIP programme. The value reduction of 29.6 million euro applies only to the amount of the pre-financing. The value reduction was estimated by deducting the amount for which recovery is almost certain (11.5 million euro) from the total. The amount of 10.3 million euro was identified thanks to a circularisation exercise made to confirm the situation concerning facilities 3 and 4. It will be transferred to the Commission following the sending of the necessary recovery orders.

1.20. As has been responded previously by the Commission, this accounting treatment for pensions is in accordance with the accounting rules adopted by the Accounting Officer of the Commission following discussion with the Accounting Standards Committee. The issue will be re-addressed when an IPSAS on the treatment of pensions in public sector entities is available.

(12) See paragraph 1.23 and paragraphs 1.10(e) and 1.14 and 1.15 of the Court’s 2002 and 2003 Annual Reports.
(13) Included in the amount of sundry debtors mentioned in paragraph 1.17.
(14) Including 19.6 million euro in interest.
(15) The provision for pensions is included under ‘Provisions for risks and charges’.
Action plan for the modernisation of the accounting system

General background

1.21. On 17 December 2002, the Commission adopted the Action Plan for the modernisation of the European Communities’ accounting system (16). This was in response to a number of previous observations by the Court and takes into account the provisions of the Financial Regulation adopted in June 2002 (17) requiring, inter alia, the introduction of accrual-based accounting (Article 125). This action plan, which was intended to be fully operational as of 1 January 2005 (18), consists of two strands, one concerning the adoption of the new accounting framework (19), and the other, the development of the information systems required for its implementation (20). A project oversight board and an advisory committee for accounting standards were set up in order to provide support to the Commission’s Accounting Officer, who is responsible for the implementation of the project.

Audit scope and approach

1.22. Given the fundamental importance of the modernisation project, the Court commenced an audit of the different phases of the Commission’s project implementation, which is ongoing. The Court provides its preliminary findings here, and will report on subsequent stages in future Annual Reports.

1.23. In the first phase, which covers the transition process during 2004, the Court concentrated on the:

— verification that the new accounting rules and accounting guidelines are compatible with the Financial Regulation and international standards (see paragraphs 1.24 to 1.27);

— identification of the data not previously available, which needed to be put into the system (pre-financing and related guarantees, invoices/payment requests, legal entities), by carrying out a system evaluation and corroborative tests (21) (see paragraphs 1.28 to 1.37);

1.22. The new accounting system is operational and the preparation of the 2005 annual accounts (including opening balance sheet) continues to progress since the finalisation of the Court’s audit in May 2005.

(18) However, a full integration of all local accounting systems was expected from the beginning to take a longer period than the two years available after adoption of the Commission.
(21) Substantive tests will be carried out in a later phase of this audit.
New accounting framework

1.24. On 28 December 2004, the Commission’s Accounting Officer adopted a set of 15 rules (22) as required by Article 133 of the Financial Regulation. These rules cover the key items for accounting and financial reporting based on the internationally accepted standards for the public sector (23), adapted to the specific needs of the Commission and of the European Communities (24). These rules were subsequently transposed into implementing rules and an accounting manual applicable in the institutions and bodies whose accounts are to be consolidated (25), in time for the drawing-up of the accounts for the financial year 2005.

1.25. With a view on its future work on the opening balance for the 2005 financial year, which by the end of the audit work (May 2005) was not yet completed, the Court limited its first analysis to four accounting rules considered as key for the transition, namely those dealing with financial statements, expenses and payables, pre-financing and provisions, contingent assets and liabilities. The remaining rules will be analysed in later phases of this audit.

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(23) International Public Sector Accounting Standards (IPSAS) issued by the International Federation of Accountants (IFAC) or, in their absence, International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

(24) Article 133(2) of the Financial Regulation provides that, in certain cases, the applicable accounting rules may deviate from the internationally accepted standards for the public sector where it is justified by the specific nature of the Communities’ activities.

THE COURT’S OBSERVATIONS

1.26. It was found that these four rules comply in all material aspects with the Financial Regulation as well as with the International Public Sector Accounting Standards (IPSAS), as far as they are covered by them (26). However, due to the complexity of the different areas covered, compliance is, to a certain extent, achieved by remaining rather general in both the basic rules and the more-detailed accounting manual, thereby leaving the interpretation of specific elements to the discretion of the different Directorates-General (see paragraph 1.32). Furthermore, there is a need for clarification concerning guarantees and pre-financing (see paragraph 1.33).

1.27. The development and approval of instructions was not yet finalised by the end of the audit work (May 2005) as, for example, for the cut-off procedure which is currently under preparation. It is important to define the financial year to which generating events should be attributed, as this has a direct impact on the accounting of transactions and the true and fair view of the financial position.

1.28. The Commission has to prepare the accounts according to the new accounting rules for the financial year 2005. This requires reprocessing the closure of the 2004 financial year in order to establish the opening balance for 2005 according to the new accounting rules. Certain data, necessary for the opening balance, do not appear in the accounts at the end of 2004. Therefore, these data must be identified, applying specific procedures, and accounted for in 2005.

1.29. The following paragraphs deal with the most important elements: pre-financing (advances), which constitutes an asset; invoices/payment requests not paid by the 31 December 2004, which constitute a liability; guarantees, which will be entered in the Annex to the balance sheet; and the legal entities, which are a necessary condition to carry out payments.

1.30. The Commission estimates the amount of the pre-financing to be entered into the accounts at approximately 64 000 million euro. Five Directorates-General represent more than 90 % of this amount: Directorate-General for Regional Policy, Directorate-General for Employment, Social Affairs and Equal Opportunities, Directorate-General for Agriculture and Rural Development, Directorate-General for Research and EuropeAid Cooperation Office. It was therefore decided to concentrate on these five Directorates-General for the audit of the pre-financing and related issues such as guarantees.

THE COMMISSION’S REPLIES

1.26. The accounting rules as adopted by the Accounting Officer of the Commission had been discussed by the Accounting Standards Committee and are, by their very nature, necessarily more general than specific. This is also the case with the international accounting rules on which they are based, the International Accounting Standards/International Financial Reporting Standards (IAS/IFRS) as well as the International Public Sector Accounting Standards. More detailed instruction and guidance is available in the accounting manual and fiches that are available on the Commission Intranet. The application of these rules is compulsory for the Directorates-General.

1.27. The development of such instructions is an ongoing process which has greatly advanced since the finalisation of the Court’s audit. Instructions were prepared in good time. The cut-off procedure was presented and discussed with Directors-General at the end of July and the beginning of August. Finally, as was envisaged, cut-off instructions were finalised and sent to Directorates-General by mid-August. They were also published on the internal website.

Additional data required for the opening balance sheet

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(26) For pre-financing and non-exchange operations not yet covered by IPSAS, it tried to respect the spirit of the IPSAS.
Pre-financing

1.31. By the end of the audit work for this Annual Report in May 2005, not all technical and conceptual issues had been addressed (see paragraphs 1.25 to 1.27). Furthermore, the amounts entered into the system were still provisional, as they had not yet been validated by the Authorising Officers with the result that definitive opening balances for the financial year 2005 were not yet available. Accurate opening balances are a precondition for establishing the financial statements for the year 2005 which show a true and fair view.

1.31. See replies 1.26 and 1.27.

The process of establishing opening balances is expected to be completed in good time. The first upload of data into the new system was done during the first week of January. Directorates-General have been verifying and correcting the figures and are required to formally validate the definitive opening balances.

1.32. The procedures concerning the recognition, clearing and measurement of pre-financing in the general accounts differ between the Directorates-General. This could have an impact on the disclosure and consequently on the information given on the economic outturn of the reporting period (27).

1.32. The many different types of contractual conditions require different procedures for the clearing of pre-financing amounts. The presentation of pre-financing in the financial statements will reflect the economic reality.

Guarantees

1.33. At the moment, all Directorates-General maintain guarantees at their initial nominal value. However, maintaining this value, irrespective of the amount which can be claimed in case an event gives rise to a call on the guarantee, overstates the total amount backed up by guarantees. Therefore it would be necessary to provide complementary information in the explanatory notes relating to contingent assets and liabilities.

1.33. All guarantees are first recorded at face value. This amount will only be reduced if the Authorising Officer has accepted a reduction in the guarantee provided. Both the value of the guarantee held and the current net amount guaranteed will be presented in the notes to the financial statements, using information coming from the accounting system.

Invoices/payment requests

1.34. As for pre-financing (see paragraph 1.31), the amounts entered into the system for invoices/payment requests were still provisional by the end of the audit work for this Annual Report in May 2005.

1.34. See reply to paragraph 1.31.

1.35. The Court’s audit revealed some risks related to the local systems. It was found (for instance in the Directorate-General for Regional Policy) that local systems and ABAC are not regularly reconciled in order to confirm a successful transfer of data, and (as found in the Directorate-General for Employment, Social Affairs and Equal Opportunities) that certain amounts were registered more than once and communicated to the central system. Furthermore, errors were found resulting from a misinterpretation of data (as found in the Directorate-General for Employment, Social Affairs and Equal Opportunities) where the larger of the cost claim and outstanding commitment was considered as invoice/payment request and loaded into the central system.

1.35. The discrepancies identified by the Court have been reviewed and corrected. Since the Court’s audit reconciliations have been made by each Directorate-General, which is required to validate its definitive opening balances.

The comments regarding the Directorate-General for Employment, Social Affairs and Equal Opportunities concern errors corrected in May 2005, and the adoption of a prudent provision for cost claims received. IT developments in early 2005 interrupted the Directorate-General for Regional Policy’s regular reconciliation of its local system to ABAC.

(27) The Court focused the checks, at this stage, on the recognition and clearing of pre-financing as such. Liaised aspects as the assessment of non-current pre-financing (actuarial method), generated interest and foreign currency translation will be covered at a later stage. Furthermore, intended accounting corrections to harmonise the content of what is considered as pre-financing were still under discussion at the time of the audit (e.g. corrections by means of provisions).
Legal entities

1.36. Starting in 2005, no budgetary transaction can be executed if it does not carry the reference of a legal entity, previously registered and validated in the legal entity file (LEF). The LEF is, generally, an area of low risk since any error occurring in this context blocks any payment. Before the payment process can continue, the LEF-entries have to be corrected and validated.

1.37. Of the five Directorates-General and Services audited only the EuropeAid Cooperation Office had problems concerning the validation of legal entities due to the nature of the activity, as the necessary documentation could not always be obtained (contractors from all over the world being subject to varying legal systems with the resulting differences in banking procedures, VAT treatment, register of companies etc.). Specific measures have been taken to resolve the particular problems the Directorate-General in question was faced with. Accordingly, these problems should not reoccur.

Validation of local systems

1.38. The Accounting Officer has to verify and validate that local systems are capable of providing the central system with data which complies with the new accounting rules (28). Once this procedure is finalised, the central system is no longer allowed to accept data provided by non-validated local systems.

1.39. This validation is carried out in two phases. In the first, the controls were solely based on management representations. Although initially foreseen for end-December 2004, 40 individual and a final Synthesis report were only available during February 2005.

1.40. Following the Accounting Officer’s review of all 40 systems, some risks were identified for five systems (29) and three other systems (30) were deemed to contain serious problems. However, as modifications could not be implemented in the short term, these systems continued to be used during 2005.

1.39. The final report was adopted at the end February 2005, after the Directorate-General for Budget had incorporated comments received from all the Directorates-General. The final version included an overall assessment of the validation exercise in 2004, plus individual assessments for the 40 Directorates-General.

1.40. Where risks were identified for five systems, the reports concluded that these risks do not currently call into question their ability to provide data for the institution’s accounts or their use to substantiate data in those accounts.

As part of the follow-up work being performed in 2005, an in-depth investigation will be carried out for 13 Directorates-General and offices. This includes the Directorates-General mentioned by the Court as well as five of the larger Directorates-General (1). This work has already started and will continue until the end of the year. Draft reports on the validation of local systems for these 13 Directorates-General will be issued before the end of 2005.

(28) In terms of Article 61(1)(e) of the Financial Regulation, the Accounting Officer is responsible for ‘laying down and validating the accounting systems and where appropriate validating systems laid down by the authorising officer to supply or justify accounting information’. The corresponding Article 57 of the Implementing Rules states that ‘where financial management systems set up by the authorising officer provide data for the institution’s accounts or are used to substantiate data in those accounts, the accounting officer must give his agreement to the introduction or modification of such systems.’

(29) Directorates-General for Informatics, Education and Culture, Humanitarian Aid, the EuropeAid Cooperation Office and the European Communities Personnel Selection Office.

(30) Directorates-General for External Relations, the Office for the Administration and Payment of Individual Entitlements and the Office for Official Publications of the European Communities.

(1) Directorates-General Agriculture and Rural Development, Employment, Social Affairs and Equal Opportunities, Regional Policy, Research and Press and Communication.
THE COURT'S OBSERVATIONS

1.41. The current validation procedure does not include a mechanism to inform the Accounting Officer about modifications to the local systems which would trigger a new validation according to Article 61 of the Financial Regulation.

1.42. In the second validation phase (scheduled still to start in 2005), in-depth checks will be carried out to ensure a sufficient level of data quality and to corroborate the results of the first phase. The requirements of Article 61 of the Financial Regulation will only be fulfilled when, still based on the results of these checks, the Accounting Officer concludes on the final validation of the local systems.

Assessment of progress made

1.43. The modernisation of the accounting system had to be planned and implemented within the timeframe imposed by the Financial Regulation. Experience in public administrations undertaking similar reforms (31) shows that projects of this scale are linked to a variety of problems delaying a frictionless implementation. Against this background the Commission has achieved significant progress towards introducing accrual-based accounting.

1.44. However, as already observed by the Court in previous Annual Reports (32), the timetable established for the necessary adaptations and validations is very ambitious. Indeed, the opening balance 2005, initially forecast to be established by the end of 2004, has not been issued by mid-2005.

1.45. Further progress has to be made, as figures needed for the establishment of the opening balance 2005 are not yet validated by the Authorising Officers of the Commission. Additionally, not all aspects are yet fully covered by the existing rules and instructions are not interpreted coherently by the services concerned. The Accounting Officer should take the necessary measures to ensure coherence and consistency with a view to the presentation of financial information giving a true and fair view. If no timely action is taken by the Commission, the shortcomings identified by the Court may affect the reliability of the 2005 financial statements.

THE COMMISSION'S REPLIES

1.41. The Directorate-General for Budget will develop a procedure for the notification of changes to the local systems before the end of 2005, based on the experience gained throughout this validation exercise.

1.42. During the course of year 2005, further validation of local systems is indeed envisaged. Initially, individual follow-up questionnaires were addressed to the 40 Directorates-General and Services, and replies were received within the deadline, that is to say by end June 2005. A progress report has been compiled and covers 27 Directorates-General, for which no significant problems have been identified. This Progress Report has been sent firstly to the Accounting Officer and will be made available, in due course, to the Court of Auditors.

1.44. The modernisation project has met its target date of January 2005 for the new system to be in place, on 1 January 2005, the Commission moved the reporting of the EU budget from cash-based to accrual-based accounts. The Commission is confident that the opening balances will be established in good time.

1.45. The accrual-based accounting system will continue to be developed and improved during 2005 and 2006. The modernisation project has largely met the objectives set for the first eight months of 2005. All services have invested heavily to prepare the information necessary for the opening of accrual-based accounts, and make the necessary adaptations to their local systems to enable the correct bookkeeping of transactions in the new system.

The Commission has, as it has done throughout this modernisation project, every intention in taking the actions necessary to ensure the completion of the work.

(31) For instance at the United Nations Headquarters or in France, Spain, Sweden and the United Kingdom.
(32) See paragraph 1.8 of the Court’s 2002 Annual Report and paragraph 1.25 of the Court’s 2003 Annual Report.
Legality and regularity of underlying transactions

The Court’s DAS approach

1.46. Taking into consideration the requirements of Article 248(1) of the Treaty, the changing audit environment (which is extremely complex and has changed fundamentally due to the financial reform of the Commission) and the expectations of the DAS’s ‘users’ (namely the discharge authority), the Court decided that its audit opinion would be the result of a consolidation of the specific assessments concerning own resources and each of the six operational chapters of the financial perspective 2000 to 2006 (13). These specific assessments, which aim to give the discharge authority the possibility to monitor the quality of the management of the funds in each of the major fields of Community intervention (14), are based on four sources of evidence:

(a) an examination of the way in which the supervisory and control systems set up both in the Community institutions and in the Member States and third countries work;

(b) a testing of samples of transactions for each major area by carrying out checks down to final beneficiary level;

(c) an analysis of the annual activity reports and declarations of the Directors-General and of the procedures applied in drawing them up;

(d) where possible, an examination of the work of other auditors who are independent of Community management procedures.

1.47. The objective of the audit of supervisory and control systems is to assess the extent to which they manage the risks concerning legality and regularity of underlying transactions. The testing of transactions seeks to obtain direct evidence on the legality and regularity and to provide indications on the origin, frequency, nature and impact of errors found. The results of the transaction testing are used to complement and contribute to the

1.47. The Commission welcomes the Court’s assessment of the extent to which the supervisory and control systems manage the risk of irregularity of underlying transactions, and will endeavour to improve them where the Court finds weaknesses. Equally, where the Court’s transaction testing indicates that the supervisory and control systems are not operating as intended, the Commission will endeavour to correct the deficiencies, and to recover any damage to the Communities’ budget.

(13) Agriculture, structural measures, internal policies, external actions, administration and pre-accession strategy.

(14) With regard to expenditure, the Financial Regulation distinguishes between the following cases (Article 53): the Commission implements the budget on a centralised basis (administrative expenditure and internal policies); the management of transactions is shared with the national authorities in the Member States (EAGGF-Guarantee and Structural Funds); the Commission decentralises the implementation of certain aspects of its operations to beneficiary countries after having carried out an ex ante check (pre-accession strategy) and the Commission may manage, jointly, certain operations with international organisations (see the Court’s Annual Report concerning the financial year 2003, paragraph 1.57).
conclusions on the systems. Information from both sources is used to identify recommendations for corrective actions. In accordance with international audit standards, the Court also takes account of the ‘management representations’ contained in the annual activity reports and declarations of the Directors-General, as well as in their Synthesis which is adopted by the Commission. Finally, the work of other auditors (35) is reviewed in order to evaluate the potential relevance for the specific assessments.

DAS audit results 2004

Need to achieve effectiveness of supervisory and control systems

1.48. The conclusions of the specific assessments to be drawn concerning the different DAS sources available are broadly consistent. In areas where, according to the Court’s audit, supervisory and control systems are implemented that allow risk to be managed adequately, the Court’s substantive testing tends to identify only insignificant findings as regards legality and regularity of underlying transactions and the Court’s assessment of the declarations of Directors-General and authorising officers by delegation (36) confirmed that no or only minor reservations had to be presented (see paragraphs 3.52 to 3.55, 8.31 and 8.32, 8.36 and 8.37, 9.13 and 9.26 to 9.28).

1.49. In areas where, according to the Court’s evaluation, supervisory and control systems exist but their effectiveness in managing the associated risk has to be improved, the Court’s substantive testing tends to identify material findings as regards legality and regularity of underlying transactions (see paragraphs 4.55 to 4.62, 5.47 to 5.50, 6.46, 7.39 and 7.40). Furthermore, the Court’s assessment of the declarations of Directors-General confirmed that major reservations were either presented or, in the Court’s view, should have been presented. This is an indication that management itself has to continue its efforts in order to ensure an adequate control of the risk concerning legality and regularity of the underlying transactions (see table 1.2).

1.49. As stated in its replies to the paragraphs referred to by the Court, the Commission considers that the Directors-General had reasonable assurance that the supervisory and control systems in place are sufficient to manage the risk of error and irregularity in the underlying transactions. When significant risks materialise, the EC budget is protected by recoveries from the claimants concerned or, for jointly managed funds, from the Member State concerned. The Commission works constantly to improve these systems, most recently through its analysis of gaps between its present systems and those recommended by the ECA in its Opinion No 2/2004, and in its regulatory proposals for the 2007 to 2013 financial perspectives.

(35) Other auditors mean any public or private person called upon to give an auditor’s assessment of operations that are financed in whole or in part from the Community budget, but whose obligation does not stem from the Community regulations.

(36) For some Institutions (Court of Justice and Committee of the Regions), the Court could not take the annual activity reports into consideration as they had not been produced before the Court’s audit was concluded (see paragraph 9.13).
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<td>Sector</td>
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<td>Other weaknesses revealed by the Court's audit</td>
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<td>External actions</td>
<td>Partnership with a non-governmental organisation</td>
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<td>Supervisory and control systems for the legality and regularity of underlying transactions at the level of implementing organisations need to be further improved to be fully operational (see par. 7.40)</td>
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<td>Non respect of contract procurement procedures by a Humanitarian Organisation</td>
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<td>Pre-accession strategy</td>
<td>ISPA: management and control systems</td>
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<td>PHARE: Risks inherent in the decentralised systems, omissions in the audit of systems and transactions</td>
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<td>Administrative expenditure</td>
<td>Implementation of internal control standards in the EU's delegations</td>
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Key:
1. Impact of these main reservations on the Director-General's declaration:
   A: reasonable assurance that the internal control systems ensure the legality and regularity of the underlying transactions with no or insignificant qualifications
   B: reasonable assurance with qualifications that the internal control systems ensure the legality and regularity of the underlying transactions (errors < 2 % or system weaknesses whose financial impact < 10 % of the budget concerned)
   C: no assurance (errors > 2 % or system weaknesses whose financial impact > 10 % of the budget concerned)

2. Content of declarations:
   A: clear and unambiguous
   B: with inaccuracies
   C: with significant or insufficiently justified inaccuracies (for example: negligence of the problems of shared management, cover of the previous financial year, lack of quantification, unusable information)

3. Relevance for the Court's audit conclusions:
   A: sufficient evidence for the Court's conclusions
   B: sufficient evidence for the Court's conclusions after corrections
   C: insufficient evidence for the Court's conclusions (e.g. due to inadequate or insufficient information)

4. Evolution:
   + improvement
   = constant
   – regression
THE COURT’S OBSERVATIONS

The Commission considers that no additional reserves should have been presented, as stated in the column ‘Other weaknesses revealed by the Court’s audit’ of table 1.2. Each case concerns issues which were known to the responsible service and, for which appropriate action had been taken to protect the EC budget, or which presented no significant financial risk (see replies to paragraphs 4.58, 5.45, 6.39 and 7.40).

With regard to the Court’s assessments in the column ‘Relevance to the Court’s conclusions’ of table 1.2, thanks to its work to improve the content of declarations and monitoring of compliance with the standards on which they are based, the Commission feels that the annual activity reports and annual declarations have become an effective management tool and a reliable indicator of the results it has obtained and of its strategy to deal with identified risks so that the Court can use them as a basis for its Statement of Assurance. However, the Commission will continue to provide more details so that the Court can use them more effectively in support of its Statement of Assurance.

The Commission would welcome guidance as to the further information sought by the Court in order to improve its assessment of the relevance of the declarations for the three budgetary areas agriculture, structural measures and external actions for 2004.

1.50. The Court has recognised in its annual reports, especially since the presentation of the White Paper on the Commission’s reform in April 2000 (37), that progress has been made in improving the design, implementation and functioning of supervisory and control systems, namely at Commission level (see paragraphs 1.71 to 1.83). This evolution has gone hand in hand with a change in the administrative culture concerning the implementation of the EU budget. Whereas, initially, the primary focus was on budgetary execution, control and audit aspects have gained in importance. Furthermore, greater attention has been given to governance issues (see paragraphs 1.55 to 1.70). The Court’s audit shows, however, that further efforts are needed, in varying degrees, to ensure that supervisory and control systems function effectively, particularly at the level of the Member States (see paragraphs 3.54 and 3.55, 4.55 to 4.62, 5.47 to 5.50, 6.42 to 6.45, 7.39 and 7.40, 8.37 and 9.26 to 9.28).


THE COMMISSION’S REPLIES

1.50. The Commission notes the Court’s positive assessment of the progress made since the beginning of the reform with regard to the control systems and management culture.

It acknowledges that improvements in internal control will always be possible. Further efforts are being made, as the replies of the Commission to the Court’s observations in the relevant chapters of the report show, in particular through the actions to ensure that key controls by Member States are properly implemented.

Moreover, at this point, the Commission is demonstrating its commitment by endeavouring to reinforce implementation of an integrated internal control system in line with the principles set out by the Court in Opinion No 2/2004 on the single audit.
Need to develop indicators for assessing progress

1.51. Careful monitoring is necessary, in order to assess whether reinforced supervisory and control systems ensure that the risk is adequately managed. This is of particular relevance if one takes into account all relevant developments in the audit environment (namely the enlargement, reforms of the policies, changes in the administrative structures).

1.52. Management is responsible for the development of the necessary indicators (38). Therefore, the Commission should ensure that supervisory and control systems consistently provide timely, accurate and adequate information on the implementation and effective functioning of key controls and the frequency, nature and impact of errors at the level of underlying transactions which are not prevented, detected and rectified. The Court could then evaluate and comment on the accuracy of the information presented by the Commission and the Member States, and assess the progress achieved (39).

The production of static indicators would not necessarily be adjusted to the changing management and control environment in the Commission. With a view to implementing the road map to an integrated control framework (COM(2005) 252/4 of 15 June 2005), an evaluation report on the differences between the internal control framework in the Commission departments and the control principles set out in the Court’s Opinion No 2/2004 relating to Community internal controls has been drawn up. It finds that global rates of error in policies do not always make sense, given the heterogeneity and multi-annual nature of the programmes that make up the policies. It appears more appropriate for each Directorate-General to define its control strategy (in particular ex post), its target indicators and the desired development over time. The Commission acknowledges that this process, which had already started in 2003, could be more formalised in its departments.

The effectiveness of internal controls relies largely on qualitative assessments using tools which cannot always be reduced to simple indicators.

1.53. The Court’s audits reveal that the design and use of indicators by the Commission is still not sufficient (40) to continuously monitor the quality of internal control systems and the legality and regularity of underlying transactions (see paragraph 1.61) (41).

The Commission already has monitoring indicators similar to those of the Court (see note 44) used in the following cases: implementation of the minimum requirements relating to internal control standards in the overview report on internal control, reform measures and reservations by the Directors-General in the annual activity reports (AAR) on the state of play with regard to the reform and the synthesis of the annual activity reports (AAR), and comments on the statement of assurance as part of the discharge, in particular. It recognises that such indicators should be developed further and it proposes to do so in its approach to risk management.

In the Synthesis, the Commission also undertook to analyse existing indicators as part of a peer review by ‘families’ with a view to examining ways to make these indicators more operational management tools.

[38] See INTOSAI — Auditing standards, Chapter 1, Point 1.0.6 (d): ‘Development of adequate information (...) and reporting systems (...) will facilitate the accountability process. Management is responsible for correctness and sufficiency of the form and content of financial reports and other information.’ The Court considers that indicators are included in the scope of the adequate information.

[39] This proceeding which was proposed by the European Parliament in its 2003 discharge resolution (see paragraphs 65 and 66) would enable it to respond to the requests presented by the discharge authorities.

[40] Annual Reports of the Court of Auditors concerning the financial year 2002, paragraphs 1.68 to 1.74 and the financial year 2003, paragraphs 1.85 to 1.87.

[41] The Court developed its own monitoring elements on: implementation of actions foreseen in the White Paper on the reform or in action plans of the synthesis reports, implementation of internal control standards, follow-up of reservations and observations concerning the DAS, follow-up of reservations of Directors-General, assessment of the implementation of key controls, etc.
THE COURT’S OBSERVATIONS

Commission’s internal control system

Audit scope

1.54. The Court assessed the Commission’s internal control system in the different management areas (see Article 53 of the Financial Regulation), in view of the guarantees it provides as regards the legality and regularity of the underlying transactions. On the one hand, the Court examined the extent to which the management representations, contained in the annual activity reports and declarations by the Directors-General and in the Commission’s Synthesis, are confirmed by the Court’s audit findings and could be taken into account, where necessary, for the DAS. On the other, the Court examined the progress made as regards the implementation of the key elements of the Commission’s internal control (internal control standards and action plans annexed to 2003 annual activity reports and their Synthesis) and assessed the effectiveness of the procedures introduced and tools developed.

The Commission’s management representations

2004 Synthesis report

1.55. In its 2004 Synthesis of the annual activity reports (42), the Commission continued its efforts to improve the transparency concerning its obligation to render account of its management, and decided on the appropriate actions to respond to cross-cutting (horizontal) aspects (43).

1.56. The assessment of the Commission’s internal control system presented in the Synthesis is generally consistent with the analysis of the Court. However, in certain cases the Court’s audit findings indicate that further measures are needed to reach the ‘globally satisfactory’ situation presented in the 2004 Synthesis (modernisation of the accounting system, see paragraphs 1.21 to 1.45; indicators assessing progress, see paragraphs 1.51 to 1.53; annual activity reports and declarations of Director-General, see paragraphs 1.59 to 1.70; action plans, see paragraphs 1.72 to 1.74).

1.56. In the 2004 Synthesis, the Commission noted that the authorising officers by delegation were able to provide the reasonable assurance required.

In the ongoing improvement process, the Commission had set itself a series of objectives relating to essential cross-cutting questions in connection with the quality of management. By way, in particular, of integrated controls, the certification of integrity, consistency and reliability of the accounts, reinforcement of the presentation of annual activity reports and a common method of risk management, the Commission has undertaken to improve its operation in line with the reform.

(43) The new horizontal action plan includes 12 measures related to the following domains: governance issues, activity-based management, financial management and reporting and human resources.
1.57. While the Parliament, in its Discharge resolution 2003, invited the Commission to convert the Synthesis into a consolidated assurance statement on the financial management and controls as a whole, the Commission explained that, the Synthesis report is an act through which political responsibilities are exercised by analysing the annual activity reports. Following the approach by which management responsibilities are decentralised, the Commission does not give any further assurance, as it deems that this is done in the declarations of the Directors-General. The Court recommends that the Commission, as an institution, should assume ‘responsibility for the implementation of the budget as provided for in the Treaty (Article 274) by adopting as its own the Authorising Officers by delegation’s management representations’, (see the Court's Annual Report for the financial year 2003, paragraphs 1.58 to 1.60).

1.58. The Synthesis Report establishes a reference framework under which the Commission aims, among other things, to obtain, in the medium term, an assurance statement from the Court with only marginal reservations. The Court notes that the Commission’s strategy implies a qualitative change because further improvements are sought, not by launching a new reform but by fully developing the performance potential of the existing systems, concentrating on the following areas:

(a) promoting accountability, by assurances from the Directors-General and accrual based accounts signed by the Accounting Officer;

(b) enhancing effective performance management, by effective supervisory and control systems and solid daily management in which risk management is embedded;

(c) reinforcing responsibility and monitoring capacity through an integrated internal control framework (see paragraphs 1.84 to 1.86).

Annual activity reports and declarations of the Directors-General for the financial year 2004

Improved guidelines

1.59. Based on the experience gained in previous years, the central departments of the Commission (Secretariat-General, Directorate-General for the Budget and Directorate-General for Personnel and Administration) drew up general guidelines for the annual activity reports and declarations, which, on the one hand, were used as a circular on the financial year 2004 (44) and, on the other, could serve as a reference for the future financial years.

1.60. The Court noted an improvement in the quality of the guidelines, as compared to 2003, particularly for the following aspects having a link with legality and regularity:

(a) inclusion of the monitoring of actions established within the framework of risk management and internal control assessment;

(b) explanations, for policies in shared management, on the links between the systems for which the Commission is responsible and those for which Member States are in charge;

(c) identification, for all management models except centralised management, if the weaknesses being the subject of a reservation are attributable to the Commission and/or to a third party;

(d) conclusions on the combined impact of reservations on declarations.

1.61. Despite the progress noted, there remains scope for improvement, in particular the presentation of indicators having a direct link to legality and regularity (see paragraphs 1.51 to 1.53).

1.62. As regards the materiality of system weaknesses and their impact on the Directors-General’s reasonable assurance, the 2004 circular refers to the basic principles already adopted in January 2003 (**45**). Difficulties with the application of the proposed criteria were treated in the peer review exercise, which focused on the analysis of the potential reservations of the Directors-General and dealt mainly with:

(a) scope of reservations, materiality and consistency (**46**);


**46** In order to establish the actual scope of the reservations, the Directors-General are asked to specify their criterion for defining the materiality threshold. Apart from materiality based on nature or context, the guidelines establish the threshold as a function of the budget for the activity in question, i.e. 2 % of the value of the activity concerned (COM(2003) 28 of 21.1.2003). As already indicated in its Annual Report concerning the financial year 2003 (paragraphs 1.64 and 1.65) the Court feels that this notion of materiality is not in itself adequate to identify system weaknesses. The Directors-General may depart from this criteria if they feel that the context requires such a decision or if the shortcoming is intrinsically significant. In such cases, the choice of a new threshold or of another materiality criteria must be justified in the annual activity report.

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1.60. The Commission feels that the provisions in the circular relating to part 3 of the annual reports (management and internal control systems) also make a significant improvement by refocusing the analysis of the departments on the risks inherent in their management environment and the effectiveness of the internal control system instead of on the evaluation of its consistency with the minimum requirements of the internal control standards. The formulation of reservations to the declaration of assurance by the Directors-General is, thus, the logical outcome on the reasoning behind the strengths and weaknesses of the internal control system which ensures consistency between the annual report, the declaration and the reservations, as the Court requested in its 2003 annual report.

1.61. Although annual reports do not have the sole purpose of supervising the implementation of control systems nor to determine to what extent they ensure the legality and regularity of operations, the Commission is prepared to step up surveillance controls and risk management in the annual activity reports.

See also replies to paragraphs 1.52 and 1.53.

1.62 to 1.63. Following the peer review of reservations that could be made, the Commission began to study the possibility of introducing a certain degree of modulation in determining the materiality thresholds for the various management areas. As stated in the report on the evaluation of the differences between the control system in Commission departments and the control principles set out in Opinion No 2/2004 of the Court of Auditors, it is normal that the rates of error found fluctuate depending on the characteristics of the programmes and also over time. This work is one of the measures launched by the Synthesis (Action 8).

For the 2005 annual activity reports, the Commission is going to explore the possibility of adopting a common method for determining the threshold of materiality of weaknesses (see 2004 Synthesis), including those of a systemic nature, with a view to making a more consistent evaluation of their impact on the reasonable assurance for the ‘families’ of shared management, research and internal policies.
(b) impact of reservations on the reasonable assurance;

(c) carry-over of reservations and envisaged measures.

1.63. The Court notes that certain progress was achieved, in particular with regard to the clarity of the reservations and their link to material weaknesses. However, no common materiality thresholds were yet established by budgetary area taking into consideration the nature of the operations concerned and the tolerable risk for the area in question (47). Furthermore, the guidelines established to determine a significant system weakness and its potential financial impact require further clarification in order to ensure a coherent and consistent interpretation by the Directors-General.

Declarations of Directors-General

1.64. In their declarations attached to the annual activity reports, the Directors-General state that the internal controls implemented in their departments provide reasonable assurance that the underlying transactions are legal and regular. In the event of material internal control weaknesses or irregularities, they make reservations. The guidelines for the annual activity reports and the Charter for Authorising Officers by Delegation specify that reservations must not make the declaration meaningless and that, in extreme cases (48), the Director-General may not be able to provide the required assurance. In order to remedy weaknesses, action plans, which include deadlines for implementation should be drawn up.

1.65. The Court’s examination of the declarations of the Directors-General confirms the heterogeneous application of the materiality criteria and the difficulties of their use for the formulation of the reservations by the Commission departments, in particular with regard to system weaknesses (see paragraph 1.63). For example, certain Directorates-General did not clarify appropriately the selected criteria and/or quantify the financial impact in a satisfactory way (49).

1.65. The Commission notes that the Court itself recognises, in point 1.63, the progress made overall in the formulation of reservations to the declaration of assurance by the Directors-General, a difficult matter and a practice still rather new to the Commission.

As stated in Objective 6 of the Synthesis of the 2004 annual reports, work is continuing towards a common method to determine the materiality of weaknesses, including those of a systemic nature having an impact on the declaration of assurance by the Directors-General by families of Directorates-General.

A certain degree of heterogeneity in the assessment of materiality is, however, inevitable given the specific characteristics and context of each area of activity and of the decentralised responsibilities and the related reporting as part of the reform of the Commission.

The declarations are intended to be read in conjunction with the annual activity reports to which they are annexed. These reports give complementary explanations.
1.66. All the Directors-General stated that they had obtained reasonable assurance that the resources allocated to them had been used for the specified purposes, and that the internal controls which they had introduced had ensured that the underlying transactions were legal and regular. Of the 40 declarations 18 contain reservations.

1.67. The main reservations are shown in table 1.2. Of the 32 reservations expressed in 2004, the majority (26) concern weaknesses already brought to light in 2003. This confirms that most of the weaknesses identified can be eliminated only in the medium term (see paragraph 1.67 of the Court's Annual Report concerning the financial year 2003). The reduction in the number of reservations from 49 in 2003 to 32 in 2004 is primarily due to the fact that the Directors-General improved the presentation of declarations by concentrating on weaknesses which represent important risks for the legality and regularity of the underlying transactions.

1.68. Due to the improved situation (see paragraphs 1.60 and 1.63), the combined impact of the reservations on the assurance given in the declarations was, in general, more clearly defined than in the 2003 financial year. However, the extent of the reservations expressed by some Directorates-General is not always compatible or sufficiently justified in view of the assurance provided (see table 1.2 and paragraphs 4.27 to 4.32, 4.62 and 5.42).

1.69. The Court’s work shows that the supervisory and control systems in several areas of the financial perspectives, have still not reached a satisfactory level and that further efforts are required in order to strengthen them. Therefore, some weaknesses singled out by the Court during its audits should have been included in the declarations of the Directors-General (see table 1.2 and paragraphs 4.58, 5.46, 6.39 and 7.37).

1.70. Due to the reinforced guidelines and the peer review, an improvement is noted as regards the annual activity reports and declarations of the Directors-General. However, the Court considers that they can still only serve as a limited source for its assurance because of difficulties of a coherent application of some methodological principles.

1.66. The determination of the impact of the reservations on the assurance is improving as the practice is consolidated. The Directors-General and Heads of Services have generally given an indication, by explicit arguments, of the impact of the reservations made on the reasonable assurance relating to the use of resources and the legality and regularity of the operations. They all concluded that they could give their assurance.

1.67. Through its work to improve the content of the declarations and the monitoring of compliance with the standards on which the declarations are founded, the Commission is endeavouring to make the annual declarations an efficient management tool and a reliable indicator of the results which it achieved and its strategy to deal with risks identified so that the Court can use them as a basis for its assurance.

With regard to the impact and scope of the reservations (see table 1.2 and paragraph 1.49), the Commission notes the Court’s observations and will continue to provide more detailed information so that the Court can take them into account to greater advantage in order to support its declaration of assurance.

1.68. The Commission notes that all authorising officers by delegation were able to provide reasonable assurance.

1.69. See replies to paragraphs 1.49, 4.58, 5.45, 6.39 and 7.37.

The Directors-General’s assurance in a given year is not based solely on the audit work carried out in the course of the year concerned, but on the assurance built up over previous years’ audit work under the Directorates-General’s audit strategy, as well as the assurance provided from the audit work of Member States.

1.70. The Commission considers that the annual activity reports and declarations are already, and will be to a greater degree in the future, a sound source of assurance and an effective management tool, which will make it possible to detect weaknesses and provide an effective remedy. It feels that in 2004, significant improvements were made in the reports and the declarations accompanying them. See also reply to point 1.49.

As stated in the Synthesis, the Commission is also continuing to reinforce consistency in the way its departments apply the guidelines it issues. The road map for an integrated internal control system (COM(2005) 252/4 of 15 June 2005) and the related commitment by all the financial actors concerned will also contribute to providing the Court of Auditors with a sounder basis for its assessment.

(50) The variation of the number of reservations between 2003 and 2004 (- 17) is composed of six new reserves and of the removal of 23 reserves of the financial year 2003.
THE COURT’S OBSERVATIONS

Progress made in reinforcing the internal control system

Overview on the state of internal control

1.71. The Directorate-General for the Budget presented, for the second year, a report providing an overview of the state of internal control in the Commission’s Directorates-General and services in 2004 (51). This report takes stock of the significant progress in implementing internal control since the establishment of the White Paper in March 2000. It also recognises that further efforts are necessary in order to support the move from compliance to an effectiveness approach. Areas identified are reinforcing the monitoring of the effectiveness of internal control of Directorates-General, enhancing supervision procedures on financial management, strengthening of risk management, review and simplification of low value contracts and grants and the creation of an integrated internal control framework. The Court considers that this overview on the internal control system of the Commission gives a balanced presentation of the progress achieved and areas in need for improvement.

Action plans

General situation as regards implementation

1.72. The Court examined the progress of implementation of the measures foreseen in the consolidated action plan annexed to the 2003 Synthesis report, that have a direct link to legality and regularity (52), as well as the horizontal actions indicated in table 1.3 of its 2003 Annual Report which are not covered by the Synthesis (53).
THE COURT’S OBSERVATIONS

1.73. The monitoring of the implementation of the horizontal action plans (as well as of the specific action plans and of the audit recommendations) has been satisfactorily integrated into the working environment of the Commission, in particular through the activity-based management of the Directorates-General (annual management plans and annual activity reports).

1.74. Table 1.3 provides an overview on the state of implementation of the 19 actions examined by the Court. At the end of the financial year, for six actions, which are in principle completed, further efforts are necessary in order to achieve the foreseen objective or to introduce certain improvements (54). At the end of 2004, five actions were still in the process of implementation (55).

Reinforcement of internal audit function

1.75. Action 87 of the White Paper required the Internal Audit Service (IAS) to review the improvements of the Commission’s internal control system and to carry out a complete cycle of audits of management and control systems in all Directorates-General. Work on this action has been largely executed over a two year period. The audit results presented in the different reports (56) (strengths and achievements, as well as areas in need for improvement) are balanced and confirm, on the whole, the Court’s audit findings.

1.76. With a view to reinforcing the relations between the IAS and the Internal Audit Capabilities (IACs) set up in all Directorates-General, in February 2004 (57) the Commission obliged the IACs to systematically send their final reports to the IAS and requested that the latter reports twice a year on their key findings. Furthermore, efforts are undertaken to coordinate work programmes and harmonise audit methodologies and reporting structures. The first joint audits took place in 2004. The Court considers that these steps should help to reinforce the internal audit function within the Commission.

THE COMMISSION’S REPLIES

1.74. The Commission feels that most of the measures referred to by the Court have since been terminated. Monitoring of measures which had not been completed was integrated into the series of objectives of a multi-annual nature set in the 2004 Synthesis affecting essential cross-cutting issues for the quality of management work.

(54) Internal controls in delegations (action 5.4.1 of the 2002 Synthesis); shared management and audit in shared management (actions 5.3.3A and 5.3.3B of the 2002 Synthesis); co-financing (action 5.3.4 of the 2002 Synthesis), interoperability (action 7 of the 2001 Synthesis), annual activity reports methodology (action 4.4 of the 2002 Synthesis).

(55) Evaluation of the devolution exercise (action 2 of the 2001 Synthesis), management risk assessment (action 3.3.2 of the 2002 Synthesis), certain aspects connected with the reliability of the accounts (recoveries, accounting framework and development of a database of legal entities and of a database of contracts (actions 5.3.2A and 5.3.7 of the 2002 Synthesis, actions 11 and 74 of the White Paper).

(56) Annual internal audit report 2003, according to Article 86(3) of the Financial Regulation, report ‘Completion of Action 87’ and a report on the RELEX family.

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<tr>
<th>Domain</th>
<th>Action</th>
<th>Character of the measure</th>
<th>Source of the action plan</th>
<th>Diagnosis / Measures still to be undertaken</th>
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<td><strong>EXTERNAL ACTIONS</strong></td>
<td>'Internal controls in delegations'</td>
<td>Internal controls</td>
<td>Synthesis 2002 (5.4.1)</td>
<td>Action finished / Implementation under way – improvements possible. Additional efforts necessary in the next years to strengthen the compliance and effectiveness of internal control systems in delegations (see paragraph 7.41(c)).</td>
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<td>'Evaluation of the devolution exercise'</td>
<td>Cross-cutting political issues</td>
<td>Synthesis 2001 (2)</td>
<td>Action in progress. Follow-up required in the next years (see paragraphs 7.48 to 7.51).</td>
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<td><strong>SHARED MANAGEMENT (STRUCTURAL ACTIONS)</strong></td>
<td>'Shared management'</td>
<td>Financial management</td>
<td>Synthesis 2002 (5.3.3A)</td>
<td>Action finished / Implementation under way – improvements possible. Follow-up required in 2005 in order to better clarify the responsibilities of Member States and the Commission in the different management areas (see paragraph 5.7).</td>
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<td></td>
<td>'Audit in shared management'</td>
<td>Audit</td>
<td>Synthesis 2002 (5.3.3B)</td>
<td>Action finished / Implementation under way – improvements possible. Strengthening of the methodology and development of the concept of single audit foreseen for 2005 and 2006 (see paragraph 5.34).</td>
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<td><strong>INTERNAL POLICIES (RESEARCH)</strong></td>
<td>'Co-financing'</td>
<td>Financial management</td>
<td>Synthesis 2002 (5.3.4)</td>
<td>Action finished / Implementation under way – improvements possible. The concept of forfaitisation for some categories of expenses to be introduced in the Financial Regulation (see paragraph 6.47).</td>
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<td><strong>HORIZONTAL ASPECTS OF INTERNAL CONTROL</strong></td>
<td>'Annual activity reports methodology'</td>
<td>Annual activity reports methodology</td>
<td>Synthesis 2002 (4.4)</td>
<td>Action finished / Implementation under way – improvements possible. Additional efforts necessary for the following issues: materiality (see paragraph 1.63), impact of reservations on the reasonable assurance (see paragraph 1.68) and indicators (see paragraph 1.61).</td>
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<td>'Management risk assessment'</td>
<td>Activity based management / Strategic planning and programming</td>
<td>Synthesis 2002 (3.3.2)</td>
<td>Action in progress. Additional efforts necessary in the next years (see paragraphs 1.78 and 1.79).</td>
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<td>'Recovery'</td>
<td>Financial management</td>
<td>Synthesis 2002 (5.3.2A)</td>
<td>Action in progress. Presentation of specific performance indicators regarding recovery not yet mandatory (see paragraph 1.61).</td>
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<td>'Accounting framework'</td>
<td>Financial management</td>
<td>Synthesis 2002 (5.3.7)</td>
<td>Action in progress. Additional efforts necessary (see paragraphs 1.21 to 1.45).</td>
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<td></td>
<td>'Development of a database of legal entities and of contracts'</td>
<td>Chapter II 'A culture based on service' and chapter V 'Audit, financial management and control'</td>
<td>White paper (11 and 74)</td>
<td>Action in progress. Additional efforts necessary (see paragraphs 1.21 to 1.45).</td>
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1.77. In addition, the Court invites the Commission to consider the possibility for ensuring synergies between the IAS and the IACs by introducing a logical chain structure (58) within the internal audit function of the Commission, so that the Internal Audit Service can take into account the work done by the IACs.

1.77. The Commission shares the Court’s concern for fully exploiting possible synergies between the different internal audit actors in the Commission.

The Commission is already taking action in this regard: a clarified information and reporting structure and a common reporting framework, established in Spring 2005, in particular covering the rating of audit observations and recommendations, are important steps in enhancing the effectiveness of the internal audit function for the Commission overall. The work programmes of the Internal Audit service (IAS) and Internal Audit Capacities (IACs) are being coordinated in order to avoid overlaps and this coordination of audit planning will be reinforced for the next programme period. There have been joint IAS and IACs audits.

The IAS has launched a quality assessment of the IACs, starting with a self-assessment exercise in 2005 and leading to an assessment by the IAS in 2006. This has not only the objective of guaranteeing the availability of quality internal audit services for the Directorates-General but also to establish an objective basis for other auditors to rely on audit work done at other levels.

Risk assessment

1.78. Action 3.3.2 of the 2002 Synthesis ‘Management risk assessment’ stipulates that the management of the risks becomes an operational and strategic instrument to decide on the allocation of the financial and human resources within the Commission’s departments. To that end, the Central Financial Service (CFS) of the Directorate-General for the Budget, initiated, in 2004, a pilot project in seven Directorates-General in order to test the preliminary version of the risk management framework and corresponding implementation manual, while preparing in parallel the activity planning process and setting their main objectives for 2005.

1.79. Despite the generally positive result, further efforts are necessary to develop methodological elements and tools for risk analysis and management, which could form a solid structural framework to be applied effectively in all Commission services. An inter-service steering committee is following up the

1.79. The Commission agrees that further efforts are necessary and that the Court observations fairly reflect the Commission’s action plan.

(58) Opinion No 2/2004 of the Court of Auditors on the ‘single audit’ (and a proposal for a community internal control framework), paragraph V.
development of the common framework, which should be adopted by the Commission in the second half of 2005, and used for the preparation of the 2006 Strategic Planning and Programming (SPP) cycle. On this basis, adequate annual management plans should allow Directorates-General to reduce risks deemed unacceptable but that could not be avoided nor transferred.

Internal control standards

1.80. The Court analysed the application of internal control standards (59) by 14 of the Commission's Directorates-General (60). The aim was not only to assess the degree of implementation but also to evaluate their effective functioning as regards the legality and regularity of the underlying transactions (see paragraphs 1.58 and 1.71).

1.81. The guidelines presented by the CFS on the definition of the internal control standards (baseline requirements) for the 2004 financial year did not introduce significant changes as compared to 2003 (61).

1.82. In their self-assessments, which are annexed to the ‘Overview on the state of internal control in the Commission DGs and services in 2004’ (see paragraph 1.71), the Directorates-General declare for the 2004 financial year that they comply with 93 % of the baseline requirements defined by the CFS. In general, the analysis of the Court confirms this presentation. Given that the baseline requirements remained essentially unchanged, the Court notes a slight increase in the compliance with the internal control standards, as compared to 2003 (91 %) The analysis of the Court on the implementation of internal control standards is presented in table 1.4.


(60) The Directorates-General for Economic and Financial Affairs, Agriculture and Rural Development, Employment, Social Affairs and Equal Opportunities, Fisheries and Maritime Affairs, Regional Policy, Research, the Information Society and Media, Enlargement, the Budget, Personnel and Administration, Health and Consumer Protection, Humanitarian Aid, the EuropeAid Cooperation Office and Eurostat.

(61) The number of the baseline requirements decreased from 74 to 71. Four of the requirements retained for 2004, were strengthened in comparison to 2003.
Table 1.4 — The Court’s analysis of the implementation of internal control standards (with a direct link to the legality and regularity of underlying transactions for the main Directorates-General) (situation at 31 December 2004)

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<td>A</td>
<td>A</td>
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</tr>
</tbody>
</table>

Assessment:
A: Implementation of baseline requirements
B: Partial implementation of baseline requirements
1.83. The innovative element introduced by the guidelines on the annual review of the internal control system for the financial year 2004 consists of the assessment, by the Directorates-General, of the effectiveness of the application of the internal control standards. The Court’s review of the annual activity reports showed, however, that the evaluation is very general and does not make it possible to systematically identify the areas in need of improvement (see paragraph 1.58). A number of the Directorates-General (62) did not sufficiently evaluate the effectiveness of their internal control system. Among the services which presented a sufficient self-assessment, the majority (63) declared that the effective operation of the internal control standards 11 ‘Risk analysis and management’ and/or 17 ‘Supervision’ requires additional effort.

Towards a Community internal control framework

1.84. The Court proposed, in its Opinion No 2/2004, the implementation of a Community internal control framework that should integrate and strengthen the elements already existing, while at the same time adding new aspects in order to increase efficiency and effectiveness of controls (common principles to be applied at all levels of administration in the institutions and Member States, internal controls should provide reasonable (not absolute) assurance on the legality and regularity of the underlying transactions, costs of the controls should be in proportion to the benefits they bring in both monetary and political terms, systems should be based around a logical chain structure where controls are undertaken, recorded and reported to a common standard, allowing reliance to be placed on them by all participants).

(62) E.g. Directorates-General for Competition, Development, Informatics, Employment, Social Affairs and Equal Opportunities, Enterprise and Industry, Press and Communication, Regional Policy, External Relations, Health and Consumer Protection, Taxation and Customs Union, the European Communities Personal Selection Office, Eurostat, the Bureau of European Policy Advisers, the Joint Research Centre, the Office for Infrastructure and Logistics in Brussels, the Office for Infrastructure and Logistics in Luxembourg, the European Anti-Fraud Office, the Office for the Administration and Payment of Individual Entitlements and the Legal Service.

1.85. The Commission adopted as a strategic objective to ensure that the Court obtains reasonable assurance concerning the legality and regularity of underlying transactions (64). Furthermore, the Commission adopted a ‘roadmap to an integrated internal control framework’ (65) with a view to initiating a process leading to a common understanding by the end of 2005, to be formalised in an interinstitutional agreement between the Parliament, the Council and itself, on how the current internal control framework can be improved in order to provide the Court with the reasonable assurance it seeks.

1.86. The Court welcomes this initiative and the Commission’s commitment to establish an effective Community internal control framework following the recommendations presented in the Court’s Opinion No 2/2004. Effective supervisory and control systems are of major relevance, particularly in a context where a large part of the Community budget consists of expenditure which is intrinsically high risk because it depends on information supplied by beneficiaries, or is subject to extremely complex or imprecise rules.

1.86. There are necessarily numerous conditions governing the eligibility of operations and expenditure, but the Commission provides guidance and has simplified the rules as far as possible.


### CHAPTER 2

**Budgetary Management**

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INTRODUCTION

2.1. This chapter analyses issues arising from the implementation of the EU general budget in 2004.

2.2. The budget of the European Union is approved by the budgetary authority (European Parliament and Council) on the basis of proposals presented by the Commission, and is set within the multiannual framework of the financial perspectives. For most expenditure areas — agriculture, structural operations, external action and pre-accession strategy — the Commission implements the budget in cooperation with Member and other beneficiary States.

2.3. Within the budget there are separate appropriations for commitments and payments. Appropriations for commitment represent the amounts the Union has available to make budgetary commitments in the current year in order to honour legal commitments (or agreements) to spend during the current or future years (1). Appropriations for payment represent amounts that can be spent during the current year. Most expenditure on structural operations and on internal and external policies takes the form of programmes managed over a number of years (e.g. 2000-2006 for the current Structural Fund programming period). In these cases, legal obligations are not generally reflected as budgetary commitments in the year they are agreed, but as approximately equal yearly tranches over the life of the programmes (2).

OBSERVATIONS

More information in Commission report, but insufficient analysis

2.4. Detailed information on budgetary implementation for 2004 can be obtained from the Commission document entitled 'Report on budgetary and financial management - Financial year 2004' (3). In its 2003 annual report (4), the Court recommended that more detailed information be given on the cumulative state of implementation of Community programmes. Additional data on the cumulative state of implementation of Community programmes has been provided which increases the information value of the report. The Court recommends that in future

2.4. The Commission has provided extensive information in the form of an introductory text, tables and graphs on the cumulative state of a number of the most important multi-annual programmes (i.e. the Structural Funds, the Cohesion Fund, Sapard and ISPA). The annual budgets illustrate the expected performance, comparing these with the actual implementation. In future, the Commission will examine the possibility of providing the additional information recommended by the Court in the Report on budgetary and financial management. On the budgetary implementation of the Structural Funds, the Commission has,

(1) The case of differentiated appropriations.
(2) See paragraph 2.21 and Annex I for further background information on the budget.
(3) This document is again, this year, only available on the Commission’s website — http://europa.eu.int/comm/budget/infos/publications_en.htm — despite Article 29 of the Financial Regulation requiring it to be published in the Official Journal of the European Union.
(4) Paragraph 2.4.
the presentation could be made more useful by better explaining and analysing the data, and comparing actual with expected performance. In the case of the Structural Funds the information is presented by policy objective. However, it would also be useful to present the information by individual Fund as this would more closely reflect the Commission’s management and accountability structure.

since 1977, published a detailed annual report. This report comprises, inter alia, a thorough analysis of the cumulative state of implementation, as well as an analysis of the individual Funds. The 2004 report was published in May 2005 and is available online at http://europa.eu.int/comm/budget/furtherinfo/index_pg2_en.htm.

In addition, detailed information on the state of the implementation of the Structural Funds (stating amounts allocated, committed and paid, by objective, Fund and Member State) is published in the Annual Report on the Implementation of Structural Funds which appears in October of the following year, see e.g. the 2003 report (COM(2004) 721 final).

2.5. Article 185 of the implementing regulations to the Financial Regulation stipulates that the report on budgetary and financial management (5) ‘shall give an accurate description [… ] of the achievement of the objectives for the year, in accordance with the principles of sound financial management’. This requirement has been complied with at a general level. More detailed information is included within the annual activity reports of the directors-general.

2.5. The purpose of the report is to provide an overview on the evolution of the annual budget and its implementation. In addition, the Commission provides a number of more specialised, detailed annual reports on several policy areas, notably the annual report on budgetary implementation of the Structural Funds.

A larger budget for a bigger Union

2.6. The 2004 budget was originally drawn up for an EU of 15 Member States (6). Total appropriations for commitments fell by 0.3 % and total appropriations for payments increased by 2.3 % compared with the 2003 final budget. Enlargement necessitated an amending budget (7) from 1 May onwards. The updated budget represented increases of 11.5 % and 7.8 % for commitments and payments respectively, compared with the 2003 final budget. The increase in commitments is proportionally larger because they can cover expenditure for more than one year (see paragraph 2.3).

2.7. Commitment and payment appropriations were below their increased financial perspective ceilings by 4.3 billion euro and 11.8 billion euro respectively. For commitments, the margin occurs mainly in agriculture (2.5 billion euro) and pre-accession strategy (1.7 billion euro) with the other headings being near or slightly over (8) the limits.

(5) Under the terms of Article 128 of the Financial Regulation this report is sent to the European Parliament, the Council and the Court of Auditors.


(8) Making use of the ‘flexibility instrument’ allowing financing of clearly identified expenditure which could not be financed within the limits of the ceilings available. The flexibility instrument should not, as a rule, be used to cover the same needs two years running.
2.8. Amending budgets voted during the year (*) resulted in an overall 1.6 billion euro reduction in appropriations for commitments (due to less than foreseen expenditure on agriculture), and a 2.0 billion euro increase in appropriations for payments, mostly related to extra appropriations for structural operations (see paragraph 2.14).

Payment spending rate increased to 95 %

2.9. Table 2.1 gives an overview of the budgetary outturn for the 2004 financial year for both payments and commitments. In 2004 the proportion of final appropriations for commitments used (the implementation rate) was 98 %, marginally lower than 2003 (99 %). For payments, the proportion of final appropriations used (the spending rate) was 95 %, an increase on 2003 (92 %, albeit based on a reduced budget (10)) and 2002 (86 %). The increase in spending occurred in all areas.

Smaller surplus

2.10. For 2004, the budget surplus (11) totalled 2.7 billion euro (see Table 2.2), for the following reasons:

— revenue received was 1.7 billion euro more than revenue budgeted;

— expenditure (taking into account carryover of payment appropriations) was 2.1 billion euro less than budgeted;

— other elements leading to a deduction of 1.0 billion euro, mainly related to an adjustment for earmarked revenue.

(10) See paragraph 2.10 of the Court’s 2003 Annual Report.
(11) The surplus is not a reserve which can be accumulated and used in future years to finance expenditure. The unused revenue that the surplus represents is offset against the own resources to be collected for the following year. The unused appropriations for payment resulting from the underspending are, in most cases, cancelled and thereby ‘lost’.
Table 2.1 — Implementation of the 2004 budget by financial perspective heading

<table>
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<th>Implementation of the budget</th>
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<td>Commitments and payments made</td>
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<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
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Payment appropriations

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<td>Total</td>
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</table>


(2) Budget appropriations amended after taking into account amending budgets (including for enlargement) and transfers, and including appropriations carried over from 2003, appropriations resulting from the contributions by third parties and other revenue corresponding to a defined purpose, and appropriations made available again.

Source: 2004 annual accounts.
Table 2.2 — Composition of surplus 2004 (and 2003)

(million euro)

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<td>84 011</td>
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<td>Other revenue</td>
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<td>8 514</td>
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<td>– 177</td>
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<td>– 920</td>
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<td>316</td>
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<td>– 113</td>
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<td>– 58</td>
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<td>– 55</td>
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<td>– 650</td>
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<td>Rounding</td>
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<td>– 1</td>
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<td><strong>Total</strong></td>
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<td>– 2 830</td>
<td>2 063</td>
<td>7 781</td>
<td>– 2 246</td>
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<tr>
<td>Earmarked revenue (3)</td>
<td></td>
<td>– 961</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Other (4)</td>
<td>– 18</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td><strong>Total surplus</strong></td>
<td></td>
<td></td>
<td>2 739</td>
<td></td>
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</tr>
</tbody>
</table>

(1) Includes the cancellation of unused credits brought forward of 276 million euro (2 074 million euro in 2003).
(2) Amount carried over includes 1 263 million euro in respect of third party earmarked revenues for which the usual cancellation rules for carry-overs do not apply (1 044 million euro in 2003).
(3) Adjustment for earmarked revenue received but not budgeted for.
(4) Sundry elements mainly related to re-used credits carried forward and EFTA contributions.

Source: 2004 annual accounts.

2.11. The 2004 surplus represents a further reduction compared with 5,5 billion euro in 2003, 7,4 billion euro in 2002 and 15,0 billion euro in 2001. Much of the reduction in the surplus is due to the higher spending rate for structural operations. This reflects not only improved management by the Commission, but also the fact that, as 2004 is well over half way through the 2000 to 2006 spending programmes, the spending rates have increased (see paragraphs 2.14 to 2.16).
2.12. In its 2002 and 2003 Annual Reports (12) the Court identified poor forecasting of structural operations expenditure by Member States as a significant reason for the Commission not being able to take timely action on management of the underspending and the resulting surplus. Estimates have improved, with the forecasting error rate falling from 50% in 2003 to 23% in 2004. However, this still represents an over-forecast of 6.5 billion euro and the Commission itself recognises the scope for further improvement. Unlike in previous years, the Commission’s 2004 report on budgetary and financial management provides no information or analysis of Member States’ estimates.

2.12. The Commission has provided a detailed report on the Member States’ payment forecasts, including a comparison of the forecasting error rates 1998 to 2004, in the aforementioned annual report on the budgetary implementation of the Structural Funds.

The Commission would like to emphasise that the annual payment budget is not directly based on the Member States’ forecasts, but on the Commission’s own assessment of the likely need for payment appropriations. The Member States’ forecasts are potentially a useful input for this assessment, which is why the Commission is continuing to press for improvement.

2.13. In the past, significant carryovers of appropriations have been made and not used (13). Of the amount of non-earmarked payment appropriations brought forward from 2003, 23% were not used (14). A total amount of 2.8 billion euro is being carried over to 2005, comprising 1.5 billion euro in respect of the operational budget (1.2 billion euro in 2003), and 1.3 billion euro in respect of earmarked third party revenues (1.0 billion euro in 2003).

Current expenditure programmes have reached the expected spending rate

2.14. A large proportion of the budget — structural operations, some internal policies and external actions — consists of multi-annual expenditure programmes running within defined cycles over a number of years (e.g. 2000-2006 in the case of the Structural Funds). The Commission and the Member States encountered significant delays in setting up and starting operation of these programmes, particularly in respect of the Structural Funds. However, in 2004 the programmes largely reached the planned annual level of spending, involving the reimbursement of claims from Member States for payments made to beneficiaries. Indeed, the budgeted payment appropriations for the Structural Funds were not sufficient so an amending budget (15) totalling 3.7 billion euro was requested prior to the year end. Of this amount, 3.3 billion euro related to the current programmes.

(12) See paragraph 2.26 of the Court’s 2002 Annual Report, and paragraphs 2.31 and 2.47 of the Court’s 2003 Annual Report.
(13) See paragraph 2.14 of the Court’s 2003 Annual Report.
(14) Payment appropriations covering earmarked revenue are subject to specific rules due to their different nature. See paragraph 2.37 of the Court’s 2003 Annual Report.
2.15. The current level of spending involves only a limited reduction in the level of outstanding commitments. The information provided in the Commission’s report on financial and budgetary management on the state of implementation of the Structural Funds (see paragraph 2.4) shows that the three policy objectives for the 2000-2006 period were implemented by around 40% by the end of 2004.

2.15. The Commission aims to budget accurately for all eligible payment requests, and this may include bringing forward amending budgets where payment flows exceed expectations.

2.16. Also ongoing is the closure of the Structural Fund expenditure programmes for the previous programming period (1994 to 1999). The Commission has experienced significant problems and delays in closing these programmes and in making final payments (see paragraphs 5.29 to 5.31). Of the 9.1 billion euro of outstanding budgetary commitments at the end of 2003, payments were made on 3.6 billion euro and 2.3 billion euro were cancelled as they will not be used. At the end of 2004, 3.3 billion euro of budgetary commitments remain outstanding for the closure of these old programmes in 2005 and potentially beyond.

2.16. Member States were obliged to submit payment claims for these programmes at the latest by 31 March 2003. A large number of claims arrived just before the deadline and the variable quality of the accompanying closure documentation made it necessary to make additional enquiries before the claims could be processed. The closure exercise made substantial progress in 2004. This is shown by the reduction in outstanding commitments by two thirds to around 5% of the total outstanding commitments for the Structural Funds.

Increase in outstanding budgetary commitments due to enlargement

2.17. Outstanding budgetary commitments represent the amounts which the Commission has legally committed to pay in the future. The higher the value of outstanding budgetary commitments, the greater is the demand on the payments budgets in future years. Outstanding budgetary commitments increased by 4.5% to 110.1 billion euro (see Table 2.3). The increase was due to the additional budgetary commitments for the new Member States after enlargement. The underlying outstanding budgetary commitments for the pre-enlargement EU remained stable. Outstanding budgetary commitments for differentiated expenditure as a whole represents 2.2 years of payments at the current spending rate (2.5 years in 2003).

2.17. The 2.2 years referred to by the Court can be regarded as a normal ratio and close to the n + 2 principle.

2.18. Graph 2.1 shows the value of outstanding budgetary commitments on differentiated expenditure since 1994. The increase is due to both the change in the system for annual commitments for the Structural Funds, introduced for the 2000-2006 programming period, and the cumulative effect of underspending between 1999 and 2003 which resulted in 40 billion euro of payment appropriations being cancelled (16).

(16) See paragraph 2.12 of the Court’s 2003 Annual Report.
Table 2.3 — Change in balance of outstanding budgetary commitments 2004

<table>
<thead>
<tr>
<th>By type</th>
<th>Total</th>
<th>By Financial Perspective heading</th>
</tr>
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<td>Agri-</td>
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<td>culture</td>
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<tr>
<td>Non-differentiated appropriations</td>
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<td>Differentiated appropriations</td>
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<td>Commitments brought forward</td>
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<td>Balance brought forward</td>
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<td>Payments</td>
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<td>-41 221</td>
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<tr>
<td>Cancellations</td>
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<td>0</td>
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<tr>
<td>Commitments made in 2004</td>
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<td></td>
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<tr>
<td>Commitments made</td>
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<td>57 779</td>
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<tr>
<td>Payments</td>
<td>-50 162</td>
<td>-7 981</td>
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<tr>
<td>Cancellations</td>
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<td>Rounding</td>
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<td>-1</td>
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<tr>
<td>Balance carried forward to 2005</td>
<td>1 313</td>
<td>108 834</td>
</tr>
</tbody>
</table>

Source: 2004 annual accounts and report on budgetary and financial management.

Graph 2.1 — Outstanding budgetary commitments 1994 to 2004

Note: Differentiated appropriations comprise expenditure on structural operations, internal policies, external actions and pre-accession strategy.

2.19. In its reply to the 2003 Annual Report the Commission stated the level of outstanding budgetary commitments to be in line with its forecasts (17). In 2002 the Commission undertook an in-depth analysis of the progress of the budgetary execution of the Structural Funds taking into account, and adjusting for, the low rates of spending in 2000 to 2002, and forecasting the level of outstanding budgetary commitments at the end of each year up to 2010 (18).

2.20. In the event, the level of outstanding commitments at the end of 2004 for 2000-2006 programmes was 3.7 billion euro higher than the Commission predicted in 2002 for the EU 15. Outstanding budgetary commitments for the 1994-1999 programmes were 3.3 billion euro: the Commission’s 2002 analysis expected them to have been completely liquidated. Furthermore there were 2.1 billion euro of outstanding budgetary commitments relating to enlargement, not included in the Commission’s analysis.

2.21. Due to the nature of the budgetary process the balance of outstanding budgetary commitments does not reflect the full extent of legal commitments, as most expenditure programmes are subject to specific rules. Financing decisions made at the beginning of the programming period — representing legal commitments to pay — are not translated immediately into budgetary commitments, but are allowed by the Financial Regulation (19) to be committed over the programming period on an approximately equal annual basis. The legal commitments made, but not yet transformed into budgetary commitments, are disclosed as off balance sheet items in the annual accounts (20).

2.20. The higher than forecast level of outstanding commitments for 1994 to 1999 is due to the delay in the closure of these programmes, which was difficult to predict at the time (see reply to point 2.16). The 2002 figures were best estimates based on information available. The difficulties in making these estimates were, to a large extent, due to the fundamental change of the payments system for the new 2000 to 2006 programmes, compared to the previous programmes.

Outstanding budgetary commitments do not represent total legal commitments

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(17) Paragraph 2.48 of the Court’s 2003 Annual Report: ‘A “RAL” for the 2000 to 2006 period of 2.3 times current annual payments […] is in line with the Commission’s forecast’.

(18) Graph 7, Commission Communication: Evolution of budget execution of the Structural Funds, in particular outstanding commitments (RAL) (COM(2002) 528 final, 20.9.2002). No similar exercise was done for the Cohesion Fund, although the balance of outstanding budgetary commitments totals 9.7 billion euro.

(19) Article 76(3): ‘Budgetary commitments for actions extending over more than one financial year may be broken down over several years into annual instalments only where the basic act so provides…’

(20) See off-balance-sheet commitments in the annual accounts: item 6 of contingent liabilities.
2.22. At the end of 2004, outstanding budgetary commitments for the Structural Funds 2000-2006 programming period were 60 billion euro, representing 2.2 years’ expenditure at the 2004 spending rate. Legal commitments not yet transformed into budgetary commitments (see paragraph 2.21), total 75 billion euro. As such, total outstanding legal commitments for the Structural Funds 2000-2006 programming period at the end of 2004 were 136 billion euro, which represents nearly five years’ payments at the 2004 spending rate. The total outstanding legal commitments only fell slightly in 2004, due to the effect of the additional legal commitments arising from enlargement. However, in order to liquidate all the outstanding legal commitments from the 2000-2006 programming period by the end of the payment period (2010), the Commission will need to maintain a high spending rate and/or to undertake significant decommitments under the n + 2 rule (see paragraphs 2.24 to 2.26).

2.22. The Commission considers that the presentation of the ratio of ‘outstanding legal commitments’ relative to payments in a given year is not, in itself, a useful indicator; the ratio of ‘outstanding legal commitments’ relative to payments naturally falls as the end of the programming period approaches. The total level of outstanding commitments should therefore always be seen in the light of the remaining time span for execution of the remaining payments. In this respect, the Commission agrees with the Court’s observations in the last sentence.

2.23. In respect of the current Structural Funds programming period, Member States can make payments to beneficiaries up to the end of 2008, and the Commission can reimburse Member State claims up to 2010, including closure. Experience with previous periods shows that spending rates fall towards the end of the cycle and closure is problematic (21). There is, therefore, a risk that spending on the current programmes will be delayed even further into the next period, and the start of the new programmes delayed.

2.23. It is normal that part of the balance for programmes for the current period will be paid in the years 2007 to 2010. Due to the application of the n + 2 rule for the Structural Funds the Commission does not expect to face any significant accumulation of outstanding commitments at the end of the current period.

The closure of 2000 to 2006 programmes should not mean that the start-up of programmes in the next period will be delayed. The Commission will propose budgets that match the expected level of eligible payment claims, whether these claims arise from the 2000 to 2006 period or the 2007 to 2013 programming period.

Year n + 2 rule has resulted in little decommitment so far

2.24. The Commission considers (22) that the risk of a high level of outstanding budgetary commitments within the Structural Funds is reduced by the year n + 2 rule. This provides that commitments on which no payment has been made within the two years following the year the commitment was made are cancelled automatically. In 2003 the cancellations following application of this rule amounted to 31 million euro. In 2004, the amount involved was higher at 219 million euro, representing just 0.3% of the balance of outstanding budgetary commitments for the Structural Funds at the end of the year.

2.24. The Commission maintains its view that the n + 2 rule will stabilise the level of outstanding commitments.

The payments on account made at the beginning of the programming period, representing 7% of the total 2000 to 2006 envelope of each programme, provide a relatively long-term protection against n + 2 decommitments as advance payments reduce the level of reimbursements needed to avoid automatic decommitments. This protection weakens over time though, which may lead to growing n + 2 de-commitments in the years ahead.

At the same time, the n + 2 rule provides an incentive for faster implementation and more regular submission of payment claims. Therefore, its impact cannot only be judged by the level of decommitments.


(22) See, for example, the Commission’s reply to paragraph 2.48 of the Court’s 2003 Annual Report: ‘The “N + 2” rule should result in a stabilised level of outstanding commitments over the next few years…’.
THE COURT’S OBSERVATIONS

2.25. Of the commitments cancelled following this rule, 76 % related to ESF expenditure in the Netherlands. In practice new commitments from the performance reserve (23) were in some cases allocated to the programmes from which commitments were cancelled, thereby negating the effect of the procedure (24). The lack of cancellations for other Member States reflects increased spending. However, the Court found evidence of claims including ineligible expenditure being submitted by Member States in order to prevent cancellations. This illustrates the real nature of the risk identified by the Court in its 2003 Annual Report (25).

2.26. Although the Commission considers the year n + 2 rule to be an important budgetary management tool, no analysis on its operation or effect is given in its report on budgetary and financial management.

THE COMMISSION’S REPLIES

2.25. The background to the situation described by the Court, regarding the additional commitment from the performance reserve to a programme from which funding had been decommitted under n + 2 is, that given the fact that appropriations cannot be shifted between objectives (amounts fixed at the Berlin European Council in 1999 and in the Structural Funds Regulation), competition for the Performance Reserve is limited to programmes of one Member State within one Objective. As there is one Objective 3 SPD in the Netherlands, the Commission had no choice but to commit the reserve to this programme, but of course putting it into the better performing priorities.

The Commission is examining the Court’s evidence found in its audits in Member States of ineligible expenditure being included in claims and will take the necessary measures. It examines this risk in its own audits.

2.26. One purpose of the n + 2 rule is to spur execution, and so the effects of the rule can be partly gauged from the information on execution given in the budgetary and financial management report. More detailed information as related to the Structural Funds is included in the aforementioned annual report on the Structural Funds, published in May 2005.

2.27. While the outturn for 2004 was largely satisfactory for the Structural Funds, many of the persistent problems — delays, increase in outstanding budgetary commitments — in implementing multiannual spending programmes arise from budgeting over the programming period which does not take sufficient account of the ability of Member States to absorb the funds within the timing foreseen. Moreover, commitments, as explained in paragraph 2.21, are made in approximately equal annual tranches over the nominal life of the programme. This neither reflects

Inappropriate budgeting over life of spending programmes

2.27. The budgeting of commitments is a direct consequence of the allocation of resources as decided by the European Council. The annual budgeted commitments normally reflect the programming (or revised programming). As a policy, the Commission aims at forecasting what is actually needed as annual payment appropriations.

(23) 4 % of the appropriations allocated to each Member State were placed in reserve for distribution to the best performing programmes in three tranches from 2004 to 2006.

(24) For example, in the case of 167 million euro decommitted from a programme following the year n + 2 rule in the Netherlands, 76 million was allocated to the same programme from the Performance Reserve.

(25) Paragraph 2.35: ‘…there is a risk of Member States claiming expenditure that is ineligible, in order to avoid the cancellation of commitments.’
THE COURT’S OBSERVATIONS

the expected payment profile, nor the full extent of legal commitments (26), and therefore provides information which can be easily misinterpreted.

2.28. Payments are intended to be made during a period stretching beyond the nominal life of the programme (up to 2010 in the case of the 2000-2006 period). The payment profile varies greatly during the programme cycle with low initial payments as programmes (and the projects they finance) are defined and started, and then higher demand in intermediate years, reducing towards the end. Where two cycles overlap, the years of lower demand at the start of the second cycle are intended, by the Commission, to be compensated for by payments from the end of the first cycle, resulting in a smooth and consistent demand for payment appropriations.

2.29. In practice, the demand for budgetary payments by the Commission depends on claims from Member States which themselves depend on the ability of beneficiaries to undertake projects and absorb expenditure. The uneven demand over the five years to 2003, resulted in significant underspending (27). Underspending has different consequences for payment appropriations and commitments: unused payment appropriations are cancelled whilst commitments remain outstanding. This difference in treatment results in growing levels of outstanding budgetary commitments (see paragraph 2.18) and the resulting time lag between commitments and payments.

CONCLUSIONS AND RECOMMENDATIONS

2.30. The Commission’s report on budgetary management now provides some additional information on the progress of spending programmes. However, the information could still be improved by being more completely explained, by assessing progress against expected performance and by reflecting more closely budgetary management and accountability. Information should also be provided on Member State spending estimates and the operation of the year n + 2 rule for the Structural Funds.

THE COMMISSION’S REPLIES

2.29. A growing stock of outstanding commitments is a normal feature of multi-annual programming such as that in the structural funds. The stock of RAL would ‘normally’ be expected to grow in the early years, stabilise and then fall back down towards the end of the period. There is no particular reason in a system with differentiated appropriations why payments and commitments in any given year should match.

2.30. As recommended in last year’s report by the Court, the Commission has provided extensive information on the cumulative state and progress of a number of the most important multi-annual programmes. (i.e. the Structural Funds, the Cohesion Fund, Sapard and ISPA).

The Commission is willing to seek to improve the information provided as has been the case in the past, including in the 2004 report. In addition, the Commission draws to the attention of the Court the extensive annual report on the budgetary implementation of the Structural Funds, published by DG Budget in May.

The Commission also refers to its response in point 2.4.

(26) Other than at the end of the last year of a particular programming period.

(27) See paragraph 2.12 and Table 2.3 of the Court’s 2003 Annual Report.
2.31. Improved spending rates and the resulting reduced surplus are a reflection of better management by the Commission and an increased level of spending within the major expenditure programmes, particularly the Structural Funds.

2.32. The level of outstanding budgetary commitments continued to rise, and totalled 109 billion euro at the end of 2004. The increase was mainly due to enlargement, with underlying outstanding budgetary commitments relating to the EU-15 falling slightly. The year n + 2 rule, which is intended to manage the situation for the Structural Funds, has resulted in very little decommitment since it was established.

2.33. Outstanding budgetary commitments for the Structural Funds are in excess of the Commission’s revised forecasts of 2002. The Court recommends the Commission should consider updating its analysis in order to identify the implications for the current and future period, and identify if any specific action is needed.

2.34. EU budgetary information neither completely reflects the reality of expenditure nor provides sufficiently clear information on the legal obligations of the Union. For the Structural Funds the budget for commitments is based on equal annual instalments, and that for payments is based on smooth and consistent supply-led assumptions for spending, but implemented following irregular demand-led claims from Member States. As already recognised by the Commission, its ability to actively manage the implementation of the budget for multiannual spending programmes is limited (28).

2.32. The level of decommitments is not in itself a proper indicator of the effectiveness of the n + 2 rule. This rule also has an effect on promoting execution (see also reply to point 2.24).

2.33. The pattern of actual execution and the actual level of outstanding commitments are analysed and used as input relevant to assessing payments needs during the preparation of the Preliminary draft budget. At present there are no plans to bring forward a revised Communication.

2.34. For the Structural Funds, the annual commitment appropriations are directly predetermined by the multi-annual programming (i.e. supply-led). To an extent, this also applies to other major multi-annual programmes.

Payment appropriations, on the other hand, must be demand-led, with the exception of limited advance payments. Payment appropriations are annually budgeted for, aiming at realistic forecasting of the actual demand on the basis of trends in execution and other relevant information. The basis for the Commission’s estimates of payments needs for the structural funds are generally provided in the Preliminary draft budget. By and large, there was a substantial improvement of the budgeting of payments in 2004.

The amount of the legal commitments for which no budgetary commitments have yet been made is disclosed amongst the contingent liabilities in the Communities’ annual accounts.

(28) See Commission reply to paragraph 2.32 of the Court’s 2003 Annual Report.
2.35. As unused appropriations for payment, together with their associated financing, cannot be carried forward to meet future demand there is a time lag between the programmed expenditure period (e.g. 2000-2006), and the timing of the actual expenditure. This results in either a high level of spending needed at the end of the programming period — which is difficult to manage — or a high and increasing level of outstanding budgetary commitments and expenditure, with current period expenditure being pushed further into the new period, potentially hampering its start. Without specific attention, the time lag will continue into the future.

2.35. The Commission has an obligation to budget sufficient payment appropriations, including proposing an amending budget if necessary, as was the case for the Structural Funds in 2004. The budget implementation in 2004 did not increase the RAL, except for the new Member States, which was natural and inevitable for such new operations. For the Structural Funds, the payments are primarily determined by the Member States' requests for reimbursements, and the budgeting has to reflect this. The n + 2 rule sets a limit on the back-loading of the programmes regarding payments, and the Commission does not share the concern that the payments relating to the 2000 to 2006 programmes could hamper the start of the subsequent programming period.

The Commission also refers to its response in point 2.23.
CHAPTER 3

Revenue

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INTRODUCTION

3.1. The revenue of the budget of the European Union consists of own resources and other revenue. As shown in Table 3.1, Graph 3.1 and Graph 3.2 own resources are by far the main source of financing for budgetary expenditure (92%). There are three categories of own resources: traditional own resources (customs duties, agricultural duties, and sugar levies) (13%), own resources calculated on the basis of value added tax collected by Member States (15%), and own resources derived from the Member States’ gross national income (72%).

Table 3.1 — Revenue for the financial years 2003 and 2004

<table>
<thead>
<tr>
<th>Type of revenue and corresponding budget heading</th>
<th>Actual revenue in 2003</th>
<th>Development of the 2004 budget</th>
<th>Actual revenue in 2004</th>
<th>% change (2003 to 2004)</th>
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<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
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<td>1 Traditional own resources</td>
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<td>— Agricultural duties (Chapter 10)</td>
<td>1 011,8</td>
<td>839,1</td>
<td>1 325,6</td>
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<td>— Sugar and isoglucose levies (Chapter 11)</td>
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<td>359,9</td>
<td>416,9</td>
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<td>— Customs duties (Chapter 12)</td>
<td>9 462,1</td>
<td>9 850,0</td>
<td>10 664,4</td>
<td>10 592,1</td>
</tr>
<tr>
<td>2 VAT resources</td>
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<td>— VAT resource from the current financial year (Chapter 13)</td>
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<td>13 139,5</td>
<td>13 579,9</td>
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<td>— Balances from previous years (Chapter 31)</td>
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<td>3 GNI resource</td>
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<td>— GNI resource from the current financial year (Chapter 14)</td>
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<td>69 444,6</td>
<td>69 010,2</td>
<td>69 214,2</td>
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<td>— Balances from previous years (Chapter 32)</td>
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<td>0,0</td>
<td>0,0</td>
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<td>4 Balances and adjustments</td>
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<td>— UK correction (Chapter 15)</td>
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<td>— Final calculation of UK correction (Chapter 35)</td>
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<td>5 Other revenue</td>
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<td>— Surplus from previous financial year (Chapter 30)</td>
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<td>5 693,0</td>
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<td>— Miscellaneous revenues (Titles 4 to 9)</td>
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<td>805,6</td>
<td>1 116,6</td>
<td>2 765,7</td>
</tr>
<tr>
<td>Grand Total</td>
<td>93 468,6</td>
<td>94 618,7</td>
<td>101 806,6</td>
<td>103 511,9</td>
</tr>
</tbody>
</table>

**Graph 3.1 — Breakdown of actual revenue in 2004**

Total Revenue — 103 511.9 million euro

- VAT resource: 13.4%
- Customs duties: 10.2%
- Agricultural duties: 1.4%
- Sugar levies: 0.4%
- Surplus: 5.5%
- Other: 2.5%
- GNI resource: 66.6%

Source: Annual Accounts of the European Communities, 2004.

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**Graph 3.2 — Evolution of sources of actual revenue 1990 to 2004**

(1) Contains surplus from previous financial year and miscellaneous revenue.

Source: Annual Accounts of the European Communities, 2004.
Traditional own resources

Introduction

3.2. Traditional own resources are established and recovered by Member States under national legal and regulatory provisions which must meet the requirements of the Community rules (1). The risks to the collection of traditional own resources are evasion of duty by misrepresentation or simply by smuggling, miscalculation or failure to establish duty because of undetected mistakes or weaknesses in systems, and errors or omissions in Member States' accounting for the duty established.

3.3. The Court's audit cannot cover either undeclared imports or those that have escaped customs surveillance. However, as well as direct testing of customs declarations and accounting systems, the Court's audit work included evaluation of supervisory and control systems, both in the Commission and in Member States, in order to assess whether the arrangements in place gave reasonable assurance of completeness. It consisted of:

(a) a review of the organisation of customs supervision and of the national systems for accounting for traditional own resources in 12 Member States (2). The Court examined in particular customs supervision at land frontiers in eight of these Member States, and the use of electronic customs clearance systems in 12 Member States (see paragraphs 3.6-3.18);

(b) verification of the sugar levies calculation completed in 2004; and


(2) Estonia, Greece, France, Italy, Cyprus, Latvia, Lithuania, Poland, Slovenia, Slovakia, Finland and the United Kingdom.
THE COURT’S OBSERVATIONS

(c) examination of the Commission’s accounts for traditional own resources, together with an analysis of the flow of duties from all Member States in order to gain reasonable assurance that the amounts recorded were complete and correct.

THE COMMISSION’S REPLIES

Evaluation of supervisory and control systems

Commission supervisory and control systems

3.4. The Commission may request Member States to carry out inspections of the establishment and making available of traditional own resources, and may also carry out such inspections itself, either in association with the Member State authorities or autonomously (3). Individual inspection reports are addressed to the Member States involved and these reports, together with the replies received, are examined during meetings of the Advisory Committee on Own Resources (4). An overall report on the functioning of the inspections is drawn up every three years and presented to the budgetary authority (5).

3.5. The Court has reviewed the inspections and has taken the results into account. As in previous years, their methodology was found to be soundly-based and the documentation to be good. The inspections found that the own resources collection systems were generally satisfactory, but confirmed the continued poor reliability of the B accounts in some Member States (see paragraph 3.23).

Supervisory and control systems in Member States

3.6. The supervisory and control systems for traditional own resources in Member States consist in the first instance of supervision by the customs authorities, as defined by the Community Customs Code (6). Community legislation does not generally prescribe either particular methods or the level of customs control, this being at the discretion of the Member States.

3.5. The Commission will continue to focus on Member States’ management of the B accounts in its own inspections of traditional own resources.

(4) The Advisory Committee on Own Resources (ACOR), established by Article 20 of Regulation (EC, Euratom) No 1150/2000, consists of representatives of the Member States and of the Commission, and provides the channel for liaison between the Commission and the Member States on own resources matters. It examines questions concerning the implementation of the own resources system, as well as the estimates of own resources.
Customs surveillance at the external land frontier of the EU

3.7. The Court examined customs supervision and clearance at selected land frontier posts in eight Member States (7). The audit concentrated on an evaluation of the customs surveillance and control procedures that are intended to ensure that all goods are subject to a customs treatment (8). The procedures for ensuring that goods arriving are properly dealt with were generally considered satisfactory at the border stations visited.

Collection of import duties using electronic customs clearance

3.8. The Commission is implementing an action plan (9) to foster more effective customs procedures generally through better use of information technology. Computer systems for the submission and clearance of customs declarations make it possible to automate the calculation of and accounting for duty, as well as various routine checks. Such systems can also be used to select which declarations and consignments should be checked by customs staff whilst clearing the rest automatically, greatly reducing disruption of international trade and the costs of control. The reliability of electronic clearance systems, and the quality of the risk analysis procedures incorporated in them thus have a major effect on the completeness and correctness of traditional own resources. Member States’ systems are at present in different stages of development. In 2003 the Commission inspected electronic clearance systems, found that they were on the whole satisfactory, and recommended that their use should be further developed (10).

3.9. The Court carried out an examination of the electronic customs clearance systems in 12 Member States (11) and of the supervision and coordination done by the Commission. Its audit did not identify substantial shortcomings either in the actions so far taken by the Commission or in the systems of the Member States visited. However, the Court draws attention to the following issues on which it recommends further action before conventional paper declarations can be dispensed with.

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(7) Estonia, Greece, Latvia, Lithuania, Poland, Slovenia, Slovakia and Finland.

(8) It should be noted that most goods are not cleared at the frontier but at inland customs posts following a transit movement.


(11) Germany, Estonia, Spain, France, Latvia, Lithuania, Hungary, Netherlands, Poland, Slovakia, Finland, United Kingdom.
3.10. Where computer systems are used there need to be tested plans to have fallback systems up and running in the event of disaster. No comprehensive disaster plans existed in three Member States visited, but some back-up procedures and instructions had been prepared. In four Member States a plan existed but had not been tested. These weaknesses represent a risk to the continuity of import and export trade and to the collection of customs duties in the event of a breakdown or other emergency.

3.10. The Commission agrees with the Court’s comments regarding the importance of fall-back mechanisms. Precautions are needed to avoid disruption of trade, to allow control by the customs authorities and to protect the collection of traditional own resources. The Commission has provided for such procedures in its legislation (Article 353 of Regulation (EC) No 837/2005) on the Community computerised transit system, NCTS. The Commission would also point out that manual systems may be subject to disruption. Where this has occurred, traditional own resources payments have been adjusted, as considered necessary, to ensure that the Community budget does not lose out.

3.11. In six Member States visited SAD (12) forms may be sent on paper accompanied by a diskette, from which data are loaded into the system without an electronic signature. Legally, only the conventional paper form is binding. In three Member States there were either no formally-established and recorded input control procedures to ensure that the data on the diskette matched the printed form, or the procedures were not always followed. In those circumstances there is a risk that data used in computer processing, including the amounts of import duty, might differ from the data presented on the SAD form.

3.11. As part of its regular follow-up of points raised by the ECA, the Commission will pursue the introduction of suitable controls with Member States.

3.12. Where 100 % checking of declarations is not feasible, risk analysis and risk profiles should be used to decide whether an import requires an examination. Risk profiles can best be implemented in a computerised clearance environment. In order to ensure efficiency and a similar level of control at all customs points, the Commission has proposed a number of tools (13), which include a common methodology and common criteria for risk management. The Commission also proposes that frontier customs offices should focus on admissibility and security checks. Fiscal and commercial policy controls are usually to be made at the traders’ premises through audits and on-the-spot checks based on common risk criteria.

3.12. Given the volume of international trade and the wide range of tasks to be performed by customs services, customs checks will always be selective. Risk analysis has a part to play, not only in the uniform collection of customs duties (and their prompt transfer to the Commission), but also in other tasks. These tasks and the respective tools proposed by the Commission, range from protecting European citizens from threats to their health, safety and security, to the collection of customs duties.

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(13) Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee: ‘A simple and paperless environment for Customs and Trade’.
3.13. The Court has previously reported on the use of risk analysis techniques (14). However, despite the Commission’s support and recommendations, differences still remain between the Member States in the degree to which they make systematic use of risk analysis and risk profiles in targeting controls, even though computerisation of customs processes has made this possible.

3.14. An amendment of the Customs Code (15) introduces an obligation for Member States to use risk management and stipulates the time periods within which the Member States shall use appropriate risk-based controls and when customs controls shall be based on risk analysis using automated data processing techniques. To comply with these new rules additional efforts will be necessary. As the Court found during its audit, in 2004 risk profiles were not used at all in two Member States, leaving decisions about physical or documentary checks to be based mainly on purely personal subjective initiative of the customs officer. In another two Member States risk profiles were used only on part of imports, leaving goods imported under certain simplified procedures without any profile-based targeting of control measures.

3.15. In one Member State fiscal risk profiles at borders have been reduced and substituted for by audit-based fiscal controls made at the economic operators' premises. This strategy is in accordance with the Commission’s proposal in its communication of July 2003. This approach, however, can weaken customs control, since the frequency of checks on many operators is low.

3.16. Although the importance of random sampling as a supplementary element was generally recognised in the Member States, statistical random selection of goods is not used in six of the Member States visited.

3.17. Customs authorities should regularly monitor and review the results of customs controls to assess the effectiveness and efficiency of the risk management system using feedback from the customs clearance process to update the analysis and prioritisation of control work.

3.13. Following the recent amendment of the Customs Code (Regulation (EC) No 648/2005 of 13 April 2005), the Commission and the Member States are further cooperating to implement a Community-wide risk-management framework.

3.14. The two Member States found not to have been using risk analysis by the Court were on the brink of doing so and both introduced systems for imports by the end of 2004. This is an important initial level but adopting a risk-analysis basis for customs control has a much wider-reaching impact. The analysis of risk has a part to play in all types of customs controls, including the selection of importers for authorisation, to use simplified procedures, and the frequency and content of audit-based checks. It is to be expected that, apart from the security and safety issues for which specific targets have been set, Member States will adopt a variety of measures at different speeds depending upon the volume and types of customs traffic they handle.

3.15. The Commission will remind Member States of the key role that frequency of control can play in the implementation of an audit-based control strategy.

3.16. The Commission will continue to recommend that the Community risk framework includes a random element in the basis for the selection of consignments or declarations subject to customs controls.

3.17 to 3.18. The Commission agrees that recording results and reviewing and updating risk profiles are key aspects of properly managing risk and will continue to urge Member States to implement suitable procedures to achieve this.

(14) Special Report No 13/98 concerning the use of risk analysis techniques in customs control and the clearance of goods.

3.18. Weaknesses were noted in some customs administrations in recording the results of documentary/physical checks and in reporting to central level. In some cases filters were overridden without justification and management approval. In addition, risk profiles were not always appropriately reviewed to ascertain whether they were effective, or there was a lack of coordination between the branches responsible for setting up filters at different levels (central, regional, local). Insufficient monitoring and review of the functioning of risk profiles and of the results of customs controls lead to lack of feedback from the process, which in turn prevents both timely updating of the risk profiles and optimal prioritisation of the control work done by Customs.

Findings of audits in respect of the transactions of the financial year

**Amounts established but not yet made available to the Commission**
(B accounts)

3.19. Entitlements without security, and, those which have been challenged and might be subject to change, need not be made available to the Commission if they are instead entered by the Member States in separate accounts (the B accounts). Each Member State provides a quarterly statement of its B accounts to the Commission. The net balance included in the Communities’ balance sheet under ‘Amounts owed by Member States’ is 739,4 million euro (2003: 729,3 million euro).

3.20. At 31 December 2004 the gross balance for the B accounts standing in the Commission’s books was 1 905,0 million euro, 19,4 % less than the equivalent figure at 31 December 2003 (2 364,3 million euro) (16). The major reason for this

(16) Figures given are gross before deductions as follows:

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross balance</td>
<td>1 905,0</td>
<td>2 364,3</td>
</tr>
<tr>
<td>Collection costs to be retained by Member States (25 %)</td>
<td>(476,2)</td>
<td>(591,1)</td>
</tr>
<tr>
<td>Write-down (see paragraph 3.22)</td>
<td>(689,4)</td>
<td>(1 043,9)</td>
</tr>
<tr>
<td>Net</td>
<td>739,4</td>
<td>729,3</td>
</tr>
</tbody>
</table>
change is that entries relating to the import of New Zealand butter products have been taken out of the B account following resolution of the case (17).

3.21. The Court welcomes the adoption of Council Regulation (EC, Euratom) No 2028/2004 (18), which requires Member States to write off amounts of traditional own resources that are not recovered by a specific deadline. The regulation also introduces a requirement for Member States to provide an estimate of the amount standing in their B accounts for which recovery has become unlikely.

3.22. To recognise the extent to which recovery is unlikely, the Commission has entered in its balance sheet a write-down based on the information newly provided by the Member States. The total write-down is in the range expected by comparison with previous years. However, most of the Member States have not provided information about the methods they used to make their estimates. In consequence, the Court cannot confirm the amount of the write-down, and considers that the Commission should provide guidance with the aim of ensuring a consistent approach throughout. The estimates of the unrecoverable proportion provided by the Member States vary from 10 % (12.8 million euro, in the case of the United Kingdom) to 96 % (118 million euro, in the case of Spain) (19).

3.22. The Commission considers that, in using the estimates prepared by Member States, it has applied the principle of prudence required by the Financial Regulation. Recovering customs debts depends upon national laws and procedures; only Member States are aware of the solidity of the grounds for demanding payment, whether or not the debtor has assets and the likelihood of the enforced recovery proceedings available to them proving successful. The Commission explained to Member States the underlying principle they should use in preparing their estimates during the ACOR meeting on 9 December 2004. It will remind Member States of their responsibility to produce estimates based on realistic data.

3.23. As in previous years (20), the Court’s audit and the Commission’s inspections (see paragraph 3.5) found systematic problems with B accounts, such as delays in making entries, erroneous entries, omissions and incorrect cancellations, in several Member States (Belgium, Germany, Ireland, Italy, Cyprus, Poland, Slovakia, Sweden, United Kingdom). In 2003 Germany removed entries totalling 40.1 million euro from its B account, without providing a full explanation of this reduction.

3.23. The Commission is pursuing these points with the Member States concerned to obtain explanations and corrections of the errors.

(17) For the origin of these entries see the Court’s Special Report No 4/98 on importation at reduced rate of levy into the Community and disposal of New Zealand milk products and Swiss cheese. The cancellations finally made result from the litigation in the case and were already taken into account in the write-downs made in previous years. The amount recovered (11.6 million GBP) has been made available to the Commission in the usual way.


(19) In addition, seven Member States which have only small amounts standing in their B accounts (together less than 0.1 % of the total B-account balance) considered that the whole amounts were recoverable.

THE COURT’S OBSERVATIONS

Sugar levies

3.24. In the common organisation of the markets in the sugar sector the producers have financial responsibility for the losses incurred from disposing of the surplus production under quota (21). This is implemented by setting levies on the production of sugar, isoglucose and inulin syrup. The levies are calculated by the Commission (479.8 million euro for the marketing year 2002/03) and collected from the manufacturers by the Member States. The Member States retain 25 % of the levies as collection costs (22).

3.25. The Court followed up previous work on sugar levies and examined the calculation finalised in September 2004 (for the marketing year running from 1 July 2002 to 30 June 2003). The Court found that the system for calculating sugar levies was operating in a generally satisfactory way despite ambiguities in the prescribed calculation method (23), which need to be resolved. The Court also draws attention to the following points, on which corrective action is recommended:

(a) the total amount of sugar levies (479.8 million euro) was erroneously understated by some 6 million euro;

(b) regarding the two main sources of data on which the calculation is based:

(i) the Eurostat COMEXT database (24) has shown inaccuracy concerning the quantities of inulin syrup exported and consequently the Commission, contrary to the Regulation, was obliged to use other data obtained from the Member States;

(ii) the communications submitted by the Member States were not systematically checked by the Commission. Furthermore the Commission has still not issued guidance on best practice in the design of control mechanisms to ensure the reliability of these communications as recommended in the Court’s Special Report No 20/2000 (25).

(24) COMEXT is the title of the Eurostat reference database containing external trade statistics.
(25) Paragraph 61.
THE COURT’S OBSERVATIONS

3.26. In addition it is still the case that, as noted in the Court’s Special Report No 4/91 (26), no conclusive reconciliation between the revenue and the expenditure to be financed by sugar levies is feasible within the Commission’s current system of accounting.

VAT/GNI own resources

Introduction

3.27. In contrast to the revenue from traditional own resources, the VAT and GNI own resources reflect macroeconomic statistics whose underlying data cannot be audited directly. For this reason, the VAT/GNI audit takes as its starting point the receipt by the Commission of the macroeconomic aggregates prepared by the Member States (either as forecasts or as final figures) and seeks to assess the Commission’s system for handling the data until they are ultimately included in the final accounts. The audit thus covers the establishment of the annual budget and its implementation in respect of the monthly payments by Member States. The audit further concentrates on the Commission supervisory and control systems which are intended to provide assurance that the EU revenue is correctly established and collected. Specific aspects of the VAT/GNI own resources are the subject of separate audits.

3.28. The Court’s separate audits concerning the VAT and GNI own resources covered Commission controls on Member States’ inventories for the European System of Accounts (ESA 95) (27), the calculation of the weighted average VAT rate (WAR) in the Member States’ VAT statements (28) and supervisory and control systems in relation to the compilation of National Accounts at Statistical Offices in Member States.

THE COMMISSION’S REPLIES

3.26. There is no need to carry out an accounting reconciliation between resources obtained from the levies and budgetary expenditure, since the calculation method currently provided for in the Council rules does not give the two elements equal status. Comparisons may be made outside the accounting system whenever necessary.

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(26) Paragraph 5.19.
(28) The VAT statement is a document drawn up by the Member States which contains the data used to determine the VAT base. The VAT base constitutes the basis for the calculation of the VAT own resource and is required for the Commission’s control (Articles 7 and 11 of Council Regulation (EEC, Euratom) No 1553/89 of 29 May 1989 on the definitive uniform arrangements for the collection of own resources accruing from value added tax (OJ L 155, 7.6.1989, p. 9)).
Evaluation of supervisory and control systems

Commission supervisory and control systems

3.29. The Commission inspection activities carried out in cooperation with the Member States constitute an essential element of the control system for VAT/GNI-related own resources. The Court examined the work of the units carrying out these inspections.

VAT own resource

3.30. In respect of the VAT own resources, the Commission’s on-the-spot inspections carried out during the financial year 2004 led to 28 new reservations (29) in respect of specific elements of Member States’ VAT statements (30). The preparation and the reporting of the results of these inspections were of good quality. However, given the limited resources available, the Commission faces difficulties to maintain the same quality and frequency of inspection visits to Member States as before enlargement (31). Furthermore, as far as the follow-up of the audit observations related to reservations is concerned little progress was made (only six reservations were lifted during the year) and thus 107 remained at the end of 2004. These reservations often cover several financial years and four of them date back to VAT statements submitted more than 10 years ago. Their financial impact has not been estimated by the Commission.

3.30. The Commission’s analysis shows how difficult it is to estimate the financial impact of reservations since they mainly concern cases where reliable data are lacking. They are generally made precisely in order to oblige Member States to seek reliable quantitative data and an acceptable methodology. Finally, the Commission announced in 2003 its willingness to take longstanding reservations to the European Court of Justice where this appears useful. This has already proved effective in the case of two Member States which met the Commission’s wishes while the infringement procedure was still at the preparatory stage. The Commission is aware of the increased workload resulting from enlargement and is examining how to make the best use of its resources to maintain the quality of inspections.

Controls carried out on the calculation of the weighted average VAT rate in the VAT statements produced by Member States

3.31. Member States that apply differing VAT rates are required to calculate a weighted average rate (WAR) to be used in the calculation of the VAT own resource by the Commission. Any error in this calculation would affect the VAT base used for the calculation of own resources and can consequently affect the amount of VAT own resources paid. The Court examined the Commission’s inspections of this aspect of the system, audited the calculation of the WAR in five Member States (32) and checked its compliance with Community legislative requirements (33).

(29) 10 of the 28 concern a subdivision of existing reservations.
(30) Reservations are an important tool used by the Commission to ensure that corrections to the Member States’ VAT Statements can be made beyond the four years time limit mentioned in Community legislation.
(31) On average every two years.
(32) Germany, Italy, Netherlands, Finland and Sweden.
(33) See Articles 3 and 4 of Council Regulation (EEC, Euratom) No 1553/89.
3.32. As far as the 29 specific reservations on the WAR are concerned, the Court found that a number of them have been pending for an excessively long period. Once a reservation was placed, the Member States had an indefinite length of time to solve the problem.

3.33. On the other hand, the Commission placed no reservation in cases of systematic shortcomings in the WAR calculation.

3.34. Within the Commission, the Directorate-General for the Budget (DG Budget) has delegated a substantial part of the checks on the WAR calculation to Eurostat and certain fiscal aspects of the calculation to the Directorate-General for Taxation and Customs Union (DG TAXUD). Their respective roles and responsibilities were not formally documented at the time of the Court's audit.

3.35. In respect of the GNI own resources, there was still insufficient direct verification by the Commission of the underlying National Accounts which are the basis for the figures presented in the GNI questionnaires. However the Commission has

(34) For example, 'The small firms adjustment' for Germany, applicable to the years 1991 to 2001, which was placed during a 1995 inspection, subsequently prolonged and lifted in 2004 (except for the reservation related to 2000), and the 'Car compensation' reservation in Austria made in 1999 in respect of the 1995-2001 VAT statements.

(35) In Italy, methods used to obtain the required breakdown of final consumption of households and of expenditure for gross fixed capital formation (GFCF) were not fully reliable.

(36) Document based on a common model by which the National Statistical offices communicate the GNI figures to Eurostat each year.
THE COURT’S OBSERVATIONS

started to set up a unit that will undertake verification of public and National Accounts produced by Member States.

3.36. Since 2003, Community legislation provides for the transmission of an annual report on the quality of GNI data by Member States to the Commission. The report should supply the information necessary to show how the aggregate GNI figure was reached, and, in particular, describe any significant changes in the procedures and basic statistics used and explain the revision made to earlier GNI estimates. Pursuant to Article 2(3) of Council Regulation (EC, Euratom) No 1287/2003 the content and format of this report should follow the guidelines laid down by the Commission (37).

3.37. A review of the quality reports submitted in 2004 shows that:

(a) some Member States have not followed the guidelines on content and format;
(b) significant differences exist in the amount and detail of the information given;
(c) no information is given on the results of investigations on the quality of GNI and its components, although such information is requested by the guidelines.

THE COMMISSION’S REPLIES

Commission controls on ESA 95 inventories

3.38. An important part of Commission supervisory and control systems in respect of the GNI own resource concerned the ESA 95 inventories. GNI and the underlying National Accounts, which constitute the basis for the calculation of the GNI own resources, have to be compiled by Member States in accordance with ESA 95. For this purpose, Member States are required to produce GNI inventories, which are country-specific descriptions of methods and procedures used for the calculation of the GNI aggregates and underlying National Accounts.

3.39. In order to evaluate the effectiveness of checks for ensuring that Member States comply with ESA 95 requirements, the Court assessed the way in which the Commission has carried out these checks on GNI inventories for ESA 95 for the 15 pre-enlargement Member States (38).

3.37. Quality reports were submitted in 2004 for the first time and produced a significant improvement in the information supplied with the questionnaire compared with previous years. It is not unusual or surprising to observe that the new guidelines were interpreted differently to some extent when used for the first time. The GNI Committee, at its July 2005 meeting, approved Eurostat proposals for extended guidelines that are intended to ensure a more harmonised result this year.

(37) See Minutes of the 2nd GNI Committee meeting of 25-26 March 2004 in which the Committee accepted the proposed structure of the 2004 questionnaire and quality report.

(38) The GNI inventories of the 10 new Member States are foreseen to be produced in 2006.
3.40. GNI inventories had to be presented to the Commission by the end of the year 2000. Though the majority of Member States submitted their inventory during 2001, France and Luxembourg presented their inventories only in 2003 and 2004 respectively.

3.41. Through the development of the GNI Inventory Assessment Questionnaire (GIAQ) (39), the Commission has improved the control approach in setting up a systematic and structured tool for carrying out its checks. However, the Commission did not check that the systems and methods described in the inventories are actually applied by the national statistical offices.

3.42. The documentation of the Commission’s checks on inventories was incomplete. Only those cases were documented where the Commission noted problems or outstanding issues. Such an approach does not provide a full audit trail of checks performed by the Commission, thus reducing auditability and reliance that can be placed on such checks.

Illegal activities

3.43. Exhaustiveness is an important aspect of GNI to ensure that a reliable basis exists for the equitable share of GNI own resources between Member States. ESA 95 provides that all categories of illegal activities are to be included in GNI. The Commission has requested that Member States should start with an estimation of certain categories of illegal activities (40).

3.44. From the Commission checks on the inventories for ESA 95 it appears that only a few Member States have included such estimates in GNI, moreover for different types of illegal activities. Thus GNI estimates are not fully comparable which affects the GNI own resources calculation and do not fully comply with ESA 95 requirements.

Intermediate consumption

3.45. ESA 95 stipulates that purchases of low value (small tools with a value lower than 500 euro) by companies are to be considered as intermediate consumption. Derogation from this rule requires an adjustment by the Member States in question to comply with the ESA requirement.

(39) The GIAQ is a standard questionnaire used by the Eurostat to control the GNI inventories; the GIAQ contains 277 questions on a large field of topics.

(40) Estimated by Eurostat on the basis of already existing studies to amount to 1-2% of GNI.
THE COURT'S OBSERVATIONS

3.46. In two of the eight Member States (41) audited (Belgium and Ireland), there is no threshold in the business accounting rules and no adjustment is made for compliance with ESA 95. The Commission accepted this situation after discussions with these two Member States without further seeking evidence that this deviation from ESA 95 was not material.

3.47. Community legislation on the harmonisation of Gross National Income (42) requires particular efforts to be made to improve Member States’ GNI compilation practices and the dissemination of best practices in this domain. It also foresees the adoption of measures to make GNI data more comparable, reliable and exhaustive. The Court has examined in seven Member States (43) to what extent supervisory and control systems were set up and implemented at Statistical Offices in respect of the compilation of National Accounts.

3.48. The Court notes that significant differences exist between Member States in the existence and implementation of the following elements of supervisory and control systems in respect of the National Accounts compilation process:

(a) the performance of a formal and structured risk analysis in respect of the process of National Accounts compilation (44);

(b) the existence of agreements or equivalent arrangements between National Accounts departments and units providing basic statistical data, which set out the conditions for the delivery and the quality of data (45);

(c) the systematic production of 'quality reports' accompanying statistical surveys (46);

(d) the documenting of supervisory controls performed by management on National Accounts compilation (47);

(e) the performance of internal audits on the process of statistical data collection and compilation (48).

Supervisory and control systems in Member States

3.46. In both Belgium and Ireland, it is not known which thresholds companies apply in practice as there is no fiscal or accounting threshold. Because in such cases it is not even known which sign a possible adjustment should have, let alone its size, the Commission considers the most prudent course is not to apply an adjustment.

3.48 and 3.49. Because of differences between Member States, the Commission uses the same standardised tools to verify the reliability, comparability and exhaustiveness of all Member States’ GNI data used for own resources, including very detailed descriptions of sources and methods (GNI inventories) with annual updates in the form of the quality reports. The Commission considers that these systems give sufficient guarantees that the GNI data are reliable, comparable and exhaustive.

The Commission will discuss with the Member States in the GNI Committee the extent to which the national supervisory and control systems should become part of the GNI verification process.

(41) Belgium, Denmark, France, Ireland, Luxembourg, Netherlands, Sweden and United Kingdom.

(42) Council Regulation (EC, Euratom) No 1287/2003, in particular Articles 2, 3 and 5.

(43) Germany, Greece, Spain, France, Hungary, Poland and United Kingdom.

(44) This element is fully implemented in the United Kingdom.

(45) This element is fully implemented in Germany, Poland and the United Kingdom.

(47) This element is fully implemented in the United Kingdom.

(48) Takes only place in France and the United Kingdom.
3.49. The Court points out that the differences in the existence and implementation of supervisory and control systems could lead to varying degrees of reliability, comparability and exhaustiveness of National Accounts.

Annual activity reports and declarations of the Directors-General

3.50. The Court has examined the annual activity reports and declarations of the Directors-General of DG Budget and Eurostat. As in 2003, the annual activity report for DG Budget includes the number of VAT inspection visits in Member States but says nothing else about the verification of the VAT own resources data. It mentions neither control activities related to the GNI own resource, the existence of 107 reservations in respect of Member States’ VAT statements or changes in the number of reservations during the year.

3.51. The Eurostat annual activity report mentions the checks on Member States’ ESA 95 inventories of statistical sources and methods. It says that these have led to replace former general reservations placed on all data for all Member States by a small number of specific reservations. The report does not, however, mention the actual number of specific reservations (57) and the fact that there was still a general reservation in force for Germany and Luxembourg at the end of 2004. Neither does the Eurostat annual activity report mention to what extent key priorities for 2004 in verifying VAT and GNI data produced by Member States, mentioned in the Statistical Programme of the Commission for the year 2004, had been achieved.

Conclusions and recommendations

3.52. Taking into account the scope of the audit (see paragraph 3.3) and with the exception of the B-account matters noted in paragraph 3.23, the audit work carried out by the Court gave satisfactory overall results concerning the reliability of the accounts recording traditional own resources and the legality and regularity of the underlying transactions.

3.53. Taking into account the scope of the audit, as set out in paragraph 3.27, the Court is of the opinion that, on the basis of data supplied by Member States, the VAT and GNI resources in all material respects had been correctly calculated, collected and entered in the Community accounts by the Commission.

3.50. The annual activity reports made by Directors-General are by their nature highly selective and present activities either of particular importance or having a certain illustrative value. In the case of DG Budget, it was considered sufficient to mention the controls themselves without giving details of the reservations, which are a routine tool for the improvement of VAT statements. DG Budget will nevertheless re-examine its presentation of its controls on the VAT resource.

3.51. The number of reservations for each Member State is small. Moreover, the simple number of reservations is not a very significant indicator because they may be of greater or lesser numerical impact on GNI. Eurostat agrees to provide more information on verifying GNI and VAT in its Annual Activity Report.

3.52. As the Court remarks in paragraph 3.21 of the report, the regulation governing the B accounts was amended at the end of 2004. The changes introduced will help in obtaining more reliable and accurate B accounts.
3.54. However, the Court’s audit work on the GNI own resource has identified weaknesses that could impact on the quality of the data on the basis of which Member States’ GNI contributions are established. The Court recommends the Commission:

(a) to perform (direct) verification checks on selected National Accounts aggregates (see paragraph 3.35);

(b) to expand its checks on Member States’ inventories of sources and methods applied in the compilation of National Accounts and to improve its system for documenting checks (see paragraphs 3.41-3.42);

(c) to pursue that all Member States comply with ESA 95 requirements in respect of illegal activities in GNI (see paragraphs 3.43-3.44);

(d) to review in consultation with the Member States how best practices for supervision and controls in respect of the National Accounts compilation can be implemented (see paragraphs 3.47-3.49);

(e) to perform a comparative analysis of the quality reports, formulate more precise guidelines and strengthen the follow-up on their implementation (see paragraphs 3.36-3.37).

3.55. In respect of the Commission’s controls on the systems underlying the calculation of the VAT own resource, the Court:

(a) notes that reservations, especially given their high number (107) impact on the correctness of the Member States’ VAT statements and recommends that the Commission should in consultation with the Member States, where possible, quantify these reservations (47) (see paragraph 3.30);

(b) recommends that the Commission should increase its efforts to reduce the number of long-standing reservations (see paragraphs 3.30 and 3.32);

3.54. The Commission considers that its systems give sufficient guarantees that the GNI data are reliable, comparable and exhaustive. The recently adopted Recommendation on the independence, integrity and accountability of the national and Community statistical authorities (COM(2005) 217), which includes a European Statistics Code of Practice, should in any event help to strengthen the quality of macroeconomic statistics, including GNI.

(a) The Commission is currently examining ways in which more direct verification, in the sense indicated by the Court, might be carried out.

(b) The Commission will endeavour to improve documentation within the limits of its resource constraints.

(c) The Commission is already pursuing this actively.

(d) The Commission encourages best practices in national accounts compilation through the GNI Committee. The Commission will put forward the Court’s recommendation to the GNI Committee.

(e) Since the Court’s audit, the results of a comparative analysis and more precise guidelines were presented to and approved by the July 2005 GNI Committee.

3.55. Reservations are generally made precisely in order to oblige Member States to seek reliable quantitative data and an acceptable methodology. Moreover, the Commission’s practice since 2003 of subdividing certain reservations in order to make them more transparent and potentially easier to lift has led to an apparent increase in their number. The control cycle of two to three years between visits leads to a time-lag in the beneficial effect of this policy.

(b) The reduction in the number of longstanding reservations depends mainly on the capacity of the Member States’ administrations to meet an adequate quality standard. Inevitably, where data become outdated, new reservations are necessary. In 2003, the Commission announced its readiness to use the infringement procedure to seek to end longstanding reservations, where appropriate.

THE COURT'S OBSERVATIONS

(c) observes that, with the number of Member States increased from 15 to 25, the same coverage and quality of the inspections could in the future only be maintained if human resources are increased, the inspection policy is further rationalised through the use of risk analysis and/or the regulatory and procedural framework for producing VAT statements is reinforced (see paragraph 3.30).

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(c) The Commission expects a significant reduction in the number of reservations applicable to certain Member States in the near future and will focus its controls on the basis of risk analysis.
# CHAPTER 4

## The common agricultural policy

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Prefinancing of Export Refunds
Potato and cereal starch

Principal observations in Special Reports
Forestry measures within rural development policy
Agri-environment
4.1. Expenditure in 2004 on the common agricultural policy (CAP), i.e. the European Agricultural Guidance and Guarantee Fund (EAGGF Guarantee section), totalled 43 579 million euro (2003: 44 379 million euro). Graphs 4.1 and 4.2 show how the money was spent. Graph 4.1 shows the breakdown of expenditure by economic category (direct payments, export refunds, etc.). Graph 4.2 shows the distribution by main agricultural sector (beef and veal, olive oil, etc.).

4.2. Payments to farmers based on the amount of land they farm or the number of livestock on their farms constitute the greater part (59 %) of CAP spending. These payments are primarily intended to compensate farmers for reductions that have been made in CAP prices.

4.3. Virtually all CAP expenditure is effected by the paying agencies of the Member States. The process for payments to farmers is as follows:

(a) farmers present claims to paying agencies in the year before payment is due, based on areas cultivated, number of eligible animals owned during a specified retention period, etc.;

(b) the paying agencies subject all claims to administrative checks and a sample of claims to on-the-spot checks, mainly through the Integrated Administration and Control System (IACS);

(c) each paying agency pays claimants, and reports expenditure made to the Commission which reimburses the paying agency;

(d) the accounts and payments of the paying agency are examined by an independent auditor (certifying body) who reports to the Commission in February of the year following the budget year;

(e) by 30 April of that year, the Commission must reach a decision (financial clearance) on whether to accept these accounts and audit reports; to ask for more work to be performed or information provided (1);

(f) the Commission may then itself examine payments made by the paying agencies. If these were irregular, or if financial controls were weak, it may decide that some expenditure should be borne by the Member States concerned and not be charged to the EU budget (in Community jargon, the Commission makes a conformity decision which ‘disallows’ such expenditure as part of the ‘clearance of accounts’) i.e., it reduces the payments to the paying agency accordingly (see paragraph 4.22).

---

(1) The Commission may disallow expenditure at this stage on the basis of the findings of the certifying bodies (see paragraph 4.3(f)).
Graph 4.1 — Breakdown of EAGGF-Guarantee Expenditure by economic category — financial year 2004

(1) Others: production, processing or consumption aid paid to producers or organisations of producers or processors and administrative expenditure.

(2) Intervention: public and private storage, fruits and vegetables withdrawal arrangements, compulsory and voluntary distillation.

NB: This breakdown by economic type was calculated on the basis of gross figures before factoring in negative expenditure (recoveries, clearance and suspension of advance, milk levies).

The total of area aid, animal premiums together with other direct aid gives an overall total for direct aid of 76.17% of CAP expenditure.

Source: The Commission’s annual accounts for 2004 — gross data.

Graph 4.2 — Breakdown of EAGGF-Guarantee expenditure by sector — financial year 2004

Source: The Commission’s Annual accounts for 2004 — Volume II.
Scope of the audit

4.4. The objective of the audit was to contribute to the Court’s Statement of Assurance on the general budget through a specific assessment for the agricultural area, in order to seek assurance on the functioning of control systems and on the legality and regularity of the transactions. For that purpose, the Court:

(a) assessed the workings of IACS (the supervisory system for area aid and animal premiums); post-payment checks and physical checks on subsidised agricultural exports (the principal supervisory systems for other types of agricultural expenditure) (see paragraphs 4.6 to 4.14);

(b) examined the Commission’s financial clearance decision for expenditure in 2004 and conformity decisions taken in 2004, which relate to payments made to beneficiaries in earlier years (see paragraphs 4.15 to 4.25);

(c) tested a sample of transactions directly (see paragraph 4.26);

(d) examined the Annual Activity Report and Declaration by the Director-General for Agriculture and reviewed the implementation of internal control standards at the Commission (see paragraphs 4.27 to 4.34).

4.5. Paragraphs 4.35 to 4.54 set out the Court’s assessment of the legality and regularity of expenditure under the CAP, based on the above sources of evidence. Observations on the reliability of the accounts are set out in Chapter 1, paragraphs 1.12, 1.13, 1.15 and 1.16.

Supervisory and control systems

IACS

4.6. The Integrated Administrative and Control System (IACS) is the key management and control tool for area aid and animal premium schemes and covers 59% of agricultural expenditure. IACS comprises a computerised database of holdings and aid applications, systems for identifying parcels of agricultural land and identifying and registering animals, and a coordinated set of administrative checks and on farm inspections. Claims for a number of other Community aid schemes must be compatible with the system.
4.7. In 2004, the Court continued its examination of the way IACS is functioning in a further five paying agencies in four Member States (2) as well as following up earlier findings in Portugal after the merger of two paying agencies. IACS checks in the five paying agencies visited other than in Greece are generally operational and satisfactory (see Annex 2); IACS functioning is comparable to that of the paying agencies audited in previous years, although there is still scope for improvement in risk analyses, administrative checks and on the spot inspections.

4.7. Although the Commission considers some of the Court's assessments in Annex 2 to be too severe, its audit results generally concur with the Court's own findings, and further enhancements are being achieved as from 2005 with implementation of the Geographical Information Systems obligatory as from 1st January. Regulation (EC) No 118/2004, amending IACS legislation as from 2004, will still further improve the already generally satisfactory situation.

4.8. More than seven years after the deadline for full implementation IACS in Greece can still not ensure compliance with legality and regularity for area aid and animal premium payments (3) (see also paragraphs 4.28(b) on the Commission's reservation in respect of the implementation of IACS in Greece and 4.44 on the results of the Court's transaction testing). The major reasons for the deficiencies and failures are:

(a) farmers' unions control the input of all data into the computer system. None of the data in the system is secure and it can be and is modified by the farmers' unions at any time before payment. The computer system does not record when and why changes to the original data are made. For 2004 expenditure, farmers' unions changed data for more than 22 000 parcels more than five months after the claim period ended. Analysis shows that these irregular changes have an estimated financial impact of at least 10 million euro, and the impact over the whole claim period could be significantly more;

4.8. Facing the IACS situation in Greece, the Commission has regularly applied important financial corrections (384 million euro from 1999 to 2004). In addition, in 2002 the Commission initiated an infringement procedure against Greece. The European Court of Justice found against Greece in 2004.

Moreover, following the DG AGRI Director-General's reservation to his annual declaration, a specific action plan was put in place in 2003 and 2004, consisting of an enhanced audit programme and other supervisory measures. In 2004, nine missions to Greece were carried out on IACS and IACS-related measures. These actions on the part of the Commission and the setting up of a new paying agency in Greece (Opekepe) have led to good progress, so that by the end of 2004 (2005 financial year) the different elements of the IACS system were in place. However the Commission will continue to identify and assess the remaining deficiencies in the functioning of the IACS in Greece, and to apply appropriate financial corrections.

As regards the weaknesses mentioned by the Court, the Commission has repeatedly criticised the role of the farmer's unions in the claim procedure and the weakness of supervision. By letter of June 2004, the Commission has formally required the Greek authorities to implement a new aid application procedure, reducing the dependence on farmer's unions. This subject, as well as the insufficient quality of the on-the-spot inspections, already identified by the Commission, will be pursued through the ongoing clearance of accounts enquiries.

(2) Germany (Thuringen, Saarland), Greece, Spain (Castilla y Leon), and the United Kingdom (Scotland).

(3) In 2003, IACS expenditure in Greece amounted to 868 million euro (this figure does not include expenditure for tobacco, cotton and olive oil, which are indirectly covered by IACS).
THE COURT’S OBSERVATIONS

(b) the quality of on-the-spot inspections is low. The inspection findings are very poorly, or not at all documented, or reporting of results is unreliable. Re-performance of inspections by the paying agency for quality assurance could not confirm the results for more than one third of initial inspections. Some reports do not seem to be based on genuine inspections

THE COMMISSION’S REPLIES

Post-payment checks under Regulation (EEC) No 4045/89

4.9. Member States are required to carry out annual programmes of post-payment checks of commercial documentation for a range of CAP subsidies, including export refunds, processing and transformation subsidies, processing of cotton, olive oil and tobacco and some rural development expenditure, in total some 37 % of agricultural expenditure. Member States must satisfy themselves that transactions have taken place and been executed correctly; and must take steps to recover sums lost as a result of irregularity or negligence.

4.10. The Commission analyses the documents Member States provide on an annual basis and may visit some Member States in order to check the implementation of the Regulation on the spot. The Court examined the Commission’s monitoring of Regulation (EEC) No 4045/89 checks and found that:

(a) the analysis of the reports provided by Member States is of limited value as the existing regulation does not require co-ordination bodies to present statistics in a format which permits meaningful analysis (for example, reporting the rates of error for different categories of expenditure);

(4) Area aid: in one report examined, the local inspector asserts having measured 85 parcels in one day without reporting any discrepancies. Another local inspection team of two inspectors reports having measured 223 parcels by GPS in one day without finding any discrepancies. In claim year 2003, a team of two inspectors reported having checked the area of 653 parcels again without finding any discrepancies. Experience from area measurements and discrepancies suggests that these results are unlikely.

Sheep premiums: inspections revealed significant differences in a herd of 470 sheep, claimed to be unchanged in number from 2002 to 2004. The differences were covered by declarations of losses (70, 192 and 239 animals lost in 2002, 2003 and 2004 respectively) due to natural circumstances (by disease and wolves). The losses were supported by certificates from the local veterinary office. However no evidence could be produced by the farmer to justify how he restocked his herd.

(b) In 2003, the Court examined the application of post-payment checks in 11 Member States and concluded that fewer than one in three were wholly satisfactory (6). In response, the Commission has visited three Member States in 2004, the first visits since January 2001 dedicated to the full examination of the post-payment checks. In addition, the Commission regularly covers specific aspects of post-payment checks in the framework of its clearance of Member States’ audit of export refunds (which accounts for some 25% of the expenditure to be covered by these checks).

Following the Court’s 2003 Annual Report where a similar remark was made, the Commission took further measures to improve the situation. Even if some of those checks are not to be considered as wholly satisfactory, the Commission considers that due to the complexity of post-payment checks, there might often be a margin for improvement without putting into question the value of the checks carried out.

In 2004, DG AGRI carried out three missions (to Belgium, Greece and Portugal) on the application of Regulation (EEC) No 4045/89 to cover the general aspects, i.e. the annual report, risk-analysis and control programme. In 2005, six further missions are ongoing during which the specific findings of the Court will be followed up.

In addition, the Commission has given added emphasis to Regulation (EEC) No 4045/89 controls in the framework of compliance audits in 2005.

(c) The delays in completion of Member States’ annual programmes of post-payment checks, highlighted by the Court in its 2003 Annual Report (7), persist. At the end of 2004 almost 40% of the checks planned had not been completed according to the Member States’ annual reports.

The Commission acknowledges that there have been delays in the completion of post-payment checks in certain Member States. However, the number of scrutinies planned by most Member States exceeds significantly the minimum number required. On this basis the shortfall is less than 40%.

While some scrutinies are not completed at the end of the scrutiny period, they must be followed up and be completed in the following scrutiny period. The Commission is investigating the reasons for the failure to complete in due time control programmes in certain Member States and, where appropriate, will request clarification from Member States.

Graph 4.3 shows the number of checks carried out and the number of irregularities discovered for the last six reporting periods as presented by Member States. Given that the data does not provide for analysis by amount or by type of expenditure, it is not possible to draw conclusions on the significance and cause of the variation in the reported frequency of irregularity.

Graph 4.3 Member States report the total amount of the irregularities detected by Regulation (EEC) No 4045/89 scrutinies which for the 2001/2002 control programme amounted to 23.4 million euro.
4.11. Export refunds paid to exporters of EU agricultural products cover the difference between EU internal and world market prices and allow surplus EU production to be disposed of on world markets. In 2004, refunds accounted for some 3.6 billion euro, 7.5 % of CAP expenditure (8.3 % in 2003). Member States are required to physically check 5 % of exports to ensure that they are correctly described and entitled to the export refund claimed. The Commission monitors the quality and number of checks carried out by Member States.

4.12. In 2004, the Commission visited 7 Member States to evaluate the performance of physical checks. The Commission’s main preliminary findings indicate weaknesses relating to:

(a) quality and/or frequency;

(b) procedures for selection of consignments;

4.12. As the Court states, the remarks are of preliminary nature and the Commission can only finalise its position once the Member States have exercised their right of reply.
(c) prior notification;

(d) statistics.

These weaknesses of variable importance were not found in all Member States visited.

4.13. The Commission was unable to provide information on the value of transactions physically checked and the value of irregularities detected. During 2004, the Commission adopted a regulation requiring Member States to report this information with effect from the 2005 report. Table 4.1 summarises the numbers of declarations checked and of irregularities detected for the period 2001 to 2003.

Table 4.1

<table>
<thead>
<tr>
<th>Year</th>
<th>Declarations Checked</th>
<th>Irregularities Detected</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>10,000</td>
<td>500</td>
</tr>
<tr>
<td>2002</td>
<td>15,000</td>
<td>750</td>
</tr>
<tr>
<td>2003</td>
<td>20,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>

4.13. Following the Court’s recommendation, made for the first time in its 2002 Annual Report, the Commission responded in timely fashion by adopting Regulation (EC) No 1454/2004, which stipulates that, as from 2005 the value of transactions checked, as well as irregularities exceeding the amount of 200 euro, have to be communicated by Member States.

Until 2005, the information on the value of irregularities depended on the reliability of the communication of irregularities referred to in Article 3 of Regulation (EEC) No 595/91 delivered by the Member States to OLAF and did not comprise irregularities below 4 000 euro.

4.14. The Commission’s Annual Activity Report 2004 contains information on the number of export declarations lodged, the number checked by the Member States and the number of irregularities found. There is no reference to the results of the Commission’s evaluation of the performance of physical checks by Member States, nor of the extent to which assurance can be gained from them.

4.14. The assurance gained from Regulation (EEC) No 386/90 is an integral part of the overall assurance obtained by the Director-General as explained in the Annual Activity Report (section 4.2.2). See also reply to paragraphs 4.29 to 4.31.

Clearance of accounts

Financial clearance

4.15. The Court examined:

(a) the reports of the certifying bodies on the 25 paying agencies (see Table 4.2) from which transactions were tested (see paragraph 4.26) and of all paying agencies whose accounts were qualified;

(b) the Commission’s financial clearance decision;

(c) the Commission’s clearance of accounts postponed from previous years (9).

(9) As part of its cyclical examination of various aspects of the paying agencies’ functions, the Court also examined the Commission’s enquiry started in 2002, into the way in which paying agencies delegate certain functions to other bodies. The Commission’s reports show two common weaknesses: failure by paying agencies to exercise adequate supervision over the delegated bodies, and failure to specify the role of delegated bodies. In particular the Commission found widespread weaknesses over the management of delegated bodies by AGEA (Italy): the weaknesses persisted in 2003 and 2004.
Table 4.1 — Regulation (EEC) No 386/90: Number of physical checks and irregularities detected (1)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2002</th>
<th>2001</th>
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<tr>
<td></td>
<td>Irregularities</td>
<td>Physical checks</td>
<td>Irregularities</td>
</tr>
<tr>
<td>Spain</td>
<td>23</td>
<td>4 786</td>
<td>59</td>
</tr>
<tr>
<td>Germany</td>
<td>20</td>
<td>6 644</td>
<td>61</td>
</tr>
<tr>
<td>France</td>
<td>8</td>
<td>3 459</td>
<td>19</td>
</tr>
<tr>
<td>Denmark</td>
<td>8</td>
<td>1 470</td>
<td>22</td>
</tr>
<tr>
<td>Ireland</td>
<td>6</td>
<td>872</td>
<td>3</td>
</tr>
<tr>
<td>Belgium</td>
<td>2</td>
<td>2 776</td>
<td>2</td>
</tr>
<tr>
<td>Portugal</td>
<td>2</td>
<td>494</td>
<td>2</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1</td>
<td>7 229</td>
<td>0</td>
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<td>Finland</td>
<td>1</td>
<td>668</td>
<td>0</td>
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<tr>
<td>Italy</td>
<td>0</td>
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<td>Greece</td>
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<td>United Kingdom</td>
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<td>Austria</td>
<td>0</td>
<td>835</td>
<td>0</td>
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<tr>
<td>Sweden</td>
<td>0</td>
<td>242</td>
<td>0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>71</strong></td>
<td><strong>36 487</strong></td>
<td><strong>168</strong></td>
</tr>
</tbody>
</table>

(1) Number of cases more than 4 000 euros reported under regulation (EEC) No 595/91.
Source: ‘Summary of Member States annual reports on the year 2003’ and ‘Summary of Member States annual reports on the year 2002’, by the Commission, DG AGRI D03.
Table 4.2 — Paying agencies by expenditure declared in 2004

<table>
<thead>
<tr>
<th>No</th>
<th>Member State</th>
<th>Paying agency</th>
<th>Amounts declared in million euro</th>
<th>% of total</th>
<th>Qualified accounts</th>
<th>Disjoined accounts (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>France</td>
<td>ONIC</td>
<td>4 413.80</td>
<td>10.19</td>
<td>×</td>
<td>×</td>
</tr>
<tr>
<td>2</td>
<td>Italy</td>
<td>AGA</td>
<td>3 853.46</td>
<td>8.86</td>
<td>×</td>
<td>×</td>
</tr>
<tr>
<td>3</td>
<td>United Kingdom</td>
<td>RPA</td>
<td>2 854.11</td>
<td>6.59</td>
<td>×</td>
<td>×</td>
</tr>
<tr>
<td>4</td>
<td>Greece</td>
<td>OPEKEP</td>
<td>2 781.44</td>
<td>6.42</td>
<td>×</td>
<td>×</td>
</tr>
<tr>
<td>5</td>
<td>France</td>
<td>OHIVAL</td>
<td>1 897.26</td>
<td>4.38</td>
<td>×</td>
<td>×</td>
</tr>
<tr>
<td>6</td>
<td>Ireland</td>
<td>DAF</td>
<td>1 820.73</td>
<td>4.20</td>
<td>×</td>
<td>×</td>
</tr>
<tr>
<td>7</td>
<td>Spain</td>
<td>Andalucia</td>
<td>1 709.70</td>
<td>3.95</td>
<td>×</td>
<td>×</td>
</tr>
<tr>
<td>8</td>
<td>Denmark</td>
<td>EU-direktorat</td>
<td>1 215.85</td>
<td>2.81</td>
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<td>9</td>
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<tr>
<td>11</td>
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<tr>
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<td>14</td>
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<td>SVI</td>
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<td>15</td>
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<tr>
<td>18</td>
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<td>0.88</td>
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<td>22</td>
<td>Netherlands</td>
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<tr>
<td>23</td>
<td>United Kingdom</td>
<td>NAAD</td>
<td>278.70</td>
<td>0.64</td>
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<td>×</td>
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<tr>
<td>24</td>
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<td>0.63</td>
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<td>×</td>
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<tr>
<td>25</td>
<td>Belgium</td>
<td>ARKL (Vlaamse Gemeenschap)</td>
<td>220.88</td>
<td>0.51</td>
<td>×</td>
<td></td>
</tr>
</tbody>
</table>

Subtotal (1) 11 903.25 27,49

Note: The exchange rates for Member States outside the euro zone: Czech Republic: 30.031; Denmark: 7.4302; Estonia: 15,6466; Hungary: 247.15; Latvia: 0.6960; Lithuania: 3.4528; Poland: 4.0876; Slovakia: 38.75; Slovenia: 239.7; Sweden: 9.1687; United Kingdom: 0.6876.

NB: The Court examined the reports and certificates of these 25 paying agencies in respect of which a sample of transactions was selected for testing.

Work of the certifying bodies

4.16. A certifying body must be operationally independent of the paying agency (10). It must base its certificate on an examination of procedures and on a sample of transactions. The certificate must state whether the accounts are true, complete and accurate and whether the internal control procedures have operated satisfactorily. This certificate must be supported by a report on the certifying body’s findings. Work on legality and regularity is limited to ensuring that the paying agency is able to demonstrate that it has the necessary administrative structures to ensure that claims are checked for compliance before they are paid. Claims submitted by beneficiaries of EU aid are not usually checked on the spot by the certifying body.

4.17. The Commission seeks to ensure that the certifying bodies properly audit expenditure managed by the paying agencies. It issues guidelines for the certifying bodies (including on sampling of transactions), and reviews their reports to ensure that its guidance has been followed.

4.18. In its summary accompanying its financial clearance decision, the Commission states that it is generally satisfied with the quality and content of the certifying bodies’ reports, but mentions the following areas where certifying bodies need to pay more attention: advances and securities; debts; follow-up of financial errors detected during previous certification audits; sampling and error evaluation; checking maximum guaranteed quantities and the audit of rural development. The Court endorses these conclusions.

Financial clearance decision for 2004

4.19. The Commission took its Financial Decision on 13 May 2005 (11). For the financial year ending 15 October 2004, 71 paying agencies managing 32 billion euro received an unqualified audit opinion from their certifying bodies (see Table 4.2). The remaining 20 agencies received a qualified or negative opinion albeit for limited amounts. Reasons included: overpayments and ineligible expenditure found by the certifying bodies; missing supporting documents; weaknesses in the arrangements whereby paying agencies delegate some functions to other bodies; or incomplete, incorrect or misleading information about debtors.

4.19. The qualifications and negative opinions refer, in the great majority of cases, to particular aspects and particular measures within the 20 paying agencies concerned.

The Commission has already initiated a procedure to recover any material undue payments (see also paragraph 4.20).

(10) Article 3 of Regulation (EC) No 1663/95.
(11) The 30 April deadline was not met due to translation difficulties.
THE COURT’S OBSERVATIONS

4.20. The Commission approved the accounts of 86 of the 91 paying agencies, and postponed its clearance of the accounts of five paying agencies (representing 4 billion euro, 9 % of the total expenditure declared) because of imprecise or insufficient work by the certifying bodies concerned (12). It intends to make financial corrections, totalling some 7 million euro, in respect of 14 paying agencies (13).

4.21. In 2004, the Commission completed work on the accounts it had not cleared in the financial decision of 2001 and 2002, in most cases because of inadequacies in the work performed by certifying bodies or because of the need to clarify some information. It cleared the accounts of four paying agencies which were not accepted for 2001 and 17 which were not accepted for 2002.

Conformity decisions taken in 2004

4.22. Conformity decisions usually relate to several years of expenditure and are taken a few years in arrears. Thus, corrections made in the conformity decisions taken in 2004 do not relate to CAP payments to final beneficiaries in 2004.

THE COMMISSION’S REPLIES

4.22. The audits leading to conformity decisions primarily concentrate on the management and control systems set up by Member States. Where those audits do not reveal any deficiencies or lead to subsequent improvements of the systems, they are also relevant for the legality and regularity of related expenditure in subsequent years. They are the proof that the existence of a clearance of accounts procedure contributes to the reasonable assurance sought.

(12) The main reasons for not clearing these accounts were: a failure by the certifying bodies to quantify the financial impact of all identified errors (Bayern-Umwelt, (DE) AGEA, (IT)); inadequate audit by the certifying body for Luxembourg; a scope limitation for Madrid (ES) and failure by SDE (FR) to carry out the on-the-spot controls.

(13) The certifying bodies identified material error (more than 1 % of expenditure declared) affecting either the whole account or specific areas in seven paying agencies (Navarra, Baden-Württemberg, Bayern-Umwelt, IFADAP, Region Wallonne, ONIVINS and SDE). The Commission reached the same conclusion for three other paying agencies (La Rioja, ODEADOM and ONIFLHOR). Furthermore, the Commission intends to make corrections based on financial errors detected in a further four paying agencies (Andalusia, Canary Islands, Forestry Commission and SERAD).
4.23. In 2004, the Commission took three conformity decisions in respect of expenditure declared from 1998 to 2003 (14), refusing to finance 406 million euro (15). As in previous years, most of them (71 %), are flat-rate corrections (16). The corrections mainly relate to animal premiums (186 million euro), fruit and vegetables (70 million euro) and arable crops (67 million euro) and mainly concern France (213 million euro), Italy (63 million euro), Greece (46 million euro) and Spain (34 million euro). The principal reasons quoted by the Commission for the corrections were weaknesses in the system of identification and registration of cattle and deficiencies in the number and/or quality of on the spot inspections.

Conformity decisions in recent years

4.24. Table 4.3 shows the results of the Commission’s clearance decisions in respect of 1991 and subsequent years. As at the end of 2004, clearance was not complete for any year later than 1998. The total corrections represent the Commission’s view, for the budget headings and Member States it has examined, of the amount of expenditure which, mainly because of weaknesses in Member States’ systems for managing and controlling expenditure, should not be borne by the Community budget.

4.24. The Commission would like to finish with the past and the most longstanding cases still pending were closely examined when the audit work programme relating to agricultural expenditure for 2005 was drawn up. The situation in June 2005 is that 94,3 % of the audits carried out in 2001 (which allow financial corrections back to 1999) and 78,7 % of the audits carried out in 2002 (which allow financial corrections back to 2000) have been closed.

4.25. Graphs 4.4 and 4.5 set out the distribution of corrections in decisions taken by the Commission during the period 1999 to 2004 (17), by Member State and market sector. These decisions relate to items of expenditure from the Community budget years 1996 to 2003.

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(15) These conformity decisions were offset against expenditure for the year 2004.
(16) The flat-rate corrections are applied as follows: 2 % when key controls are satisfactory but secondary controls are partly or totally ineffective; 5 % when key controls are executed but the number, frequency or rigour required by regulations is not respected, and the risk of loss to the Fund is significant; 10 % when one or more key controls do not operate making it impossible to determine the eligibility or regularity of a claim, with, as a result, a high risk of loss to the Fund.
(17) 1999 was the first year in which the Commission took conformity decisions under the revised procedure for clearance of accounts introduced in 1996.
### Table 4.3 — Corrections in clearance of accounts decisions in respect of budget years 1991 to 2003

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure declared</td>
<td>31 255.9</td>
<td>30 480.2</td>
<td>34 008.0</td>
<td>33 592.8</td>
<td>35 654.4</td>
<td>39 062.5</td>
<td>40 884.3</td>
<td>38 857.4</td>
<td>40 726.2</td>
<td>40 410.6</td>
<td>41 593.8</td>
<td>42 710.8</td>
<td>44 212.0</td>
</tr>
<tr>
<td>Total amount of corrections</td>
<td>−1 504.1</td>
<td>−788.2</td>
<td>−736.6</td>
<td>−307.8</td>
<td>−572.8</td>
<td>−790.0</td>
<td>−481.4</td>
<td>−329.3</td>
<td>−275.6</td>
<td>−380.4</td>
<td>−251.7</td>
<td>−147.5</td>
<td>−37.0</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Milk super levies</td>
<td>−979.2</td>
<td>−419.7</td>
<td>−230.6</td>
<td>−2.7</td>
<td>−15.1</td>
<td>−215.0</td>
<td>−110.2</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
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</tr>
<tr>
<td>(b) Disallowed expenditure</td>
<td>−524.9</td>
<td>−368.5</td>
<td>−506.0</td>
<td>−305.1</td>
<td>−557.7</td>
<td>−575.0</td>
<td>−371.2</td>
<td>−329.3</td>
<td>−275.6</td>
<td>−380.4</td>
<td>−251.7</td>
<td>−147.5</td>
<td>−37.0</td>
</tr>
<tr>
<td>Disallowed expenditure as a percentage of expenditure declared</td>
<td>1.7 %</td>
<td>1.2 %</td>
<td>1.5 %</td>
<td>0.9 %</td>
<td>1.6 %</td>
<td>1.5 %</td>
<td>0.9 %</td>
<td>0.8 %</td>
<td>0.7 %</td>
<td>0.9 %</td>
<td>0.6 %</td>
<td>0.3 %</td>
<td>0.1 %</td>
</tr>
</tbody>
</table>

Source: Clearance of accounts decisions in respect of budget years 1991 to 2003.
Graph 4.4 — Corrections by Member State (1999 to 2004)

Source: Commission's conformity decisions taken from 1999 to 2004.

Graph 4.5 — Corrections by market (1999 to 2004)

Source: Commission's conformity decisions taken from 1999 to 2004.
THE COURT’S OBSERVATIONS

The Court’s sample of transactions

4.26. The Court examined a representative sample of payments drawn from the expenditure of 25 paying agencies (which were collectively responsible for 72.5% of CAP expenditure) as well as from the direct expenditure of the Commission. Through these tests, the Court sought to obtain direct evidence that payments were properly made for an eligible activity. Such tests provide good evidence of whether expenditure on area aid is legal and regular (see paragraphs 4.35 to 4.38) and, to a lesser extent, animal premiums (see paragraphs 4.39 to 4.42) where physical evidence is usually available to the auditor. By contrast, in areas such as export refunds (see paragraphs 4.49 and 4.50) or aids paid on the basis of the quantity produced (see paragraph 4.43), the auditor can only check documents. The extent to which such documents provide reliable evidence is influenced by both the nature of the transaction (see paragraph 4.48) and the control system concerned (see paragraph 4.54).

Annual Activity Report of the Director-General for Agriculture for the year 2004

Some improvement from last year

4.27. The Annual Activity Report (AAR) contains a declaration by the Director-General that control procedures give him assurance that CAP transactions for 2004 are legal and regular.

4.28. The report states that:

(a) Directorate-General for Agriculture (DG AGRI) is in overall compliance with the internal control standards although further work is required in some areas (18);

(b) IACS provides, except in Greece, an excellent means of ensuring the proper use of Community funds;

(c) post-payment checks provide reasonable assurance that the expenditure concerned complies with Community legislation;

(d) the certification procedure provides assurance about the completeness, accuracy and reliability of the accounts of the paying agencies and a certain degree of assurance about the functioning of their internal control systems and their ability to ensure that payments are legal and regular;

THE COURT'S OBSERVATIONS

(e) for the 2004 expenditure, the audit work on control systems will be concluded, and final financial corrections decided, at the earliest, in 2006;

(f) there is a risk that ineligible expenditure has been financed, but this expenditure may be audited in subsequent years under the conformity procedures and may be subject to financial corrections (19);

(g) the financial corrections under the clearance procedure along with the recoveries in Member States cover the ‘global financial risk’.

4.29. The sources of information on which the Director-General bases his declaration provide limited coverage of, and assurance on, the legality and regularity of 2004 expenditure. IACS inspection results address the legality and regularity of payments to farmers, but these are insufficiently verified and validated by an independent body. The work of certifying bodies may bring to light problems at the level of paying agencies, but cannot be relied upon to provide assurance on claims by farmers and traders.

4.30. In order to obtain reliable information on the legality and regularity of payments to final beneficiaries, the Director-General would need:

(a) either to make arrangements for certifying bodies to extend their work to final beneficiaries, through extending their sample tests to the level of farmers or by doing more work to verify and validate IACS inspections statistics and post-payment checks (20); or

(b) to require his own staff, on the basis of an appropriate sampling method, to verify the legality and regularity of transactions for the year at the level of final beneficiaries.

4.29 and 4.30. The Commission takes the view that the Director-General already has sufficient information to have reasonable assurance of the legality and regularity of agricultural expenditure.

As already indicated in response to the Court’s annual report 2003 the set-up and accreditation of the Member States’ paying agencies, the annual certification procedure and the application of the various management and control systems, including IACS, permit a great deal of reliance to be placed on the control over expenditure declared. In order to further improve the overall system the new basic regulation on the financing of the common agricultural policy provides that the heads of paying agencies shall henceforth sign an ex post declaration of assurance on the legality and regularity of their expenditure.

The information on which the Director-General relies is derived from a system which is based on a multi-annual approach. The Commission therefore does not support the options set out by the Court.

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(19) Annual Activity Report 2004, paragraph 4.2.2.

(20) The critical aspect in checking the legality and regularity of the transactions is the existence and accuracy of the information declared by beneficiaries, many of which can only be verified by physical inspection at the final beneficiary level. Such coverage would represent a stronger and clearer chain of accountability for CAP spending. It would provide increased assurance to the Commission on the legality and regularity of transactions. See Court Opinions No 2/2004 on the single audit model, paragraphs 21, 41 and 42 and No 1/2005 on the Financing of the CAP, paragraph 24.
4.31. The fact that the Director-General's declaration relates to expenditure which may subsequently be the subject of financial corrections, and does not indicate to what extent expenditure might be affected by such corrections, limits the assurance which the Court can derive from his declaration (21). The declaration should distinguish, on the one hand, expenditure which has been verified (and has been or will be the subject of corrections where necessary) for which the Director-General can give reasonable (or no) assurance and, on the other hand, expenditure which is the subject of further verification (and possible correction).

(21) See Opinion No 2/2004 on the single audit model, paragraphs 57 and 58.

4.31. The Commission is of the opinion that it would not be appropriate in the AAR to distinguish, as the Court suggests, between expenditure which has already been verified and expenditure which will be subject to further verification. Given the multi-annual nature of the conformity clearance process, such a distinction would be largely arbitrary; it would also prejudice the Member States' right of defence in the context of the clearance of accounts procedure.

The Director-General's declaration and the accompanying AAR need to be placed in the broader regulatory framework for the clearance of the EAGGF accounts set out in Article 7 of Regulation (EC) No 1258/1999. The whole process is divided into an annual financial clearance on the one hand and a multi-annual conformity clearance on the other, which allows the Commission to exclude expenditure from Community financing that has been effected less than 24 months prior to the Commission's written communication of the results of its audits to the Member State concerned.

Against this background, reasonable assurance as regards the legality and regularity of agricultural expenditure carried out under shared management cannot be obtained on an annual basis, in particular in the context of the Director-General's AAR, from the audit work of the Commission services alone, but must be predicated on the premise that Member States fulfil their management and control obligations. Where Commission audits subsequently identify deficiencies, the risk of ineligible expenditure will be determined and appropriate financial corrections applied.

The fact that the clearance of accounts decisions are usually taken some years after the year of the expenditure concerned is an integral part of the procedure, which includes the right of Member States to respond to the findings, and this fact is explicitly acknowledged in the Director-General's 2004 AAR.
4.32. At present, the level of irregular payments financed by the CAP is not known to, or estimated by, the Director-General (22). He has no reliable basis on which to assert that a sum equivalent to the total sum of irregular payments is likely to be recovered through the clearance of accounts (23) procedure and through the recovery procedures in the Member States. The conformity decisions are in most cases flat-rate corrections for weaknesses in the control systems rather than an assessment of the impact of the individual errors.

4.32. The Commission considers the total financial corrections in respect of a given year, together with the sanctions imposed on final beneficiaries at national level, to give a valuable estimation of the overall level of irregular payments.

Internal Control Standards — Some standards are not fully implemented

4.33. One of the innovations introduced in the framework of the reform of financial management in the Commission services was the requirement to meet 24 Internal Control Standards which were made more concrete in the form of 71 baseline requirements. DG AGRI’s 2004 self-assessment concluded that all standard and baseline requirements had been met (see paragraph 4.28(a)).

4.34. The Court examined the implementation of eight standards (24), and found that four of them showed room for improvement (25). DG AGRI’s Internal Audit Capability (see Chapter 1, paragraph 1.81) reports issued during 2004 confirmed this.

4.34. The Commission must emphasise that DG AGRI by the end of 2004 was in compliance with all the baseline requirements laid down by the Commission for the 24 ICS. This does not exclude that improvements in some areas are still possible and desirable, which DG AGRI also indicated in its assessment of the situation at the end of 2004.

(22) In order to estimate the level of irregularities, an appropriate sampling method should be clearly defined (Opinion No 2/2004 on the single audit model, paragraph 48) and the legality and regularity of expenditure should be verified at the level of the beneficiary (Opinion No 1/2005 on the Financing of the CAP, paragraph 24).

(23) Conformity decisions have the objective of excluding expenditure from Community financing where the Commission has found it has not been in compliance with Community rules (Council regulation (EC) No 1258/1999, Article 7(4). These decisions are (in most cases) flat-rate corrections for disfunctioning key elements of the control systems.

(24) ICS 11 (Risk analysis), ICS 12 (Management information), ICS 14 (Reporting improprieties), ICS 17 (Supervision), ICS 18 (Recording exceptions), ICS 20 (Internal control weaknesses), ICS 21 (Audit reports) and ICS 22 (Internal audit Capability).

(25) ICS 11 (risk analysis), no action plan was drawn up to address risks in respect of 2004. ICS 12 (management information), reporting on ‘qualitative aspects’ such as the implementation of the Annual Management Plan is not yet satisfactory. ICS 17 (supervision), effective supervision of financial activities by the authorising officers is doubtful and no evidence on ex post control procedures. ICS 18 (recording exceptions), the recording requirements were not met by the units involved.
The Court's assessment of areas of CAP spending

**Area aid schemes**

4.35. Spending on arable crop subsidies paid on an area basis amounted to 17 475 million euro in 2004, 39 % of CAP expenditure. All of this expenditure is covered by IACS.

4.36. The IACS inspection results on declarations of area for 2003 (for payments in 2004) are set out in Table 4.4.

4.37. Member States reported to the Commission that they checked 8,1 % of claims on the spot, representing 11,4 % of the total area claimed. For the 14 Member States that have implemented IACS satisfactorily, their random checks showed an error rate of 1,6 %. This provides a reasonable estimate of the likely error in claims paid. For on-site inspections, areas not found in the claims inspected (26) (see Table 4.4 and Graph 4.6) include both the results of checks on claims selected at random and selected on the basis of an analysis of risk. As in previous years, in certain Member States, risk-based transactions proved to have a lower rate of error than randomly selected transactions.

4.37. It should first be noted that the overall on-the-spot inspection levels are well in excess of the minimum requirements. It is correct to say that in some Member States random checks appear to be more effective. As explained previously, this is largely due to some Member States' reporting of remote sensing controls as 'random', when in fact they are also at least partly risk-based. As of 2004, with the introduction of Regulation (EC) No 118/2004, there is a regulatory requirement for Member States to review the results of inspections and to improve their risk analysis procedures accordingly, which will resolve the issue.

However, it is pointed out that there are to some extent ‘diminishing returns’. Because of the quality of the IACS system, including 100 % administrative checks, the frequency of anomalies detected on the spot is low, so that the difference in results achieved between random and risk-based inspections is marginal, and possibly explained by the difference in sample sizes. Furthermore, the Court bases its calculations on discrepancies in terms of areas, whereas the same comparison in terms of frequency of farmers with irregularities gives a different result for several Member States.

(26) Percentage expressed of areas claimed by inspected farmer.
### Table 4.4 — Area Aid, forage areas and other crops — Results of IACS field inspections and remote sensing in 2003, relating to claims paid in 2004

<table>
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<th>Member State</th>
<th>Applications submitted</th>
<th>Applications checked</th>
<th>Applications with errors</th>
</tr>
</thead>
<tbody>
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<td></td>
<td>Number</td>
<td>Area (ha)</td>
<td>Average size (ha)</td>
</tr>
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<td>Belgium</td>
<td>41 618</td>
<td>1 019 389</td>
<td>24</td>
</tr>
<tr>
<td>Denmark</td>
<td>49 574</td>
<td>2 319 081</td>
<td>47</td>
</tr>
<tr>
<td>Germany</td>
<td>305 315</td>
<td>14 008 476</td>
<td>46</td>
</tr>
<tr>
<td>Greece</td>
<td>328 200</td>
<td>3 897 336</td>
<td>12</td>
</tr>
<tr>
<td>Spain</td>
<td>429 069</td>
<td>17 889 474</td>
<td>42</td>
</tr>
<tr>
<td>France</td>
<td>409 976</td>
<td>23 777 964</td>
<td>58</td>
</tr>
<tr>
<td>Ireland</td>
<td>127 532</td>
<td>4 686 612</td>
<td>37</td>
</tr>
<tr>
<td>Italy</td>
<td>588 069</td>
<td>7 068 768</td>
<td>12</td>
</tr>
<tr>
<td>Luxembourg</td>
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<td>62</td>
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<td>654 439</td>
<td>14</td>
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<td>Sweden</td>
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<td>47</td>
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<tr>
<td>United Kingdom</td>
<td>128 135</td>
<td>14 146 232</td>
<td>110</td>
</tr>
<tr>
<td><strong>Total 2003</strong></td>
<td><strong>2 840 349</strong></td>
<td><strong>98 871 264</strong></td>
<td><strong>35</strong></td>
</tr>
<tr>
<td><strong>Total 2002</strong></td>
<td><strong>2 894 917</strong></td>
<td><strong>97 955 796</strong></td>
<td><strong>34</strong></td>
</tr>
<tr>
<td><strong>Total 2001</strong></td>
<td><strong>2 935 273</strong></td>
<td><strong>98 275 675</strong></td>
<td><strong>33</strong></td>
</tr>
</tbody>
</table>

**NB 1:** Remote sensing involves the use of satellite or aerial photography to check IACS applications.

**NB 2:** Test performed in year N are relevant to payments made in year N + 1.

**Source:** IACS statistics submitted by Member States to DG AGRI.
4.38. For area aid as a whole, the results of the Court’s testing of transactions are broadly consistent with the results of random testing performed by the Member States, and the distribution by type is similar to previous years:

(a) the majority of the payments were free of error;

(b) around one in three was affected by relatively small errors of measurement. As in previous years, errors of this nature and scale, while frequent, have no marked impact on overall expenditure;

(c) a small number of cases were affected by larger errors, but the number and impact of such cases was however lower than in previous years.

4.38. The Court’s remarks broadly correspond to the Commission’s own findings of a generally satisfactory situation in the great majority of Member States.
4.39. Spending on animal premiums amounted to 9 019 million euro in 2004, 20 % of CAP expenditure. IACS inspection statistics for animal premiums show the number of animals claimed by farmers which inspectors found not to exist or not to be eligible for subsidy. Statistics for animal premiums are still less reliable than the equivalent statistics for area aid applications.

4.40. In 2003 (i.e. in respect of claims paid in 2004), for the largest scheme, the suckler cow premium (see Table 4.5 and Graph 4.7), Member States inspected 17.3 % of the animals claimed, finding 1.4 % of these to be missing or ineligible, a decrease on 2002, when 2 % were found to be ineligible. For the sheep and goat premiums the percentage of missing animals increased from 7.2 % in 2002 to 8.2 % in 2003. Italy and Greece report significantly higher levels of error for sheep and goat premiums than the other Member States; the rate of error for the remaining 13 Member States in 2003 was 1.8 % (2.2 % in 2002).

4.41. Overall, the rate of error found by IACS inspections of cattle in 2003 shows small variations from Member State to Member State, except for Italy where the percentage of ineligible cattle is still very high (10.2 % of animals claimed for the suckler cow premium and 22.3 % of animals claimed for the special beef premium).

4.42. The direct testing performed by the Court did not reveal any significant errors.
Table 4.5 — IACS inspections for suckler cow premium — Results of on-the-spot checks in 2003, relating to claims paid in 2004

<table>
<thead>
<tr>
<th>Member State</th>
<th>Claims inspected</th>
<th>Inspected claims partially rejected</th>
<th>Inspected claims fully rejected</th>
<th>Animals inspected</th>
<th>Inspected animals rejected</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total number of claims submitted</td>
<td>Number</td>
<td>%</td>
<td>Number</td>
<td>%</td>
</tr>
<tr>
<td>Belgium</td>
<td>15 433</td>
<td>748</td>
<td>4.8</td>
<td>7</td>
<td>0.9</td>
</tr>
<tr>
<td>Denmark</td>
<td>8 754</td>
<td>1 053</td>
<td>12.0</td>
<td>20</td>
<td>1.9</td>
</tr>
<tr>
<td>Germany</td>
<td>33 326</td>
<td>4 967</td>
<td>10.5</td>
<td>302</td>
<td>8.6</td>
</tr>
<tr>
<td>Greece</td>
<td>11 513</td>
<td>1 426</td>
<td>99.2</td>
<td>213</td>
<td>1.9</td>
</tr>
<tr>
<td>Spain</td>
<td>62 837</td>
<td>5 912</td>
<td>9.4</td>
<td>319</td>
<td>5.4</td>
</tr>
<tr>
<td>France</td>
<td>121 849</td>
<td>17 311</td>
<td>14.2</td>
<td>1 946</td>
<td>11.2</td>
</tr>
<tr>
<td>Ireland</td>
<td>62 861</td>
<td>4 655</td>
<td>7.4</td>
<td>326</td>
<td>7.0</td>
</tr>
<tr>
<td>Italy</td>
<td>58 890</td>
<td>6 567</td>
<td>11.2</td>
<td>184</td>
<td>2.8</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>508</td>
<td>38</td>
<td>7.5</td>
<td>1</td>
<td>2.6</td>
</tr>
<tr>
<td>Netherlands</td>
<td>4 234</td>
<td>652</td>
<td>15.4</td>
<td>13</td>
<td>2.0</td>
</tr>
<tr>
<td>Austria</td>
<td>61 324</td>
<td>6 872</td>
<td>11.2</td>
<td>468</td>
<td>6.8</td>
</tr>
<tr>
<td>Portugal</td>
<td>25 066</td>
<td>2 777</td>
<td>11.1</td>
<td>170</td>
<td>6.1</td>
</tr>
<tr>
<td>Finland</td>
<td>1 532</td>
<td>203</td>
<td>13.3</td>
<td>22</td>
<td>10.8</td>
</tr>
<tr>
<td>Sweden</td>
<td>9 599</td>
<td>616</td>
<td>6.4</td>
<td>5</td>
<td>0.8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>31 273</td>
<td>2 977</td>
<td>9.5</td>
<td>534</td>
<td>17.9</td>
</tr>
<tr>
<td><strong>Total 2003</strong></td>
<td><strong>508 999</strong></td>
<td><strong>65 297</strong></td>
<td><strong>12.8</strong></td>
<td><strong>4 530</strong></td>
<td><strong>6.9</strong></td>
</tr>
<tr>
<td><strong>Total 2002</strong></td>
<td><strong>539 093</strong></td>
<td><strong>78 087</strong></td>
<td><strong>14.5</strong></td>
<td><strong>6 056</strong></td>
<td><strong>7.8</strong></td>
</tr>
</tbody>
</table>

NB 1: A claim is fully rejected when a difference of more than 20 % is found between the number of animals declared and that determined to be eligible, or when the difference is the result of irregularities committed intentionally.
NB 2: Tests performed in year N are relevant to payments made in year N + 1.
Source: 2003 IACS statistics submitted by Member States to DG AGRI.
4.43. The EU subsidises olive oil, cotton and tobacco production (4 132 million euro, 9.2 % of CAP expenditure in 2004) on the basis of the quantity produced, rather than the area used to grow the crop. Expenditure of this kind poses particular risks that Community legislation tries to meet by providing for a number of control mechanisms. These include:

(a) requiring claims to be compatible with IACS area declarations;

(b) a number of requirements for processors (for example, quality of weighing equipment, standard accounting information);

(c) requiring Greece, Spain, France, Italy and Portugal to set up an olive tree register and a Geographical Information System (27) and (except in France) setting up olive oil control agencies to carry out checks on mills, producers and producer associations.

If these control mechanisms do not operate effectively there can be no assurance on the accuracy of payments made.

(27) The Geographical Information System links parcel identification, registers and aerial photographs to allow administrative checks on the number and location of olive trees.
4.44. The Court's audit identified a number of deficiencies:

(a) in Greece some claims for olive oil could not be verified as the parcels declared were not at the location indicated;

(b) Greece still did not have a functioning olive oil GIS for the period relevant to payments made in 2004 and the regulatory compensating on-the-spot-checks were not carried out satisfactorily;

(c) in Greece cases were found of producer organisations failing to make the necessary checks, for example on the disposal of olive oil or on the milling certificate supporting the claim;

(d) in Andalusia, incorrect calculations for the applications of sanctions for olive growers who had declared more olive trees than recorded in the GIS.

4.45. The findings of the olive oil control agencies in the four Member States concerned are set out in Tables 4.6 and 4.7. The agencies work includes checks on olive mills (producers are paid on the basis of quantities of olive oil certified by the mills). Where the agencies find errors and weaknesses (such as incorrect accounting or reporting increased quantities), they may propose a range of penalties, the most severe being withdrawal of approval. Checks on mills in 2003 (affecting payments in 2004) led to the agencies proposing the revocation of the authorisation of 9% of mills visited. However these proposals are often not implemented by authorities in the Member States (see Annual Report 2003, paragraph 4.39).

<table>
<thead>
<tr>
<th>Member State</th>
<th>No of mills</th>
<th>Mills checked</th>
<th></th>
<th></th>
<th></th>
<th>Proposals to withdraw authorisation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td>In depth</td>
<td>Summary</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No</td>
<td>%</td>
<td>No</td>
<td>%</td>
<td>No</td>
<td>%</td>
<td>No</td>
</tr>
<tr>
<td>Greece</td>
<td>2 198</td>
<td>1 097</td>
<td>49,9</td>
<td>739</td>
<td>33,6</td>
<td>358</td>
</tr>
<tr>
<td>Spain</td>
<td>1 686</td>
<td>958</td>
<td>56,8</td>
<td>825</td>
<td>48,9</td>
<td>133</td>
</tr>
<tr>
<td>Italy</td>
<td>5 762</td>
<td>3 124</td>
<td>54,2</td>
<td>1 852</td>
<td>32,1</td>
<td>1 272</td>
</tr>
<tr>
<td>Portugal</td>
<td>579</td>
<td>428</td>
<td>73,9</td>
<td>428</td>
<td>73,9</td>
<td>(2)</td>
</tr>
<tr>
<td>Total</td>
<td>10 225</td>
<td>5 607</td>
<td>54,8</td>
<td>3 844</td>
<td>37,6</td>
<td>1 763</td>
</tr>
</tbody>
</table>

(1) Summary checks are essentially documentary checks.
(2) Portugal do not carry out summary checks.
Source: Annual Reports for 2002 to 2003 of the Greek, Spanish, Italian and Portuguese olive oil agencies.
### Table 4.7 — Olive oil inspection agencies: checks on producers (2002 to 2003), relating to claims paid in 2004

<table>
<thead>
<tr>
<th>Member State</th>
<th>No of producers</th>
<th>Producers checked</th>
<th>Aid payments withdrawn or reduced</th>
<th>% of producers checked</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>On site</td>
<td>Using documents</td>
<td></td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>%</td>
<td>No</td>
<td>%</td>
</tr>
<tr>
<td>Greece</td>
<td>593 500</td>
<td>3 591</td>
<td>0.6</td>
<td>2 619</td>
</tr>
<tr>
<td>Spain</td>
<td>485 000</td>
<td>1 324</td>
<td>0.3</td>
<td>943</td>
</tr>
<tr>
<td>Italy</td>
<td>932 822</td>
<td>2 013</td>
<td>0.2</td>
<td>432</td>
</tr>
<tr>
<td>Portugal</td>
<td>148 542</td>
<td>1 768</td>
<td>1.2</td>
<td>1 768</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2 159 864</strong></td>
<td><strong>8 696</strong></td>
<td><strong>0.4</strong></td>
<td><strong>5 762</strong></td>
</tr>
</tbody>
</table>

Source: Annual Reports for 2002 to 2003 of the Greek, Spanish, Italian and Portuguese olive oil agencies.

### Rural development

4.46. EAGGF-Guarantee rural development expenditure amounted to 5 395 million euro in 2004 (28) (12 % of CAP spending). This covers spending on agri-environmental schemes, compensatory amounts for farming in less-favoured areas, forestry, investments and support for young and for retiring farmers. Schemes of this kind frequently have relatively complex eligibility conditions which are difficult and costly to check and which therefore present a high risk of irregularity.

4.47. For rural development expenditure the certifying bodies have qualified their audit opinion on the accounts of 12 paying agencies (29), although with limited financial impact. Reasons for qualifying the accounts were material errors, ineligible expenditure, missing supporting documents and, concerned mostly agri-environment measures and investments in agriculture and forestry. In two cases the Commission has already started the follow-up of the weaknesses identified (Greece and Luxembourg).

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(28) Total rural development expenditure, including EAGGF-Guidance, amounted to 8 805 million euro.

(29) The 12 paying agencies concerned are: the regions of Catalunia and Madrid (Spain), Agea (Italy), Bayern Umwelt and Saarland (Germany), Ministère de l’Agriculture (Luxembourg), INGA and IFADAP (Portugal), OPEKEPE (Greece), Région Wallone (Belgium), CNASEA and SDE (France).
4.48. Most entitlements to rural development support are dependent on respect of commitments entered into by the beneficiaries, such as respect of good farming practices, and are calculated on the basis of the number of hectares used, number of animals etc. The Court’s Special report on agri-environment measures (see paragraphs 4.98 and 4.99), the largest type of expenditure in the rural development area, concludes that the verification of such expenditure poses particular problems and that verification can rarely lead to reasonable assurance of the legality and regularity of expenditure at a reasonable cost.

Other expenditure

4.49. Expenditure not discussed in paragraphs 4.35 to 4.48 amounts to 8 674 million euro. This includes export refunds (3 384 million euro), subsidies for the withdrawal and storage of excess production, a number of small subsidy schemes and veterinary expenses.

4.50. The Court examined how the Commission has monitored the application of two regulations relevant to expenditure not covered by IACS and predominantly classified here as other expenditure.

4.51. The Commission’s monitoring of post-payment checks in 2004 could have been more extensive. A significant proportion of checks planned were not completed and reporting by Member States on the value, nature, and distribution of errors and the value of transactions tested was deficient. Taking these factors into account, the Court considers that the Commission did not have a sufficient basis to take assurance from the work performed (see paragraph 4.10).

4.51. The Commission also closely monitored the post-payment checks in 2004 by analysing the documents provided by the Member States and by visiting Member States in order to check the implementation of the Regulation on the spot (see the response on paragraph 4.10).

Considering

— that post-payment checks provide an additional supplementary level of controls to the pre-payment checks (which for the majority of measures provide already reasonable assurance), and

— that the major part of the required minimum number of post-payment checks had been performed by the end of 2004, and

— that the Member States have communicated in their annual reports the number, value and nature of irregularities identified and the value of transactions tested,

the Commission had sufficient basis to take part of its assurance from the work performed (see also reply to paragraph 4.52).

Although the quality of reporting will be further improved, it is already of sufficient quality to provide assurance over the work performed.
4.52. Physical and documentary checks on goods under Regulation (EEC) No 386/90 at the time of export should cover at least 5% of most subsidised exports. The Commission carried out a programme of missions to seven Member States and provisionally found weaknesses in the execution of these checks (see paragraphs 4.11 to 4.14). It has not stated the degree of assurance to be gained from them.

4.52. The range of physical, pre- and post-payment checks available to Member State authorities is exhaustive and weaknesses in any one form of check must be evaluated in this context. Nevertheless, any control failures are subjected to financial correction under the clearance of accounts procedure. Thus the Director-General gains assurance from the clearance of accounts system as a whole. Subjects to be audited are selected based on an annual risk analysis on which the Court previously has commented positively, and it is from this total population of audits and their follow-up that the Director-General derives assurance.

4.53. While export refunds accounts for less than 10% of the CAP budget, in 2004, by value, they accounted for some 26% of CAP irregularities reported to the Commission under Regulation (EEC) No 595/91. The Commission should therefore improve its monitoring of the system of post-payment checks and state its findings on the execution of physical checks and the degree of assurance to be gained from them.

4.53. The Commission is already carrying out regular audits on specific aspects of post-payment checks concerning export refunds, as stated by the Court in paragraph 4.10(b).

Regarding physical checks, the Commission does not consider it appropriate to publish specific findings before they have been dealt with in the clearance of accounts procedure.

The disproportionate share of export refunds in CAP irregularities is at least partly due to average export refund payments being considerably higher than for other intervention measures and especially direct payments. Therefore irregularities for export refunds are more likely to exceed the 4 000 euro threshold for being reported under Regulation (EEC) No 595/91.

4.54. The Court found weaknesses in subsidies for dried grapes (Greece, also reported on in both 2002 and 2003 Annual Reports) and nuts (Spain).

4.54. The Commission has made and will continue to propose financial corrections for the deficiencies found concerning dried grapes.

Concerning nuts, the Commission will follow up these cases.

Conclusion and recommendations

Global conclusion

4.55. As in previous years, the Court found recurrent evidence that CAP expenditure, viewed as a whole, and drawing on all available sources of evidence, was still affected by significant errors. The Court recognises that different degrees of risk and weaknesses attach to the main categories of CAP expenditure.

4.55. The Commission concludes from this observation together with the points made under paragraphs 4.38 and 4.42 that for the agricultural expenditure managed and controlled by the IACS the situation is satisfactory, the risks identified by the Court being concentrated on the other CAP measures (see paragraph 4.57). At the moment IACS covers some 60% of CAP expenditure. It should be noted that the CAP reforms of 2003 and 2004 reduce the overall risk even further by extending the expenditure covered by IACS to around 80%.

As a general remark concerning the errors, the following should be noted: due to the tight timetable for the Court’s Annual Report, the Court’s conclusion on the individual cases is drawn before all Member States have replied to the Court’s findings. The Commission services, where necessary in collaboration with the Member States concerned, make a thorough analysis of the errors found by the Court, some of which do not lead to a clearance of accounts financial correction.

THE COURT’S OBSERVATIONS

4.56. The result of the Court’s work shows that, where properly applied, IACS (25 000 million euro) is an effective control system to limit the risk of irregular expenditure. Even though the elements that constitute IACS are formally in place in Greece, there are serious deficiencies in the functioning of the system with the result that the system is not reliable (1 000 million euro).

4.57. All other expenditure (19 500 million euro) which cannot be checked by IACS poses greater risk because the systems available to control them are not as effective.

THE COMMISSION’S REPLIES

4.56. The Commission shares the Court’s opinion that IACS is an effective control system to limit the risk of irregular expenditure.

Important weaknesses in the application of the system still exist in Greece, and these are followed up in the framework of the action plan consisting of an enhanced clearance of accounts audit programme for Greece, see also the reply to paragraph 4.8.

4.57. Even if the other expenditure poses a greater inherent risk, it should be noted that many of these schemes are managed in an IACS compatible way. Furthermore, this expenditure is subject to an additional layer of controls, i.e. the ex post controls pursuant to Regulation (EEC) No 4045/89.

Post payment checks

4.58. In view of the limited scope of the Commission’s monitoring action (involving visits to only 3 Member States to check full implementation in 2004) and of the backlog of incomplete checks, and given that weaknesses were already reported in the Court’s 2003 Annual Report (31), the Court cannot agree with the basis of the Commission’s statement in the Annual Activity Report 2004 that ‘Based on the information received and based on on-the-spot missions undertaken annually in order to evaluate the application of the Regulation it can be concluded that the controls pursuant to Regulation (EEC) No 4045/89 provide reasonable assurance as to the compliance with Community legislation of the expenditure in the sectors covered by the Regulation’.

4.58. As outlined in paragraph 4.10, the Commission is of the view that it has fulfilled all of its obligations as set out in Regulation (EEC) No 4045/89. Risk analysis proposals, annual programmes, annual reports, mutual assistance requests and replies, overviews of payments to undertakings established in other Member States and other forms of communication/reporting have been received and analysed. In addition to the three missions mentioned by the Court, another six are scheduled in 2005. Furthermore, regular missions covering specific aspects of Regulation (EEC) No 4045/89 regarding export refunds have been taking place since 2001. All questions or enquiries from Member States have been replied to.

Considering the above reasons as well as the following:

— that post-payment checks provide an additional supplementary level of controls to the pre-payment checks (which for the majority of measures provide already relatively complete assurance), and

— that the major part of the required minimum number of post-payment checks had been performed by the end of 2004, and

— that the Member States have communicated in their annual reports the number, value and nature of irregularities identified and the value of transactions tested,

the Commission is of the view that Regulation (EEC) No 4045/89 checks contribute to the overall assurance on the legality and regularity of the 2004 expenditure.

4.59. The reports of the certifying bodies provide assurance that financial information provided by the paying agencies (and incorporated in the Commission's accounts) is materially accurate. The Commission's financial clearance decision for 2004 was, in general, soundly based on the work of the certifying bodies on the reliability of accounts. It has dealt correctly with decisions to defer approval of the accounts (see paragraphs 4.19 to 4.21).

4.60. The work of the certifying bodies, however (as defined by Regulation (EC) No 1663/95) is not designed to, and does not, provide direct assurance that the information supplied by claimants, and used by paying agencies to calculate the payment due, is correct and, therefore, that payments are legal and regular. The Court maintains its view that certification, or any other part of the control chain, should cover the legality and regularity of expenditure at the level of beneficiaries, current arrangements provide limited assurance to the Court as certifying bodies do not generally check beneficiaries of aid.

4.60. As already indicated in the response to the Court's annual report for 2003, the set-up and accreditation of the Member States' paying agencies, the annual certification procedure and the application of the various management and control systems, including IACS, permit a great deal of reliance to be placed on the control over expenditure declared.

In order to further improve the overall system, the new basic regulation on the financing of the common agricultural policy provides that the heads of paying agencies shall henceforth sign an ex post declaration of assurance on the legality and regularity of their expenditure.

4.61. Commission's conformity decisions, whereby it can exclude expenditure from Community financing, were not complete for any year later than 1998 (see paragraph 4.24).

4.61. As indicated in the response to paragraph 4.24, the situation in June 2005 was that 94.3 % of the audits carried out in 2001 (which allow financial corrections back to 1999) and 78.7 % of the audits carried out in 2002 (which allow financial corrections back to 2000) have been closed.

Annual activity report of the Director-General for Agriculture

4.62. Notwithstanding improvements made in the report, it provides limited coverage of, and assurance on the legality and regularity of 2004 expenditure. As the report cannot indicate to what extent expenditure might be affected by subsequent financial corrections, it limits the assurance which the Court can derive from it. The report does not assert that irregular payments are recovered through the clearance of accounts procedure and through the recovery procedures in the member states.

4.62. The Annual Activity Report and the annual declaration of DG AGRI are based on the assurance which can be gained from the systems in place and their functioning. The activity report explains the whole chain of controls of CAP expenditure under shared management. This system gives reasonable assurance that by the end of the whole process, possible serious shortcomings will have been detected and appropriate financial corrections will have been imposed on Member States. This is the basis which allows the Director-General to provide the Statement of Assurance.

By the time of signing of the annual declaration, all expenditure under shared management may still be subject to clearance of accounts audits and possible financial corrections. This is inherent to the system of shared management, in conformity with EU legislation, and should not be seen as a limiting factor for the Director-General for providing the annual declaration.

The assurance will be further consolidated with the annual statements of paying agencies provided in the new CAP Financial Regulation as well as by other measures proposed by the Commission in its communication COM(2005) 252 final on a road map to an integrated internal control framework.

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(32) Materiality was set at 1 % of expenditure declared by the paying agency. Certifying bodies used statistical sampling to examine 26 000 transactions at paying agency level.

THE COURT'S OBSERVATIONS

Recommendations

4.63. The Commission should seek to:

(a) improve the checks of CAP spending in those areas where significant shortcomings persist;

(b) as indicated last year, improve the format of reporting of the results of all supervisory systems. In particular make post-payment checks a more valuable tool in the identification of irregular CAP payments by addressing the deficiencies in the data requested from Member States, notably by reporting on value of transactions tested and irregularities detected by budget heading (see paragraph 4.10(a)). It should assess the quality of checks performed, and if appropriate, programme further visits to Member States (see paragraph 4.10(b)) and take appropriate measures to ensure the completion of planned programmes (see paragraph 4.10(c));

(c) ensure that control and supervisory systems provide assurance on the legality and regularity of the transactions at the level of the final beneficiary;

THE COMMISSION'S REPLIES

4.63.

(a) The Commission is committed to address continuing shortcomings still existing, such as the application of IACS in Greece. In this context, it should be noted that the CAP reforms of 2003, and for Mediterranean products of 2004, reduce the overall risk by extending the expenditure covered by IACS.

(b) First, the Commission accepts that reporting in accordance with Regulation (EEC) No 4045/89 could be improved and will introduce a proposal to amend Commission Regulation (EC) No 4/2004 to this effect. New tables will be introduced for communication on the value of transactions tested and of irregularities detected so that their number, value and nature can be clearly identified and analysed.

Secondly, the Commission is already assessing the quality of checks performed on a regular basis. In the course of 2001 to 2004, 27 missions that included the review of Regulation (EEC) No 4045/89 controls on export refunds were carried out by DG AGRI. The Commission took, following the Court's 2003 Annual Report, further measures to improve the monitoring of checks performed by programming, with regard to general aspects, three missions in 2004 and six missions in 2005 and, with regard to conformity issues, 10 missions in 2005.

Finally, new ways of identification and reporting of the backlog are foreseen (in the proposal to amend Commission Regulation (EC) No 4/2004) so that the checks not completed during the reporting period can be followed up in the reports in respect of following reporting periods. The Commission is, in this respect, also investigating the reasons for the failure to complete in due time control programmes in certain Member States and, where appropriate, will request clarification from Member States.

(c) The Commission is of the opinion that the existing management and control systems, if properly placed in the context of a multi-annual process, already provide reasonable assurance on the legality and regularity of the transactions at the level of the final beneficiary. The whole process is divided into an annual financial clearance on the one hand and a multi-annual conformity clearance on the other, which allows the Commission to exclude expenditure from Community financing that has been effected less than 24 months prior to the Commission's written communication of the results of its audits to the Member State concerned.
THE COURT’S OBSERVATIONS

Against this background, reasonable assurance as regards the legality and regularity of the transactions carried out under shared management cannot be obtained on an annual basis from the audit work of the Commission services alone, but must be predicated on the premise that Member States fulfil their management and control obligations. Where Commission audits subsequently identify deficiencies, the risk of ineligible expenditure will be determined and appropriate financial corrections applied.

(d) soundly estimate the level of irregularities and ensure that it is recovered through the different procedures;

(d) As regards the requested estimation of the level of irregularities, the Commission considers the total financial corrections in respect of a given year, together with the sanctions imposed on final beneficiaries at national level, to give a valuable estimation of the overall level of irregular payments.

The recovery of sums lost as a result of irregularities falls under the responsibility of Member States. The Commission follows up on the national recovery procedures on the basis of Article 8 of Regulation (EC) No 1258/1999.

(e) distinguish in the declaration of assurance of the Director-General, on the one hand, expenditure which has been verified (and has been subject of corrections where necessary) for which the Director-General can give reasonable (or no) assurance and, on the other hand, expenditure which is the subject of further verification (and possible correction);

(e) The Commission considers that it would not be appropriate in the AAR to distinguish, as the Court suggests, between expenditure which has already been verified and expenditure which will be subject to further verification. Given the multi-annual nature of the conformity clearance process, such a distinction would be largely arbitrary; it would also prejudice the Member States’ right of defence in the context of the clearance of accounts procedure.

(f) continue to investigate the reasons why, for IACS checks on areas, tests performed on a random basis continue to show a higher level of error than those selected on the basis of risk analysis. It should also analyse the effects of the changes made in the risk analysis in 2004.

(f) Regulatory amendments introduced with effect from 1 January 2004 will improve the situation and the Commission continues to audit the issue as normal.

The effect described by the Court is limited to some Member States and is sometimes due to the classification of remote sensing controls as random. Furthermore, when expressed in terms of farmers with irregularities, the results from the risk-based selection are indeed more successful than those from the random selection.

However, it should be noted that with decreasing levels of irregularity, and effective 100% administrative checks, the difference in results achieved between random and risk-based on-the-spot checks is expected to be marginal.
NEW MEMBER STATES: TRANSITION

Accreditation of the EAGGF paying agencies in the new Member States

4.64. The acceeding countries were required to have established and accredited EAGGF paying agencies by 1 May 2004.

4.65. The new Member States had to designate a competent authority responsible for accrediting the paying agency. The body that carries out the accreditation review must report on the administrative and accounting conditions, including those adopted to protect the Community's interests regarding advances paid, guarantees obtained, intervention stocks and amounts to be collected. Based on this report the Member State’s competent authority decides whether to grant provisional or final accreditation.

4.66. Of the 11 paying agencies, seven have been granted accreditation (34), but two of them were accredited for a limited period of time (35) and four have provisional status.

4.67. The Commission has not verified whether these paying agencies meet the accreditation criteria. Expenditure for 2004 was negligible (19.5 million euro) but significant amounts are likely to be charged to the Fund in the 2005 EAGGF year. It is therefore important that the Commission completes its work as soon as possible.

4.68. As can be seen from Table 4.8, accreditation reports indicate that five paying agencies have attained a satisfactory level of compliance. Two agencies have significant weaknesses in two areas, while four are weak in at least four areas.

---

(34) Czech Republic, Lithuania, ARR (Poland), Slovenia and Slovakia.
(35) Estonia, Malta.
### Table 4.8 — Summary of weaknesses identified in the accreditation reports for the paying agencies in the new Member States (1)

<table>
<thead>
<tr>
<th>Member State</th>
<th>EAGGF Expenditure in 2004 (million euro)</th>
<th>Paying agency</th>
<th>Written procedures</th>
<th>Segregation of duties</th>
<th>Payment checks and procedures</th>
<th>Accounting procedures (2)</th>
<th>Computer security</th>
<th>Internal audit</th>
<th>Delegated Bodies (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>—</td>
<td>Cyprus Agricultural Payments Organization (CAPO)</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>4.70</td>
<td>SAIF (SZIF) State Agriculture Intervention Fund</td>
<td></td>
<td></td>
<td>No major problems</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>0.50</td>
<td>ARIB (PRIA) Agricultural Register and Information Board</td>
<td>×</td>
<td>×</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hungary</td>
<td>0.50</td>
<td>ARDA (MVH) Agricultural and Rural Development Agency</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Latvia</td>
<td>0.50</td>
<td>RSS (LAD) Rural Support Service</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lithuania</td>
<td>0.50</td>
<td>NPA (NMA) National Paying Agency</td>
<td></td>
<td></td>
<td>No major problems</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>10.80</td>
<td>ARMA (ARiMR) Agency for Restructuring and Modernization of Agric.</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>—</td>
<td>AMA (ARR) Agricultural Market Agency</td>
<td></td>
<td></td>
<td>No major problems</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malta</td>
<td>—</td>
<td>‘Paying Agency’ Dept. within MRAE</td>
<td></td>
<td></td>
<td>×</td>
<td>×</td>
<td>×</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>1.40</td>
<td>APA (PPA) Agricultural Paying Agency</td>
<td></td>
<td></td>
<td>No major problems</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td>0.10</td>
<td>AAMRD Agency for Agricultural Markets and Rural Development</td>
<td></td>
<td></td>
<td>No major problems</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


(2) Including advances and securities and debtors.

(3) Point 4 of the Annex to Commission Regulation (EC) No 1663/95 allows for the authorization function and/or the technical service (i.e. on farm inspection) to be delegated to other bodies under specified conditions.

Source: Reports on accreditation provided to the Court by the Competent Authorities.

SAPARD — Satisfactory supervision but some weaknesses in claims assessment

4.69. The Special Accession Programme for Agriculture and Rural Development (SAPARD) (36) aims to help the 10 beneficiary countries of central and eastern Europe (37) to deal with the problems of the structural adjustment in their agricultural sectors and rural areas and to contribute to the implementation of the common agricultural policy and related policies (see chapter 8).


(37) Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia, Slovakia, Bulgaria and Romania.
The Court's Observations

4.70. The contracting period for those countries which joined the EU on 1 May 2004 ended in 2004. Payments will, however, continue to be made for the projects contracted in the previous years. During this final contracting period (38), due to the low implementation rate in the first years (39), a high number of applications was processed in a short time. Consequently, the quality of these assessments and the related payment claims present a higher risk.

4.71. Each SAPARD country is required to provide the Commission annually with a certificate on the accounts and an audit report by a certifying body, which form the basis of the Commission’s annual clearance of accounts decision. On 28 September 2004 the Commission cleared the 2003 SAPARD accounts for seven countries (Czech Republic, Estonia, Latvia, Lithuania, Hungary, Slovenia and Slovakia) but postponed its decision on the accounts for Poland, Bulgaria and Romania. The Court’s review of the Commission’s decision does not give rise to any major finding.

4.72. The Court reviewed the Commission’s analysis of the annual implementation reports which the SAPARD countries are obliged to submit. This review showed that the legal deadlines for these analyses were not always respected.

4.73. The Court visited two SAPARD Countries, Hungary and Slovenia, to check a sample of payments for 20 projects and to review the procedure, descriptions and checklists used by the SAPARD paying agencies. Notwithstanding the errors found by the Court (see next paragraph), the SAPARD systems included the key concepts (segregation of duties, internal audit, etc.); procedures were well documented and the systems as described and accredited were generally working in practice.

4.74. The review of payments, covering the main measures implemented at the time of the audit, revealed the following weaknesses and errors although with minor financial impact some of which are similar to those found for other SAPARD Countries (40):

(a) some major business plan figures were not evidenced with supporting documentation;

The Commission’s Replies

4.70. During the transition period (from Sapard to post-accession programme), the Commission drew the attention of the new Member States to the importance of maintaining an adequate level of qualified staff for the management of the Sapard Programme. The Commission is aware of the potential risk, and will take it into account in its audits, but has so far found no evidence of a financial risk arising.

4.71. The Commission has requested supplementary audit work from the certifying bodies of the countries concerned. Once this assessment is finalised, and considered satisfactory, the Commission shall proceed with the clearance of those Sapard accounts.

4.72. The Commission is paying increased attention to the respect of deadlines.

4.73. For example in one SAPARD beneficiary Country due to the lack of staff and the unexpected huge number of the applications received 50 % of the applications remained unprocessed by the end of the deadline.

(38) Annual Report 2003, paragraph 8.47.
THE COURT'S OBSERVATIONS

(b) in the project file the evidence of the checks on the total eligible cost was inadequate;

(c) the work actually carried out by the authorities during the on-the-spot visits was not clearly evidenced or was not appropriate leading in one case to a payment for an investment only partially completed;

(d) errors of non-compliance with the three price offer procedure (*) (**) (1).

4.75. Some invoices for high value items, which were subsequently reimbursed by the SAPARD agency, were settled by the beneficiary in cash. It could not be established whether payments were actually made by the beneficiary. Cash payments are more difficult to evidence than other forms of payment and therefore present a higher risk.

4.76. On the basis of the audit work performed and excepted the findings in paragraphs 4.73 to 4.75), the Court reiterates the opinion (43) that the SAPARD supervisory and control systems generally worked in practice.

FOLLOW-UP TO PREVIOUS OBSERVATIONS

CMO in the Banana sector

4.77. In November 2002 the Court published a Special Report (44) on the CMO in the banana sector. The Court observed that the definition of the CMO's objectives and the description of the expected impact were not sufficiently clear, which made measurement of its impact and effectiveness difficult, and that it was impossible to form an opinion on the cost-effectiveness of the compensatory aid system. Weaknesses were also found in the documentation of aid payments and in import controls.

4.77. As it has already pointed out in its reply to the special 2002 Court report, it feels that the CMO objectives in the banana sector correspond to those laid down for the common agricultural policy in Article 33 of the Treaty and that the detailed description and quantification of the CMO objectives are comparable to those of other CMOs.

During preparations of the current CMO evaluation criteria the Steering Committee worked systematically and defined the objectives in detail.

A more thorough and, where necessary, a review of the CMO objectives will be based on the results of the impact analysis evaluation which the Commission is going to undertake in the second half of 2005.

(*) According to the Multi-Annual Financing Agreement (Section B, Article 4(2)(e)) the costs of any services, supplies and works costing more than a predetermined amount for which the beneficiary has not obtained quotations from at least three suppliers shall be considered as ineligible.

(**) Findings pointed out included the lack of three valid offers; offers coming from less than three suppliers; acceptance without justification of the bid which was not the cheapest.

(1) Annual Report 2003, paragraph 8.43.

4.78. The Court recommended that the Commission should carry out the in-depth evaluation of the CMO, and a full analysis of the risks, costs and benefits associated with various possible options in view of the transition to tariff-only system foreseen on 1 January 2006. The Council supported (45) the Court’s recommendations by expecting the overall evaluation to be completed by 2004, and the Commission undertook this task in its action plan for the 2001 (46) discharge procedure.

4.79. The overall evaluation had not yet been completed by the Commission at the time of the Court’s follow-up audit in April 2005. Consequently, the planned in-depth review of the aims and objectives of the CMO has not taken place since the Court’s Special Report in 2002. The delay in the evaluation has deprived the Commission of important management information allowing it to make an assessment of the cost-effectiveness of the compensatory aid, prevented it from evaluating the extent of the contribution of the Structural Funds measures to the CMO, and hindered an impact analysis of the aid measures for ACP producers.

4.80. The Commission reported to the budgetary authorities in February 2005 (47), as required by Article 32 of the framework Regulation (EEC) No 404/93 (48). However, the contents and analysis of its report were limited by the absence of the evaluation results, and it presented no proposals or alternatives on the operation of the Regulation.

4.81. In view of the transition to a tariff-only system in the EU’s banana imports foreseen to take place no later that 1 January 2006 (49), the Commission agreed to the Court’s recommendation that a thorough analysis of the impact of the transition on all the parties involved would be made at the time of the above-mentioned review exercise. In January 2005, the Commission notified the WTO of its plan to introduce a new common customs tariff of 230 euro/tonne (thereby replacing the existing tariff of 75 euro/tonne for quantities under the present quotas A and B up to 2 653 000 tonnes for countries other than the ACP countries). In March 2005, the EU’s four major trading partners requested WTO arbitration on the proposed new tariff. The arbitration process is ongoing.

4.78 and 4.79. The evaluation was launched in 2003 and the contract signed at the end of August 2004. The final stage of the evaluation report will cover the operation of the CMO and its impact including an assessment of the effectiveness and efficiency in support of Community producers. The evaluation report as well as the report of the Court of Auditors will be the basis for the planned impact study. In view of these details and the public debate which it intends to open, the Commission plans to present its proposals for reform to Parliament and to the Council in 2006.

4.80. Article 32 of Regulation (EEC) No 404/93, requires the Commission to present a report on the operation of the CMO to the European Parliament and the Council no later than 31 December 2004. Pending the finalisation of the evaluation study and international negotiations on the tariff rate to be applied to imports from 1 January 2006 onwards, the Commission thought it advisable to present a purely factual report.

(45) Council recommendation of 7 March 2003 on the discharge to be given to the Commission for execution of the Budget — SN 1376/03, Annex 7.


(49) Council Regulation (EEC) No 404/93, Article 16(1).
4.82. The banana aid scheme for Community producers grants one of the highest levels of support per hectare (in average over 8 800 euro/ha (50)). The Court reported that the cost of the tariff quota system has been two to three times greater to consumers than the total aid paid to EU producers. However, the delays in the evaluation have adversely affected the Commission’s undertakings vis-à-vis almost all of the Court’s observations, all the more important given the short time left before the mandatory introduction of the tariff-only system.

4.82. The Commission acknowledges that the evaluation has not been carried out according to the initial timetable.

Nevertheless, the Commission will have a sound evaluation which certainly will enliven the proposed discussions during the second half of 2005.

4.83. The Commission acted on the control weaknesses in compensatory aid identified by the Court by imposing financial corrections on the Member States concerned. However, in the follow-up assessment of its 2001 Action Plan (51), the Commission found that import control problems still prevailed and instructed the Member States to solve them. This is not in accordance with the Court’s recommendation and the subsequent Council conclusion that ‘the Commission, in consultation with the Member States, draw up instructions on the control procedures’.

4.83. In order to improve the control environment and to take account of the interest of the legitimate traders, the Commission is currently working on a proposal to amend the provisions for checks on the weight of fresh bananas released for free circulation in the Community. After discussions with the various Commission services involved, taking input from the Customs Code Committee meeting of 13 July 2005 and the views of banana traders, the Commission is preparing a proposal for adoption before autumn 2005.

4.84. Therefore, the Court repeats its recommendation that the Commission complete the announced in-depth review and re-examination of the CMO, and conduct the wide consultation with the Community’s producers, consumers and its major trading partners with the aim of better defining the objectives of the CMO and to improve its management.

4.84. Like the Court, the Commission considers it advisable to complete the CMO evaluation with an impact analysis which is to be launched in the second half of 2005.

Pre-financing of export refunds

4.85. Subsidies for the export of certain agricultural products (export refunds) are paid to exporters up to four months in advance of the date of export (pre-financed). The products concerned have to be placed under customs control and a complex system of checks put in place to ensure that goods for which refunds have already been paid are physically exported.

4.86. In its Special Report No 1/2003 the Court criticised pre-financing for being cumbersome, difficult to control and not serving its original purpose, which was to give preference to Community sourced agricultural products. It concluded by requesting that the Commission review the system and that consideration should be given to its removal. Subsequently, in its decision on discharge (52), the Parliament requested the Commission to present a proposal for the abolition of pre-financing by December 2004.


(52) European Parliament Decision on discharge 2002, Section III, point 149.
4.87. The Commission reacted to the Court’s recommendations by implementing two new regulations establishing horizontal rules, and a further three new sector specific regulations in relation to prefinancing (**53**). The regulations did not remove the system but only modified the implementing rules for a ‘test phase’.

4.88. Since the Court’s report, the amount of refunds paid under pre-financing has fallen from around 600 million euro to 188 million euro, or around 5 % of total refunds, due to a change in market conditions and a significant reduction in refund rates in the cereals sector.

4.89. In an internal analysis subsequent to the Court’s report the Commission accepts that alternatives to pre-financing could be applied to the cereals and processed beef sectors. The Commission however justifies retention of prefinancing for ‘fresh’ (in reality frozen) beef as a way of paying the higher special rate of refund applicable to such exports; that control over beef exports would be compromised by the removal of the scheme; and that in the absence of prefinancing an increase in refund rates would be necessary to compensate companies and therefore impose extra costs to the EU budget.

4.90. The Court considers that a system reliant on making payment up to four months in advance of export in order to pay a special refund rate to a limited number of commercial traders and achieve efficient control is fundamentally flawed.

4.91. The Commission has not complied with the Parliament’s request to present proposals to abolish prefinancing by the deadline set.

4.92. The system of support for cereal and potato starch production aims to secure the competitiveness of European non-food starch user industries, and is complemented by specific direct support measures for the production of potato starch. In its Special Report No 8/2001 the Court concluded that administrative controls were satisfactory on the whole in the Member States audited (54), but that they were not sufficiently supported by physical checks, and it made a number of recommendations to address weaknesses that it identified in the implementation of the support system.

4.92. As not every measure can be audited every year, the Commission’s audits are determined on an annual risk-analysis driven basis. The Special Report of the Court dates from July 2001. As a result of the risk analysis based on a variety of risk factors including findings of the Court, the audit work programme for 2004 for clearance of accounts which was established in 2003 did envisage an enquiry into potato starch. During the audit missions carried out in 2004, the issues raised by the Court were also addressed. Clearance procedure for both audits is progressing as scheduled and for the time being at the stage of the bilateral procedure.

4.93. In the context of the 2000 discharge procedure, the Council (55) recognised that the starch support scheme did not present any major difficulties, and supported the majority of the Court’s recommendations. The European Parliament required in particular that the Commission define predictable and transparent criteria for the calculation of production refunds for potato and cereal starch (56).

4.93. The recommendations of the Parliament concerning the calculation of production refunds have been followed up by the Commission. Parameters and the calculation method used for the calculation of the production refunds for cereal and potato starch are specified in Commission Regulation (EC) No 1548/2004.

4.94. An evaluation (57) in 2002 addressed the lack of information and analysis of production refunds on the competitiveness of the EU non-food starch industry, and on the impact of direct support on the incomes of starch potato producers noted by the Court, and served as the basis for modifications to the support scheme in the context of the CAP reform. The 2003 CAP reform left the scheme components essentially unchanged, but allowed for partial decoupling of direct aid to starch potato producers.

4.94. In its proposals for the CAP reform, the Commission proposed a full decoupling of potato starch payment as well as the abolition of the minimum price paid to the producers. However, the Council favoured only a partial decoupling of the direct aid of 40 %.

4.95. As recommended by the Court, from September 2004, the Commission simplified and clarified its method for calculating the monthly production refund. Apart from this, few other recommendations were taken on board by the Commission:

(a) checks made by national authorities on the potato starch manufacturers have not yet been clearly defined by the Commission, in particular as that the number of potato starch producers has increased from 17 (EU-15) to 39 (EU-25);

4.95. (a) The Commission carried out audits in 2004 to Germany and the Netherlands allowing the clarification of a number of issues within the clearance of accounts procedure.

In addition, within the reform, plausibility checks with areas planted have been imposed as of 2004 which should further enhance the control system.

(54) The Court audited the systems in three Member States that account for 70 % of expenditure (Germany, France and the Netherlands).
(55) Council recommendation of 5 March 2002 on the discharge to be given to the Commission for execution of the 2000 Budget — SN 1651/02.
THE COURT’S OBSERVATIONS

(b) there is no reliable data on the structural disadvantage suffered by potato starch producers compared to cereal starch producers, therefore the compensatory premium has remained unchanged since 1995.

(b) Given the oligopolistic structure of the potato starch industry, the companies regard their cost structure as highly sensitive and consequently keep them confidential. The Commission has therefore only limited access to information regarding the structural disadvantage of potato starch producers. As, in addition, there are no official price quotations for different varieties of starch like stock exchange quotations, the Commission had no basis for proposing a change of the compensatory premium, subsequently maintaining it unchanged.

PRINCIPAL OBSERVATIONS IN SPECIAL REPORTS

Forestry measures within rural development policy (58)

4.96. The Court’s audit led to the following conclusions about forestry measures financed by rural development funds:

(a) programme objectives are often contradictory and it is difficult to monitor how far they are achieved;

(b) management is shared between the Commission and the Member States. There is no clear responsibility for assessing the extent to which the financed projects contribute to the achievement of the EU forestry strategy;

(c) contrary to the requirements of the relevant regulation, forestry measures are frequently not based on national or sub-national forest programmes;

4.96. (a) The approach adopted since 2000 following the rural development Regulation (EC) No 1257/1999, is consistent with the EU Forestry Strategy, which provides the overall reference framework and principles (sustainability and multifunctionality) for forestry actions in the EU. For the future programming period, the Commission has introduced a more strategic approach for rural development and has set out in its strategic guidelines the EU priorities for its three policy axes (competitiveness, sustainable land management and the wider rural economy).

(b) The link between the Forestry Strategy and the individual projects co-financed by the EAGGF funds is ensured via the Rural Development Programmes (RDPs). The Commission verifies that programmes are in line with the Forestry Strategy. The national or regional authorities approve the individual projects on basis of the RDP.

The contribution to the achievement of the EU Forestry Strategy is assessed for each Rural Development Programme in the evaluation reports prepared by the Member States and summarised by the Commission. The Commission proposed in July 2004 (COM(2004) 490 final) to reinforce the evaluation requirements for the future rural development framework.

(c) At the beginning of the present programming period only few Member States had developed national forest programmes. In the absence of such programmes, it seemed justified to accept RDPs or OPs as equivalent instruments, a possibility which was provided for in Regulation (EC) No 1257/1999. However, Member States made progress over the last years in the formulation and implementation of their national forest programmes.

THE COURT’S OBSERVATIONS

(d) the system in place for implementing forestry measures is complex, creating difficulties for both managing authorities and beneficiaries. Weaknesses found included unclear project selection criteria, weak on the spot checks of claims, and unsatisfactory control procedures for public contract tendering;

(e) there is a risk that afforestation measures by municipalities will fail at a later stage: municipalities do not receive aid for the maintenance of seedlings and young plantations;

(f) increasing woodland by grant-aided afforestation of agricultural land is very expensive, mainly due to compensation for loss of agricultural income over a period of 20 years. The results could have been obtained more cheaply.

THE COMMISSION’S REPLIES

(d) The Commission is aware of the fact that the system is complex and has consequently proposed significant simplifications for the period post 2006 (COM(2004) 490 final). A single funding and programming system will remove the need to comply with different rules for different funds.

The Commission audit services verify the selection systems on the basis of guidelines. Non-transparency or non-objectivity entails recommendations addressed to the Member State and in some cases lead to financial corrections. The Commission audit services pay particular attention to the respect of proper procedures for public contract tendering.

(e) There is a certain responsibility of municipalities to maintain their own forests. The authorities approving projects should require sufficient evidence from the municipalities that the maintenance work is ensured.

(f) Afforestation of agricultural land does indeed appear to be expensive but is justified as a long term investment in ecological stability and renewable natural resources.

The loss of income over a considerable number of years from the land planted with forest is the biggest cost to the farmer entering the scheme. Therefore, long-term compensation is necessary for afforestation of agricultural land to be attractive to farmers. Nevertheless, in its initial proposal for the post 2006 Rural Development framework, the Commission suggested to limit the compensation for income loss to 10 years. A compromise was reached with the Member States on 15 years.

4.97. The Court recommended that the Commission should review various aspects of the support scheme. In particular the Commission should reconsider how aid for afforestation can be better targeted, at a lower cost, taking into account changing public needs and the fact that the emphasis of Community legislation is now on environmental benefits.

4.97. The proposals for the post 2006 Rural Development framework contain several provisions for better targeting of the measure (e.g. strategy, designation of areas) and cost-efficiency (e.g. reduced aid ceilings, shorter duration).
4.98. Agri-environment support (AE) is paid to farmers who undertake to farm in a manner that goes beyond usual good farming practice and is deemed environmentally beneficial. The objective of the Court’s audit was to assess whether the Commission has adequate assurance that the farming practices and techniques for which AE is paid are verifiable and properly verified, and thus that the recipients of AE payments comply with their obligation to farm in an environmentally-friendly manner.

4.99. The audit found significant weaknesses in the control arrangements for AE expenditure, at both Commission and Member State level. The Court concluded that the verification of agri-environment measures is far more resource-intensive than verification of expenditure on CAP market support and other rural development measures, and can rarely lead to reasonable assurance at a reasonable cost. The Court recommended that the Commission, Council and Parliament should consider, for AE in the new expenditure programming period commencing in 2007, how to take into account the principle that if a measure cannot be adequately checked, it should not be the subject of public payment.

4.98 and 4.99. The Member States have systems in place to control agri-environment measures and these are checked in all Member States. Nevertheless, weaknesses in the implementation of the control systems exist. The Commission’s Clearance of Accounts service is, in 2005/2006, conducting an audit programme to verify the control of agri-environment measures in Member States.

A comparison of resource requirements between agri-environment measures and those of first pillar measures should be seen in a wider context. The resource requirements for AEM have to be judged in relation to the objectives pursued. The Commission agrees that the control of agri-environment measures is labour-intensive and costly. A system which provides a sufficient level of control while remaining proportionate is what is needed for the agri-environment measure, which the Commission deems to be a central element of the CAP, and essential for delivering environmental integration.

For the next programming period, the Commission has proposed a control system which will be, to the extent possible, aligned with control systems related to cross-compliance that Member States have to set up for first pillar payments (cross-compliance).

In addition, the Commission has proposed a clearer allocation of responsibilities between Member States and Commission thus reinforcing the principle of shared management. It is proposed that the roles and responsibilities under shared management will be further clarified as submitted by the Commission in its communication COM(2005) 252 final on a roadmap to an integrated internal control framework.
### ANNEX 1

**Evolution of key observations – Agriculture**

<table>
<thead>
<tr>
<th>2003 and years before</th>
<th>The Commission's replies</th>
<th>2004</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Internal control standards</strong></td>
<td>The report notes that 14 of the internal control standards had been fully implemented by 31 December 2003. By February 2004 only four remained to be partly implemented (4.23).</td>
<td>No answer</td>
<td>DG AGRI's 2004 self-assessment concluded that all standards and baseline requirements had been met (4.28(a) and 4.33). The Court examined the implementation of eight standards and found that four of them showed room for improvement (4.34).</td>
</tr>
<tr>
<td><strong>Area aid schemes</strong></td>
<td>The overall rate of error found in random checks is 2.4%, compared to 1.5% for checks selected on the basis of an evaluation of risk (4.26). For some Member States it is remarkable that tests performed on a random basis show a higher rate of error than those selected on the basis of an analysis of risk (4.27).</td>
<td>The IACS Regulation has been amended as regards risk analysis, especially in introducing an obligation for Member States to review annually the efficiency of the risk factors used (4.26 and 4.27).</td>
<td>As in previous years and for some Member States risk-based transactions proved to have a lower rate of error than randomly selected transactions (4.37).</td>
</tr>
<tr>
<td><strong>Animal premium schemes</strong></td>
<td>Overall, the amount of error found by IACS inspections of animals continues to show considerable variation from year to year and from Member State to Member State (4.32).</td>
<td>As indicated in point 4.11(d) the inspection statistics are under scrutiny and subject to audit as part of the annual work programme (4.32). (See also paragraphs 4.11 and 4.12)</td>
<td>Statistics for animal premiums are still less reliable than the equivalent statistics for area aid applications (4.39).</td>
</tr>
<tr>
<td><strong>Subsidies paid on the basis of quantities produced</strong></td>
<td>(a) in Greece, staff in regional offices did not always have access to the IACS database, which is an obstacle to effective on-site checks (4.35(b)). (b) neither Greece nor Spain had a functioning olive oil GIS for the period relevant to payments made in 2003, and Spain failed to perform the number of on-site inspections required to compensate for this (4.37).</td>
<td>IACS's shortcomings in Greece are taken into account in the context of the clearance of the accounts. (b) the olive oil GIS is one element of the system of checks on production aid for olive oil and has only been obligatory since the 2003/04 marketing year (4.37).</td>
<td>Transactions concerning olive oil show a number of deficiencies: (a) in Greece some claims could not be verified as the parcels declared were not at the location indicated; (b) Greece still did not have a functioning olive oil GIS for the period relevant to payments made in 2004; (c) in Greece cases were found of producer organisations failing to make the necessary checks, for example on the disposal of olive oil; (d) in Andalusia, incorrect calculations for the application of sanctions for olive growers who had declared more olive trees than recorded in the GIS (4.44).</td>
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<td>A key part of the agencies' work relates to checks on olive mills. Where the agencies find discrepancies at the mills they may propose a range of penalties, the most serious being to remove the mill from the approved list. In 2002 (checks affecting 2003 expenditure) the agencies proposed this course of action at one in 10 of the mills inspected. In practice, ministries of agriculture of the Member States often impose a lesser penalty (4.39).</td>
<td>The Commission oversees the quality of the monitoring by Member States of the work of the control agencies (4.39).</td>
<td>The agencies work includes checks on olive mills. Where they find errors and weaknesses the agencies may propose penalties, the most severe being the withdrawal of approval. Checks on mills in 2003 (affecting payments in 2004) led to the agencies proposing the revocation of the authorisation of 9% of mills visited. However these proposals are often not implemented by authorities in the Member States (4.45).</td>
</tr>
<tr>
<td>Other expenditure</td>
<td>2003 and year before</td>
<td>The Commission's replies</td>
<td>2004</td>
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<tr>
<td><strong>Observations</strong></td>
<td><strong>The Commission's replies</strong></td>
<td><strong>Observations</strong></td>
<td><strong>Recommendations</strong></td>
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<tr>
<td>For the checks carried out under the requirements of Regulation (EEC) No 4045/89, the Court found that:</td>
<td>(a) According to the Member States' annual reports the number of scrutinies completed was 2 469 which is 63 % of the 3 907 checks planned for the period.</td>
<td>(a) the existing regulation does not require coordinating bodies to present statistics in a format which permits meaningful analysis;</td>
<td>The Commission should take the necessary steps to standardise the various statistics and data provided and so make them comparable. The Commission ought also to intensify its scrutinies in the Member States and be more vigilant as regards observance by them of the time limits for completion of their inspection programmes (4.10 and 4.51).</td>
</tr>
<tr>
<td>(a) coordinating bodies in the Member States generally prepared scrutiny plans in accordance with the Regulation, but only half of checks planned for the period were complete at the end of 2003;</td>
<td>(b) The Commission will take these elements into consideration in its future work in relation to Regulation (EEC) No 4045/89 controls.</td>
<td>(b) in 2003 the Court concluded that only one in three post-payment checks for 11 Member States was wholly satisfactory. The Commission's response in 2004 has been to visit three Member States, the first visits since 2001;</td>
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<td>(b) one fifth of scrutinies examined by the Court were wholly unreliable;</td>
<td>(c) Information received is analysed and treated by the Commission services in order to provide elements of comparison between Member States.</td>
<td>(c) the delays in completion of Member States' annual programmes of post-payment checks persist. At the end of 2004 almost 40 % of the checks planned had not been completed.</td>
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<td>(c) the annual reports by the coordinating bodies do not present statistics on the results of scrutinies in a format which permits meaningful analysis and comparison;</td>
<td>(d) Such programmes of inspections have taken place in previous years based on risk analysis and another round is currently being carried out (4.15).</td>
<td>(d) Given that the data does not provide for analysis by amount or by type of expenditure, it is not possible to draw conclusions on the significance and cause of the variation in the reported frequency of irregularity (4.10).</td>
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<td>(d) the Commission had not put in place a programme of inspections to ensure the effectiveness of checks carried out (4.15).</td>
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<td>(See also paragraph 4.51).</td>
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<tr>
<td>(See also paragraph 4.46(a)).</td>
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<td>For the checks of export refunds carried out under Regulation (EEC) No 386/90, the Court found that all Member States reported the number of checks performed to the Commission, but several did not communicate the number of errors detected. The results do not indicate the amount of subsidy claims rejected, nor the type of export refunds most affected (4.46(b)).</td>
<td>The Commission has already taken steps to start collecting data on the financial volume of the exports subject to physical checks (4.46(b)).</td>
<td>The Commission was unable to provide information on the value of transactions physically checked and the value of irregularities detected. During 2004 the Commission adopted a regulation requiring Member States to report this information with effect from the 2005 report. The Court hopes that this regulation will effectively remedy these deficiencies (4.13, 4.52 and 4.53).</td>
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<tr>
<td>The Court continues to find serious errors for dried grapes (Greece), reported on in the 2002 Annual Report (4.45).</td>
<td>The Commission has and will continue to propose financial corrections for deficiencies found in subsidies for dried grapes (4.45).</td>
<td>The Court continues to find serious errors in subsidies for dried grapes (Greece, reported on in both 2002 and 2003 Annual Reports) (4.54).</td>
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<td>The Commission ought to take action in particular in connection with the clearance-of-accounts procedure, while making sure that any regional derogations from the conditions of minimum yield and production are properly justified (4.54).</td>
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### Rural development

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<td>Schemes of this kind frequently have relatively complex eligibility conditions which sometimes need to be checked over several years (4.41).</td>
<td>The errors highlighted by the Certifying Bodies in respect of rural development expenditure will be followed up in the framework of the clearance of accounts procedure and financial corrections will be proposed if they are found to imply a risk for the Fund (4.42).</td>
</tr>
<tr>
<td>The certifying bodies have qualified their audit opinion on the accounts of three agencies which specialise in rural development measures. Errors affecting rural development expenditure are included in the audit qualification of a further five agencies (4.42).</td>
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### ANNEX 2

#### IACS monitoring elements

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<td>2</td>
</tr>
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<td>PT</td>
<td>Algarve/MAPA</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>UK</td>
<td>Scotland, Second</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>DE</td>
<td>Saxony</td>
<td>12</td>
<td>13</td>
</tr>
<tr>
<td>DE</td>
<td>Thuringia</td>
<td>16</td>
<td>17</td>
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</table>

Note: IACS is still not reliably implemented in Greece (see paragraph 4.56).

**Member State**
- **ES**: Cantabria y León
- **PT**: Algarve/MAPA
- **UK**: Scotland, Second
- **DE**: Saxony, Thuringia

**Administrative procedures**
- 1: Inadequate evaluation of effectiveness of individual risk criteria. Although Commission Regulation (EC) No 118/2004 of 23 January 2004 makes this obligatory only from campaign year 2004 (payment year 2005) the ECA considers this evaluation to be an essential element of risk analysis. Some Member States do not analyse significant errors.
- 2: Quality control procedures and results not evaluated, records of initial remote sensing control results poorly documented.
- 3: Anomalies relating to data on animal movements on the bovine database, discrepancies between regional and central bovine databases.
- 4: Permanent ineligible features of parcels established during inspections are not fed into the database for use in future administrative cross-checks.
- 5: Inefficient quality control over remote sensing control failures. 6 of 8 parcels remeasured by the auditors did not confirm original remote sensing results.
- 6: Bovines arriving from other Member States for direct slaughter are not recorded on the bovine database.
- 7: Information extracted from the bovine database for use during inspections was found incomplete (for slaughter premium inspections) or out of date (general to all inspections).
- 8: Although not provided in EU regulations, area tolerances (2 % or maximum 2 hectares) are applied for administrative checks.
- 9: Overpayment of extensification premiums due to missing payments before completion of remote sensing.
- 10: There was a high number of errors in data capture if inspection results inside 47 % of all inspection reports reviewed. More than 48 hours prior notice was given in 23 % of bovine and 40 % of sheep inspections.
- 11: The number of inspections carried out was overstated (control rate reported was 13.2 % instead of 11.3 %).
- 12: Parcel register not systematically updated. Inefficient quality control over delegated bodies.
- 13: Inefficient monitoring of corrections to be made to the bovine database in order to resolve discrepancies between the results of on-the-spot inspections and the data in the bovine database.
- 14: More than 70 % of animal inspections were concentrated to the area aid remote sensing control window. Risk analysis did not take account of all risk parameters provided for in the EU legislation. No evaluation of effectiveness of risk analysis.
- 15: Minor difference between data submitted to the Commission and underlying data provided to the auditors.
- 16: High error rates accepted for data capture, claims are not automatically blocked by the computer system when selected for inspection, inadequate audit trail for cases treated as obvious errors.
- 17: Claims files are not automatically blocked in the computer system when selected for inspection, inefficient monitoring of corrections to be made to the bovine database in order to resolve discrepancies between the results of on-the-spot inspections and the data in the bovine database.

**Animal premium**
- 18: Greece, Opekepe
- 19: Works well, few or minor improvements required
- 20: Bovines, but improvements are necessary
- 21: C
- 22: 19
- 23: 21
- 24: 22
- 25: 23

Source: Court of Auditors, reports of paying agency IACS systems.
CHAPTER 5

Structural measures

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INTRODUCTION

Structural measures funding and objectives

5.1. Structural measures support the economic and social development of the European Union and its applicant countries. The measures are financed by the four Structural Funds: the European Regional Development Fund (ERDF), the European Social Fund (ESF), the European Agricultural Guidance and Guarantee Fund, ‘Guidance’ section, (EAGGF-Guidance) and the Financial Instrument for Fisheries Guidance (FIFG); and by the Instrument for Structural Polices for Pre-accession (ISPA) and the Cohesion Fund.

5.2. The Structural Funds co-finance socioeconomic development programmes (1) in the Member States. The Cohesion Fund co-finances projects to improve the environment and develop transport infrastructure in Member States whose per capita gross national income is less than 90 % of the Union average (2). ISPA supports the development of transport and environmental protection projects in applicant countries (3).

5.3. Each programme or project must be approved by the Commission and is accompanied by an indicative financial plan which specifies the amount of Community aid and the contribution by the Member State or applicant country. The assistance is provided in the framework of multiannual periods corresponding to the Financial Perspectives. Expenditure in the Community budget in 2004 mainly concerns ongoing payments for the current programme period (2000 to 2006) and final payments for the previous programme period (1994 to 1999).

5.4. For the 1994 to 1999 period the Commission approved 1 104 Structural Funds programmes and 920 Cohesion Fund projects. For the 2000 to 2006 period there are 606 Structural Funds programmes, 1 163 Cohesion Fund projects and 72 ISPA projects (4). The measures implemented can vary widely. Examples are major infrastructure projects (ERDF, Cohesion Fund and ISPA), work training for individual persons (ESF), marketing of agricultural products (EAGGF-Guidance) or the adjustment of the fishing effort (FIFG).

(1) Programmes may be national or regional and are made up of a series of measures, under which potential beneficiaries may apply for funding.
(2) In EU15: Greece, Spain, Ireland (up to 31.12.2003) and Portugal. Since 1 May 2004 also: Cyprus, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia.
(3) In 2004: Bulgaria and Romania. For the new Member States, former ISPA projects were transferred to the Cohesion Fund.
(4) In Bulgaria and Romania.
Graph 5.1 — Breakdown of commitments by budgetary area in 2004

Total commitments — 40 834 million euro

- Objective 1: 62%
- Objective 2: 9%
- Objective 3: 9%
- Cohesion Fund: 14%
- Community Initiatives: 5%
- Other: 1%

(1) Excluding ISPA.
Source: 2004 Commission report on budgetary and financial management.

Graph 5.2 — Breakdown of payments by budgetary area in 2004

Total payments — 34 198 million euro

- Objective 1: 63%
- Objective 2: 13%
- Objective 3: 9%
- Cohesion Fund: 8%
- Community Initiatives: 6%
- Other: 1%

(1) Excluding ISPA.
Source: 2004 Commission report on budgetary and financial management.
5.5. For the 2000 to 2006 period total budgeted expenditure for the Structural Funds is 230 463 million euro, for the Cohesion Fund 28 154 million euro and for ISPA 6 149 million euro (5) (figures at 2004 prices). Most of the expenditure is directed towards the three priority policy objectives of the Structural Funds:

— Objective 1: promoting the development and structural adjustment of regions whose development is lagging behind;

— Objective 2: supporting the economic and social conversion of areas facing structural difficulties;

— Objective 3: supporting the adaptation and modernisation of policies and systems of education, training and employment.

5.6. For the 1994 to 1999 and previous programme periods, contributions from the Structural Funds (6) were paid in the form of advances (based on progress achieved with implementation, as evidenced by the expenditure declarations submitted by the Member States) and final payments, the latter constituting the ‘closure’ of the programmes. Community financing in the 2000 to 2006 programme period takes the form of a single initial advance payment of 7 % (raised to 16 % for the new Member States) of the total contribution to the programme, followed by reimbursements of expenditure declared by the Member States on a regular basis each year and a single final payment at closure of the programme. The periodic reimbursements are called ‘interim payments’. For the Structural Funds, each payment by the Commission concerns a given Fund and a given programme.

5.7. Structural measures are subject to ‘shared management’. This means that, while the Commission implements the Community budget on its own responsibility, management and control of the measures is shared by the Commission (7) and the Member States. Thus, the Member States are responsible in the first instance for the management of operations and control of expenditure and for ensuring the correctness and legality of the

(5) 2 787 million euro (in current prices) of this figure, representing the allocations of ISPA funding to eight of the new Member States over the period 2000 to 2003 are, under the Accession Treaty, now managed as Cohesion Fund appropriations.

(6) For the Cohesion Fund and ISPA, the payments system is based on a single advance, interim payments corresponding to actual expenditure, and a final payment.

(7) Four Directorates-General of the Commission are concerned: the Directorate-General for Regional Policy (DG REGIO) for the ERDF, the Cohesion Fund and ISPA; the Directorate-General for Employment, Social Affairs and Equal Opportunities (DG EMPL) for the ESF; the Directorate-General for Agriculture and Rural Development (DG AGRI) for EAGGF-Guidance and the Directorate-General for Fisheries and Maritime Affairs (DG FISH) for the FIFG. DG REGIO has a coordinating role for matters concerning all the funds, such as the development of management initiatives or the issue of technical guidance to Member States.
underlying transactions through the functioning of systems veri-
ified by national audit bodies. The Commission seeks to obtain its 
assurance through the certification by the national paying author-
ity of the expenditure declared and the statement (the winding-up 
declaration) by the independent audit body at closure, through 
the annual control reports of the Member States and through the 
audit work of its own services to check the effectiveness and com-
pliance of the national systems.

Management and control systems for structural measures: the main 
regulations and processes

5.8. The basic elements required of the management and control 
systems for the 1994 to 1999 period are set out in the Financial 
Regulation (9) and the framework regulations (9). Commis-
sion Regulation (EC) No 2064/97, which entered into force in 
November 1997, introduced a number of specific requirements 
for the management and control arrangements for structural 
measures expenditure for the 1994 to 1999 programme period (10). The principal points are:

(a) the requirement for the Member States to put in place man-
gagement and control systems which provide satisfactory cer-
tification of the validity of claims for payments (the expen-
diture declarations) and including in particular;

(i) a sufficient audit trail, permitting the reconciliation of 
declarations of expenditure made to the Commission 
and the accounting records in the Member States, as well 
as the identification of the allocation of the Community 
funding:

(9) Financial Regulation applicable to the general budget of the European 

(10) Commission Regulation (EC) No 2064/97 of 15 October 1997 estab-
lishing detailed arrangements for the implementation of Council 
Regulation (EEC) No 4253/88 as regards the financial control by 
Member States of operations co-financed by the Structural Funds 
(OJ L 290, 23.10.1997, p. 1). The Cohesion Fund systems are gov-
THE COURT'S OBSERVATIONS

(ii) a minimum level of checks (at least a 5 % sample), additional to the day-to-day checks of operations, to verify the effectiveness of the management and control systems, the respect of Community requirements and the accuracy of the expenditure declarations;

(iii) at the closure of each programme, the presentation to the Commission by the Member States of a statement drawn up by a person or organisation functionally independent of the implementing service; this statement should summarise the conclusions of the checks made in the previous years and provide an overall conclusion as to the legality and regularity of the operations underlying the final declaration of expenditure;

(b) the requirement for the Commission to ensure, in cooperation with the Member States, that the financial control objectives set out in Regulation No (EC) 2064/97 are achieved.

5.9. For the 2000 to 2006 period, the new framework Council Regulation (EC) No 1260/1999 (11), implemented by Commission Regulations (EC) Nos 438/2001 (12) and 448/2001 (13), maintained and developed these principles. In particular, provisions have been added to require the Member States to issue guidance to managing and paying authorities (14) and to provide for a clear definition, allocation and separation of functions. Member States also have to take responsibility in the first instance to make any necessary financial corrections. The checks carried out during the implementation of projects (the day-to-day management checks) and the sample checks to verify the effectiveness of the

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(14) Regulation (EC) No 1260/1999 specifically requires Member States to appoint managing and paying authorities. The managing authority is a public or private authority or body at national, regional or local level designated by the Member State to manage a programme (typically a department within a national government ministry or regional or local authority). The paying authority is a national, regional or local authority or body designated by the Member State for the purposes of drawing up and submitting payment applications and receiving payments from the Commission (for example a department outside the managing authority in the national, regional or local authority).
systems and the accuracy of expenditure declarations (the independent 5% sample checks) have been more clearly differentiated (see paragraph 5.11). Furthermore, the Commission is explicitly required to satisfy itself that the management and control systems meet the regulatory standards and to regularly review the operation of the systems. As a whole, the legislative framework provides a sound basis for the management and control of structural measures expenditure.

5.10. The main inherent risks to the legality and regularity of expenditure for structural measures arise from the shared management by the Commission and the Member States, the variety of bodies and authorities which intervene in the management process, the large number of programmes each of which may contain several thousand projects, implemented over a period of years, and the scope for potential weaknesses in the management and control systems. In addition, there are a large number of conditions governing the eligibility of expenditure which are not always clear, giving rise to the risk of divergent interpretations.

5.11. The roles of the Commission and the Member States in the management and control systems for the 2000 to 2006 period can be summarised as follows:

(a) the managing authority in the Member State receives applications from potential beneficiaries (15) for EU and national co-financing for projects;

(b) the managing authority in the Member State approves or refuses the projects;

(c) for each approved project, the beneficiary submits periodic declarations of expenditure incurred by the project in order to claim the co-financing;

(d) the managing authority performs checks that expenditure incurred by projects is legal and regular and is eligible for co-financing (day-to-day management checks);

(e) the paying authority satisfies itself that the expenditure meets all the required conditions before certifying the aggregated declarations which it sends to the Commission;

5.10. The Commission agrees that there is an inherent risk under shared management which involves the delegation of responsibilities to the Member States and subsequent delegation of tasks and functions within Member States. This risk is addressed in the Structural Funds regulations through the requirements on Member States to set up and apply effective systems for management and control, and through the exercise by the Commission of its powers to verify their functioning and where necessary to suspend payments and make financial corrections. The Communication on a roadmap to an integrated control framework (COM(2005) 252) includes further measures to strengthen shared management.

There are necessarily numerous conditions governing the eligibility of operations and expenditure, and the Commission rules set out common provisions in certain important areas. The Commission provides guidance on eligibility issues both generally and on precise questions.

(15) Applicants may range from private individuals to associations, private or public companies to local, regional or national bodies.
THE COURT’S OBSERVATIONS

(f) bodies (16) in the Member State, independent of the services responsible for implementation and payment procedures, perform audits of the management and control systems and sample checks of the expenditure declarations, covering at least 5 % of the total eligible expenditure of each programme (independent checks);

(g) at the closure of each programme, a body (which may be the same as referred to in (f)) in the Member State independent of the implementing service submits a declaration to the Commission, which assesses the validity of the application for payment of the final balance and the legality and regularity of the transactions;

(h) on the basis of the systems descriptions and annual control reports supplied by the Member States, and its own audit work, the Commission reviews the operation of the management and control systems in the Member States in order to satisfy itself that the systems meet the standards required by the regulations.

5.12. Besides the specific requirements on the Structural Funds, there are other requirements for the Commission which are intended to improve its general control environment. All Directorates-General are required to comply with a set of internal control standards.

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Objective and scope of the audit

5.13. The objective of the audit was to contribute to the Court’s Statement of Assurance on the general budget through a specific assessment for the structural measures area as a whole. For that purpose, the Court examined in particular the management and control systems at the Commission and in a sample of Member States and analysed to what extent the internal controls built into these systems give assurance on the legality and regularity of the underlying transactions. On the basis of a random selection of programmes and projects from the prior (1994 to 1999) and current (2000 to 2006) programme periods, the Court performed tests of underlying transactions (substantive testing) as an independent check and in order to obtain further evidence on the operation of the funds. The Court examined:

— the internal control environment at the Commission (internal control standards);

(16) Such as a financial service or internal audit unit within the national, regional or local authority.
THE COURT’S OBSERVATIONS

— whether, for payments made in 2004, management and control systems relating to the 1994 to 1999 and 2000 to 2006 programme periods were operating in accordance with the relevant regulations;

— whether programmes from the 1994 to 1999 programme period were closed in accordance with the relevant regulations;

— the Annual Activity Reports and declarations of the Directors-General;

— the action taken by the Commission in response to the previous observations of the Court.

Audit of the management and control systems

Implementation of the internal control standards: progress made although further efforts required

Examination by the Court

5.14. The audit examined the operation of the internal controls at the Commission, in particular the key controls relating to the legality and regularity of expenditure. The audit reviewed the structural measures Directorates-Generals’ implementation of the internal control standards (see also paragraphs 1.80 to 1.83).

5.15. The Court reviewed the implementation by the structural measures Directorates-General of the eight internal control standards (out of a total of 24) of particular importance for the legality and regularity of expenditure (17).

Incomplete implementation of internal control standards

5.16. For the Directorates-General for Regional Policy (DG REGIO) and for Employment, Social Affairs and Equal Opportunities (DG EMPL), the implementation of the standards was generally satisfactory. However, measures to improve effectiveness could be taken in the application of Standard 11 (Risk analysis and management) and shortcomings were identified for Standard 17 (Supervision), as explained below.

5.16. The Directorates-General have taken steps as indicated below to improve the effectiveness of risk management and consider for the reasons set out below that the implementation of Standard 17 is compliant with the baseline requirements.


THE COMMISSION’S REPLIES
5.17. For example, at both Directorates-General the Internal Audit Units have noted that further work is required on raising awareness among staff of actions for mitigating risk and identifying and reporting weaknesses. In the opinion of the Court, both DG REGIO and DG EMPL performed insufficient on-the-spot checks of projects to reach a sound view of the operation of the management and control systems (for 2000 to 2006). DG EMPL has introduced a computerised system for the follow-up of recommendations arising from its audits. The Court notes that the application in practice of this computerised system needs to be improved.

With regard to Standard 11, the Directorate-General for Regional Policy adopted an action plan to assist middle management in the identification and mitigation of risks and to raise awareness of the procedures in place, particularly those for reporting and correcting internal control weaknesses. A risk assessment was also made early in 2004 and an action plan implemented to reduce the risks identified in the exercise.

Concerning the same Standard, surveys by the Internal Audit Capability of the Directorate-General for Employment, Social Affairs and Equal Opportunities, show that, following the actions taken, there is continuous progress in staff’s knowledge of the internal control standards.

With regard to Standard 17, the assessment by the Directorates-General for Regional Policy and Employment, Social Affairs and Equal Opportunities of the operation of management and control systems is not solely based on the on-the-spot audit work of the Commission services, but also on their desk-checks of systems descriptions, on the audit activity of the Member States and on the national annual control reports.

As part of their systems audits both Directorates-General carry out desk checks of a large number of project files at the level of the responsible authorities, together with compliance tests of a sample of transactions.

In 2004, the Directorate-General for Regional Policy did not audit projects of the 2000 to 2006 period, but carried out system reviews in the first phase of an enquiry which are being completed by a second phase of project audits in 2005. With regard to the ESF, the Directorate-General for Employment, Social Affairs and Equal Opportunities feels that its audit methodology enables it to use its resources efficiently and thus to form an opinion on a maximum number of systems involving a large number of projects (see also reply to 5.42).

5.18. The Directorate-General for Fisheries and Maritime Affairs (DG FISH) had not fully complied with the baseline requirements on implementation for five of the internal control standards at the end of 2004 (standards 11, 12, 17, 20 and 22). The Directorate-General for Agriculture and Rural Development (DG AGRI) in its self-assessment for 2004 concluded that all standard and baseline requirements had been met. The Court examined eight of those standards and found that four of them showed room for improvement (see paragraphs 4.33 and 4.34).

5.18. The Directorate-General for Fisheries and Maritime Affairs acknowledges the observations of the Court concerning the incomplete compliance with baseline requirements for five internal control standards and has already taken action to remedy this situation.
5.19. As part of its specific assessment of structural measures expenditure, the Court examined the operation of the management and control systems for both the 1994 to 1999 and 2000-2006 programme periods on the basis of a random sample of 15 Structural Fund programmes and one Cohesion Fund project (1994 to 1999 programmes: 3 ERDF, 2 ESF, 1 EAGGF-Guidance and 1 Cohesion Fund; 2000 to 2006 programmes: 5 ERDF (including 1 Interreg III A Community Initiative), 3 ESF and 1 EAGGF-Guidance) for which payments were made by the Commission in 2004 (in Belgium, France, Germany, Greece (2), Spain (3), Italy (3), Portugal, Finland, Sweden and the United Kingdom (2)). As mentioned above (paragraphs 5.8 to 5.9), the regulatory requirements for the management and control systems for the 2000 to 2006 programmes were increased by comparison to the 1994 to 1999 period.

5.20. The Court’s audit identified various failures in the Member States to respect the regulatory requirements for the management and control systems across all the programmes in its sample for both the 1994 to 1999 and 2000 to 2006 programme periods. When compared to the previous programme period, the Commission has since implemented various measures to achieve more effective management and control systems for 2000 to 2006 expenditure. However, important failures still remain, as demonstrated by the results of the review of the selected 2000 to 2006 programmes (see Annex 1). The following findings illustrate the kind of problems which the Court found for both periods.

5.21. In four of the 16 programmes audited, the Court noted problems related to the definition, allocation and separation of functions. In two cases, checks underlying the certification of expenditure by the paying authority were made by a department which was not independent from the authorising service (18). For another programme, the unit responsible for the 5% sample checks reported to the departmental head also having

(18) 2000 to 2006: Sweden (Södra Skogsland) ESF Objective 1 1999SE161DO002; Italy (Puglia) EAGGF-Guidance Objective 1 1999IT161PO009.
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Responsibility for the management and payment of assistance (19). In a further programme, the management and the payments teams reported to the same head of division (20). The failure to ensure the proper implementation of these basic elements of management and control increases the risk of allowing the declaration and certification of expenditure which is not legal and regular.

Failure to provide a sufficient audit trail

5.22. The Court identified problems with the audit trail in seven programmes. In one programme, the audit trail was deficient for three of the ten projects examined (21) and in another for three out of eight projects audited (22). In one case, a break in the audit trail was found for two projects and, for the same programme, expenditure records were not retained, contrary to the regulatory requirement (23). In another case, for two programme measures examined, the Court identified a lack of reconciliation between payments by the managing authority and expenditure by projects (24). For three projects in one programme, invoices and proofs of payment were not retained, contrary to the regulatory requirement, and evidence of the expenditure could only be obtained through the internal accounting system of the beneficiary itself (25). In one programme, audit trail problems were identified in most of the projects audited by the Court (26). For another programme, the amount certified to the Commission did not reconcile with the total in the programme accounts (26). In the absence of an adequate audit trail, there is no straightforward basis for certification of expenditure by the Member State.

Failure to carry out adequate checks

5.23. In nine cases in the Court’s sample, the day-to-day management checks of operations were found not to be working or to contain shortcomings. The Court’s sample included two cases where this control was not working and there was no evidence of day-to-day management checks (27). In these cases a number of errors were found by the Court while auditing individual projects. In another case, during their on-the-spot checks, the managing

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5.22. The Commission notes that four of the cases relate to the 1994 to 1999 period and three to the 2000 to 2006 period.

With regard to the 2000 to 2006 programme for Belgium (1999BE053DO002), since the audit by the Court, the managing authority has reconstituted the expenditure declared to the Commission for one of the three files in question and the two other projects are under examination. Concerning the 1994 to 1999 Finnish programme (956001FI8), following a special audit on the social allowances by the Commission in November 2002, the system was also deemed insufficient. Thereupon, Finland started modifying its system for the current period. The progress has been monitored by the Commission services and the situation has improved since then.

Concerning the 1994 to 1999 Spanish programme (940112ES1), the Member State’s underdeclaration has not had a negative financial effect on the Community budget.

5.23. The Commission notes that two cases concern the 1994 to 1999 period and seven the 2000 to 2006 period. With regard to the Greek programme, the Commission, following its examination of the management and control system in Greece, is now satisfied that the measures taken adequately ensure the establishment of procedures for management checks that meet the requirements of the regulations.

Concerning the 2000 to 2006 Swedish programme, (1999SE161DO002), the Commission will make sure that the improvements made also include the verification of the actual implementation of the operations.

(19) 1994 to 1999: United Kingdom (Western Scotland) ERDF Objective 2 97UK16004.
(20) 1994 to 1999: Spain (Asturias) ERDF Objective 1 94ES16002.
(22) 2000 to 2006: Sweden (Sodra Skogslan) ESF Objective 1 1999SE161DO002.
(26) Spain ESF 940112ES1.
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authorities had not verified the actual implementation of the activities funded (22). For this case, there was no proof of the delivery of the services co-financed. These findings demonstrate the importance of making checks at the premises of beneficiaries, rather than relying solely on centralised checks of documentation.

5.24. Shortcomings in day-to-day management checks were identified in six cases. In one case, insufficient day-to-day checks had been performed (28). In three other cases, the content and depth of checking were not sufficient and aspects of eligibility of the expenditure were not properly covered (28). A number of errors were found for one of these cases which is a closed programme for which the final expenditure had been certified (29). In a further two cases, no checks were made of activities performed by third parties and the Court found no evidence that this expenditure was eligible (30).

THE COMMISSION’S REPLIES

5.24. With regard to the 2000 to 2006 programme for Belgium (1999BE053DO002), the Commission will ensure that the beneficiary provides the Managing Authority, on the basis of his analytic accounts, with the details of the actual costs included in internal invoicing, as the Managing Authority has checked the eligibility and grounds for this expenditure.

5.25. For the 2000 to 2006 programmes audited, satisfactory progress was achieved on the 5% checks except in one case where the checks were lagging behind in terms of coverage (31). Nevertheless, the Court also identified weaknesses in the independent checks in 11 programmes in its sample. In seven cases, the risk analysis underlying the sampling was incomplete or could not be explained and the checks did not sufficiently cover all aspects of eligibility (32). In another case, there were no audit working papers allowing the Court’s auditors to verify the application of the sampling methodology and the audit work performed (33). Delays in reporting the results of the checks were noted in two cases (34). For one programme, the checks did not sufficiently cover the whole programme period and the sampling did not take account of risk analysis (35).

5.26. Checks made by the paying authority before certifying statements of expenditure were found not to be working or to contain shortcomings in seven cases. In one case, the paying authority certified expenditure, relying solely on the checks done

5.25. The Commission notes that six of the 11 cases concern the 1994 to 1999 period and five the 2000 to 2006 period.

Before making the final payment for the 1994 to 1999 Industria e Servizi programme, the Commission, noting the lack of audits of projects below LIT 3 billion in value, required further audits of such projects and in the final payment, based on the average rates of error found by measure, applied financial corrections to all projects in this category.

5.26. With respect to the Greek Interreg programme, this problem has now been remedied following the actions referred to in the reply to point 5.23. The paying authority now requires information on management checks and independent audits on projects before it certifies expenditure from the projects.

With regard to the 2000 to 2006 programme for Italy (1999IT161PO011), quarterly reports detailing these controls are now being sent to the paying authority.

by the managing authority and without performing further verification (23). In two other cases, the paying authority had no overview of the day-to-day management checks which had been carried out on the programme concerned (36). In another case, expenditure was certified in the absence of management checks and of systems checks by the paying authority (37). For one programme, the unit within the paying authority responsible for performing checks had no formally defined working procedures and insufficient checks had been done (38). For a further programme, the coverage of the checks by the certifying body had not been specified and checklists failed to cover aspects of eligibility (39). In another case, there was no evidence that any checks had been performed (23).

5.27. If adequate checks are not performed at the various levels, there is an increased risk that expenditure which is not legal and regular will be declared to the Commission.

Closing of 1994 to 1999 programmes: delays and systems weaknesses in complying with the regulations

Examination by the Court

5.28. The Court reviewed the action taken by the Commission in closing programmes from the 1994 to 1999 programme period. The examination was done at the Commission and included the 6 Structural Fund programmes and one Cohesion Fund project sampled by the Court (see paragraph 5.19), plus an additional sample of 23 closed programmes (40). The Court also examined the audit work carried out by the Commission, based on a sample of audit reports across the structural measures Directorates-General. A sample of programmes not yet closed were examined to identify the reasons for delay.

Weaknesses and delays in closing programmes

5.29. The examination by the Court of the action taken by the Commission in 2004 in making final payments for 1994 to 1999 programmes has identified programmes closed by DG REGIO and DG EMPL although the closure statements submitted by

5.27. The adequacy of the checks is assessed by the independent body at the closure of the programmes for the purposes of the closure statement. The Commission also took measures to address this risk in the procedures for closure of the 1994 to 1999 programmes.

(36) 2000 to 2006: Italy (Sicily) ESF Objective 1 1999IT161PO011; Sweden (Södra Skogsland) ESF Objective 1 1999SE161DO002.
(38) 2000 to 2006: France (Réunion) ERDF Objective 1 1999FR161DO001.
(39) 2000 to 2006: Germany (Sachsen) ERDF Objective 1 1999DE161PO006.
(40) 3 ERDF, 10 ESF, 5 FIFG, 5 EAGGF-Guidance.
the Member States did not contain full details of the methodology applied (41). This concerns in particular the use of the risk analysis and the representativity of sampling for the minimum 5 % checks carried out by the Member State authorities before certifying the final expenditure for the programmes.

5.30. The Court observed last year that the variable quality of the closure documentation submitted by the Member States contributed to the slow progress in closing 1994 to 1999 programmes (42). In 2004, delays have persisted. This is partly because Member States have been slow to respond to enquiries from the Commission (particularly regarding completion of sufficient independent checks of the management and control systems and expenditure declarations), but also because the Commission has failed to take timely action in a number of cases (43).

5.30. As noted in its reply to points 5.37 and 5.67 of the Court’s report for 2003, the Commission checked closure documentation thoroughly, consulted OLAF to ensure that all irregularity cases had been resolved, and required further information or audit work where necessary. This has inevitably delayed the date of closure in some cases, especially where Member States have contested the Commission’s closure proposals involving financial corrections.

For the Directorate-General for Employment, Social Affairs and Equal Opportunities, four of the cases mentioned refer to programmes which had been closed and in respect of which the delays were the result of the constraints linked to the appropriate handling of irregularities.

Concerning the closure of the 5 FIFG programmes mentioned by the Court in footnote 48, one is already closed, for two the closure proposal will shortly be sent to the Member States concerned and for the other two the closure procedure is ongoing.

For the ERDF cases mentioned there were complex points which required exchanges with national authorities and which were protracted because of the overall work volume in the closure process.

(41) Austria ESF 955501AT5; Italy ESF 94001611; Spain ESF 940127ES1; Spain ESF 940112ES1; United Kingdom ESF 93001UK4; United Kingdom ESF 979203UK8; Netherlands ESF 972005NL2; Netherlands (Zuid-Limburg) ERDF Objective 2 1997-1999 970713006; France (Lorraine) ERDF Objective 2 1997-1999 970313006.

(42) Court of Auditors - Annual Report concerning the financial year 2003, paragraphs 5.29 to 5.39 and 5.67.

(43) DG FISH: Spain 94ES14101; Italy 94IT14101; United Kingdom Objective 1 94EU16002, 94UK16003; France Objective 5a 94FR14105. DG REGIO: Portugal 94PT161PO007; Peace and Reconciliation Special Support Programme 1995EU161PC005; Luxembourg 97L162DO001. DG EMPL: United Kingdom 972103UK2, 979203UK8; France 949701F8, 942601F1; Netherlands 972005NL2; Portugal 942000P1.
5.31. *Table 5.1* provides information on the closed programmes for each of the Structural Funds as at 31 December 2004 and 31 March 2005. It shows that DG AGRI closed 137 programmes during 2004, so that 158 of its 388 programmes remained open at the end of 2004. DG FISH closed three programmes, leaving 41 out of 52 open. DG EMPL closed 335 programmes (out of a total of 786) in 2004 and 264 remained to be closed. DG REGIO closed 317 programmes (out of a total of 944) during 2004, leaving 333 programmes open (44).

The tables show programmes that have been completely closed in the sense that both the final payment and the final decommitment have been made. The amounts shown as payments are only payments made to completely closed programmes, not including those made to programmes for which the final decommitment has not yet been effected. Where a Member State contests the Commission’s determination of the final payment due, the Commission cannot make the final decommitment until this has been settled, which in some cases means at the end of a formal procedure under Article 24 of Regulation (EEC) No 4253/88. The total level of outstanding commitments for the 1994 to 1999 period — net of payments to open programmes not included in Table 5.1 — was reduced by two thirds in 2004 and at the end of the year stood at 3.3 billion euro, or around 5 % of the original budgeted amount (see paragraphs 2.16 and 2.20 of the 2004 report).

### Table 5.1a — Structural measures: European Regional Development Fund programmes 1994-1999 closed at 31 December 2004 and 31 March 2005

<table>
<thead>
<tr>
<th>Budgetary area (1)</th>
<th>Total</th>
<th>Closed before 2004</th>
<th>Closed at 31 December 2004</th>
<th>Closed at 31 March 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of programmes</td>
<td>Planned Community contribution (EUR)</td>
<td>Number of programmes</td>
<td>Total Community contribution paid (EUR)</td>
</tr>
<tr>
<td>Objective 1</td>
<td>181</td>
<td>57 571 255 951</td>
<td>44 12 221 092 714</td>
<td>94 37 550 653 114</td>
</tr>
<tr>
<td>Objective 2 94-96</td>
<td>84</td>
<td>5 165 903 927</td>
<td>70 3 504 374 582</td>
<td>79 4 194 775 934</td>
</tr>
<tr>
<td>Objective 2 97-99</td>
<td>73</td>
<td>7 157 716 211</td>
<td>13 841 930 911</td>
<td>48 3 132 569 307</td>
</tr>
<tr>
<td>Objective 3</td>
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<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 4</td>
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<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 5 (a)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 5 (b)</td>
<td>84</td>
<td>3 302 548 791</td>
<td>25 1 050 903 786</td>
<td>62 2 458 401 459</td>
</tr>
<tr>
<td>Objective 6</td>
<td>2</td>
<td>355 453 472</td>
<td>1 149 180 357</td>
<td>2 333 854 319</td>
</tr>
<tr>
<td>Community Initiatives</td>
<td>520</td>
<td>9 223 064 769</td>
<td>141 1 177 790 541</td>
<td>326 3 916 629 881</td>
</tr>
<tr>
<td>Total</td>
<td>944</td>
<td>82 775 943 121</td>
<td>294 18 945 272 891</td>
<td>611 51 586 884 014</td>
</tr>
</tbody>
</table>

(1) Structural measures objectives have since been regrouped for the 2000 to 2006 programme period. 
Source: Table prepared by the Court of Auditors on the basis of data provided by the Commission.

(44) Where more than one Fund contributes to the same programme, each Fund part of the programme is closed separately. Thus the figures do not reconcile to the total number of programmes given in paragraph 5.4.
### Table 5.1b — Structural measures: European Social Fund programmes 1994-1999 closed at 31 December 2004 and 31 March 2005

<table>
<thead>
<tr>
<th>Budgetary area (1)</th>
<th>Total</th>
<th>Closed before 2004</th>
<th>Closed at 31 December 2004</th>
<th>Closed at 31 March 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of programmes</td>
<td>Planned Community contribution (EUR)</td>
<td>Number of programmes</td>
<td>Total Community contribution paid (EUR)</td>
</tr>
<tr>
<td>Objective 1</td>
<td>102</td>
<td>22 806 888 948</td>
<td>20</td>
<td>4 263 436 869</td>
</tr>
<tr>
<td>Objective 2 94-96</td>
<td>82</td>
<td>1 597 251 132</td>
<td>70</td>
<td>1 225 350 076</td>
</tr>
<tr>
<td>Objective 2 97-99</td>
<td>72</td>
<td>2 112 708 834</td>
<td>10</td>
<td>109 292 853</td>
</tr>
<tr>
<td>Objective 3</td>
<td>56</td>
<td>13 221 222 835</td>
<td>10</td>
<td>802 312 390</td>
</tr>
<tr>
<td>Objective 4</td>
<td>16</td>
<td>2 614 128 525</td>
<td>3</td>
<td>121 340 718</td>
</tr>
<tr>
<td>Objective 5 (a)</td>
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<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 5 (b)</td>
<td>83</td>
<td>1 057 483 760</td>
<td>5</td>
<td>51 049 826</td>
</tr>
<tr>
<td>Objective 6</td>
<td>2</td>
<td>177 902 801</td>
<td>1</td>
<td>104 798 749</td>
</tr>
<tr>
<td>Community Initiatives</td>
<td>373</td>
<td>4 664 895 421</td>
<td>68</td>
<td>568 697 469</td>
</tr>
<tr>
<td>Total</td>
<td>786</td>
<td>48 252 482 256</td>
<td>187</td>
<td>7 246 278 950</td>
</tr>
</tbody>
</table>

(1) Structural measures objectives have since been regrouped for the 2000 to 2006 programme period.
Source: Table prepared by the Court of Auditors on the basis of data provided by the Commission.

### Table 5.1c — Structural measures: European Agricultural Guidance and Guarantee Fund, Guidance Section programmes 1994-1999 closed at 31 December 2004 and 31 March 2005

<table>
<thead>
<tr>
<th>Budgetary area (1)</th>
<th>Total</th>
<th>Closed before 2004</th>
<th>Closed at 31 December 2004</th>
<th>Closed at 31 March 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of programmes</td>
<td>Planned Community contribution (EUR)</td>
<td>Number of programmes</td>
<td>Total Community contribution paid (EUR)</td>
</tr>
<tr>
<td>Objective 1</td>
<td>69</td>
<td>14 301 716 000</td>
<td>4</td>
<td>565 075 313</td>
</tr>
<tr>
<td>Objective 2 94-96</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 2 97-99</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 4</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Objective 5 (a)</td>
<td>66</td>
<td>5 544 906 000</td>
<td>30</td>
<td>421 287 186</td>
</tr>
<tr>
<td>Objective 5 (b)</td>
<td>84</td>
<td>3 163 701 000</td>
<td>21</td>
<td>693 559 284</td>
</tr>
<tr>
<td>Objective 6</td>
<td>2</td>
<td>288 794 000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Community Initiatives</td>
<td>167</td>
<td>1 156 618 000</td>
<td>38</td>
<td>132 882 889</td>
</tr>
<tr>
<td>Total</td>
<td>388</td>
<td>24 455 735 000</td>
<td>93</td>
<td>1 812 804 672</td>
</tr>
</tbody>
</table>

(1) Structural measures objectives have since been regrouped for the 2000 to 2006 programme period.
Source: Table prepared by the Court of Auditors on the basis of data provided by the Commission.
## Table 5.1d — Structural measures programmes 1994-1999 closed at 31 December 2004 and 31 March 2005 — FIFG

<table>
<thead>
<tr>
<th>Budgetary area (1)</th>
<th>Total</th>
<th>Closed before 2004</th>
<th>Closed at 31 December 2004</th>
<th>Closed at 31 March 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of programmes</td>
<td>Planned Community contribution (EUR)</td>
<td>Number of programmes</td>
<td>Total Community contribution paid (EUR)</td>
</tr>
<tr>
<td>Objective 1</td>
<td>18</td>
<td>1 797 039 031</td>
<td>1</td>
<td>32 744</td>
</tr>
<tr>
<td>Objective 2 94-96</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 2 97-99</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 4</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 5a</td>
<td>12</td>
<td>850 431 000</td>
<td>2</td>
<td>23 715 837</td>
</tr>
<tr>
<td>Objective 5 (b)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Objective 6</td>
<td>2</td>
<td>8 260 000</td>
<td>1</td>
<td>3 523 447</td>
</tr>
<tr>
<td>Community Initiatives</td>
<td>20</td>
<td>127 103 242</td>
<td>4</td>
<td>2 245 131</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>52</strong></td>
<td><strong>2 782 833 273</strong></td>
<td><strong>8</strong></td>
<td><strong>29 517 159</strong></td>
</tr>
</tbody>
</table>

(1) Structural measures objectives have since been regrouped for the 2000 to 2006 programme period.
Source: Table prepared by the Court of Auditors on the basis of data provided by the Commission.

### The Commission’s programme of closure audits

5.32. The Court noted long delays (over eight months in some cases) by the Commission in reporting the results of the audits to the Member States (45). Such delays increase the time required for the Commission to make any necessary proposals for appropriate financial corrections and subsequently recover irregular expenditure.

5.33. DG EMPL made a limited examination of closure procedures in four Member States. In one case (46), DG EMPL closed the programme with a minimal financial correction, although serious deficiencies were found by the national control authority.

5.32. The Commission services endeavour to send audit reports to Member States within a reasonable time. All of the ERDF cases mentioned by the Court concern closure audits where not all documentation was available on the spot and had to be submitted some weeks after the on the spot visit. In some of the FIFG cases, the time taken to report the audit results was due to long discussions with national authorities prior to issue of the audit report.

5.33. In the Directorate-General for Employment, Social Affairs and Equal Opportunities audit strategy for 2004, given the audit resources available, the audit priority was given to the coverage of the 2000 to 2006 period because of their preventive effects.

Closure audits for the remaining Member States are being carried out from 2005.

For the Belgian case mentioned, the Directorate-General for Employment, Social Affairs and Equal Opportunities considers that the flat rate correction made by the Member State was sufficient in regard to the problems found for the years audited by the Member State’s independent authority.

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(45) For the audits by DG FISH concerning Finland (95FI14105, 95FI16002), Sweden (96SE14115) and United Kingdom (94UK16002, 94UK16005, 95UK16005); DG REGIO: France (Haute Normandie) 97FR16010 SPD Objective 2 1997-1999, Spain (Andalucia) 1994ES161P0001 1994-1999, Netherlands (Flevoland) 940713001 SPD Objective 1 1994 to 1999 and United Kingdom (Greater Manchester) 97UK16008 SPD Objective 2 1997 to 1999.

(46) Belgium ESF 943010B3.
5.34. By the end of 2004, DG REGIO had carried out ex post audits in all the EU15 Member States of 56 programmes covering 35% of the ERDF contribution. It found significant levels of error in programmes in nine Member States. In the opinion of the Court, the quality of these audits was satisfactory.

Results of substantive tests of projects

Examination by the Court

5.35. The Court carried out substantive tests of 167 projects in the Member States, under the programmes it had selected for audit (paragraph 5.19 above), in order to obtain further evidence on the operation of the Funds.

Various problems found by the Court

5.36. The weaknesses in the management and control systems outlined above (paragraphs 5.20 to 5.27) give rise to an increased risk as regards the legality and regularity of the underlying expenditure. The problems found by the Court in its tests on projects are wide-ranging. The most frequently occurring examples include a large number of instances of the declaration of ineligible items of expenditure (**), declaring expenditure incurred outside the eligible period, declaration of recoverable value added tax, declaration of expenditure although funds had not been paid out to projects by the final beneficiaries, failure to take account of potential generation of revenue or other income.

(**) Declaration of ineligible items of expenditure:
- Declaration of costs unrelated to the programmes or projects concerned:
  - 1994 to 1999: Greece Cohesion Fund 970961015; Spain (Asturias) ERDF Objective 1 94ES161002; Finland ESF 956001FI8 (ADAPT 1995-1999); Spain (Valencia) EAGGF-Guidance Objective 1 94ES06019; Spain ESF 940112ES1;
  - 2000 to 2006: Italy (Puglia) EAGGF-Guidance Objective 1 1999IT161P0009; Italy (Sicily) ESF Objective 1 1999IT161P0011; Sweden (Södra Skogslän) ESF Objective 1 1999SE161DO002; Belgium ESF Objective 3 1999BE033DO002; Germany (Sachsen) ERDF Objective 1 1999DE161P0006.
- Declaration of expenditure incurred outside the eligible period:
  - 1994 to 1999: United Kingdom (Western Scotland) ERDF Objective 2 97UK16004; Spain (Asturias) ERDF Objective 1 94ES16002; Italy (Industria e Servizi) ERDF Objective 1 94IT16030;
  - 2000 to 2006: Portugal (Norte) ERDF Objective 1 1999PT161P0017; France (Réunion) ERDF Objective 1 1999FR161DO001.
- Declaration of recoverable value added tax:
  - 1994 to 1999: Spain (Valencia) EAGGF-Guidance Objective 1 94ES06019;
- Declaration of expenditure although funds had not been paid out to projects by the final beneficiaries:
  - 1994 to 1999: United Kingdom (Western Scotland) ERDF Objective 2 97UK16004; Spain (Asturias) ERDF Objective 1 94ES16002; Italy (Industria e Servizi) ERDF Objective 1 94IT16030;
  - 2000 to 2006: Germany (Sachsen) ERDF Objective 1 1999DE161P0006.
- Failure to take account of potential generation of revenue or other income:
  - 1994 to 1999: United Kingdom (Western Scotland) ERDF Objective 2 97UK16004; Finland ESF 956001FI8 (ADAPT 1995-1999); Spain (Valencia) EAGGF-Guidance Objective 1 94ES06019; Spain ESF 940112ES1;
  - 2000 to 2006: Italy (Puglia) EAGGF-Guidance Objective 1 1999IT161P0009; Portugal (Norte) ERDF Objective 1 1999PT161P0017; United Kingdom (North-East England) ERDF Objective 2 2000GB162DO004.
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twice (48), non-respect of rules relating to State aid schemes (49) and to public procurement (50), inadequate supporting documentation held at projects (51) and failure to use a duly justified and equitable method for the allocation of overhead expenditure to projects (52).

Work of other auditors

5.37. In December 2004 a ‘Report on the Parallel Audit of the Management and Control Systems for Assistance Granted under the Structural Funds’ was produced by a Working Group on Structural Funds of the Contact Committee of the Heads of the Supreme Audit Institutions of the EU Member States and the European Court of Auditors (53). The results were intended to be

(48) Declaring expenditure twice:
— 1994 to 1999: Italy (Industria e Servizi) ERDF Objective 1 94IT16030; Spain ESF 940112ES1;
— 2000 to 2006: United Kingdom (North-East England) ERDF Objective 2 2000GB162DO004; Italy (Puglia) EAGGF-Guidance Objective 1 1999IT161PO009.

(49) Non-respect of rules relating to State aid schemes:
— 1994 to 1999: United Kingdom (Western Scotland) ERDF Objective 2 97UK16004;
— 2000 to 2006: Italy (Puglia) EAGGF-Guidance Objective 1 1999IT161PO009.

(50) Failure to respect Community rules on the award of public contracts:
— 1994 to 1999: Spain (Asturias) ERDF Objective 1 94ES16002; United Kingdom (Western Scotland) ERDF Objective 2 97UK16004; Greece Cohesion Fund 970961015; Spain ESF 940112ES1;
— 2000 to 2006: United Kingdom (North-East England) ERDF Objective 2 2000GB162DO004; Greece ERDF Interreg IIIA 2000CB16OPC013; Germany (Sachsen) ERDF Objective 1 1999DE161PO006.

(51) Inadequate supporting documentation held at projects:
— 1994 to 1999: Spain (Valencia) EAGGF-Guidance Objective 1 94ES06019; United Kingdom (Western Scotland) ERDF Objective 2 97UK16004; Spain (Asturias) ERDF Objective 1 94ES16002; Italy (Industria e Servizi) ERDF Objective 1 94IT16030; Finland ESF 956001FI8 (ADAPT 1995-1999); Spain ESF 940112ES1;
— 2000 to 2006: United Kingdom (North-East England) ERDF Objective 2 2000GB162DO004; Greece ERDF Interreg IIIA 2000CB16OPC013; Italy (Sicily) ESF Objective 1 1999IT161PO011; Germany (Sachsen) ERDF Objective 1 1999DE161PO006; Belgium ESF Objective 3 1999BE053DO002; Portugal (Norte) ERDF Objective 1 1999PT161PO0017; Sweden (Södra Skogsland) ESF Objective 1 1999SE161DO002.

(52) Failure to use a duly justified and equitable method for the allocation of overhead expenditure to projects:
— 1994 to 1999: United Kingdom (Western Scotland) ERDF Objective 2 97UK16004; Finland ESF 956001FI8 (ADAPT 1995-1999); Spain ESF 940112ES1;
— 2000 to 2006: United Kingdom (North-East England) ERDF Objective 2 2000GB162DO004; Italy (Sicily) ESF Objective 1 1999IT161PO011; Sweden (Södra Skogsland) ESF Objective 1 1999SE161DO002; Germany (Sachsen) ERDF Objective 1 1999DE161PO006; Belgium ESF Objective 3 1999BE053DO002.

(53) The report is published on the websites of the Supreme Audit Institutions of the participating Member States.
used by Member States in the development of their own management and control systems. The Working Group, comprising nine Member States (**4), carried out parallel audits in 2003 to 2004 to examine how two specific regulatory requirements (**5) for the management and control systems for the 2000 to 2006 programme period were applied in their countries - provision of a sufficient audit trail (Article 7) and organisation of independent sample checks of operations (Articles 10 to 12).

5.38. Among their main conclusions were:

— in most countries there is a sufficient audit trail as defined by the Regulation. Although some weaknesses were noted when examining individual projects, these were not usually systematic weaknesses but individual project failings. The most significant weaknesses identified were the lack of complete documentation of examinations carried out, and the lack of definition of the distinction between irregularities and simple errors;

— in most countries the execution and reporting of the independent sample checks complied with the Regulation. Where this was not the case the Working Group stated that the relevant authorities have taken appropriate steps to ensure that the required checks would be carried out by the end of the programme period. The independence of the organisations carrying out the checks was guaranteed in all programmes examined. However, the implementation of the checks has been relatively slow;

— the legal framework leaves room for ambiguous or even contradictory interpretations. Furthermore, the Working Group expressed concern at the increased bureaucracy in the implementation of the provisions for the 2000 to 2006 programme period, resulting in increased staff and other costs.

**4) Denmark, Germany, Spain, Italy, Netherlands, Portugal, Finland, Sweden and United Kingdom.

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Annual activity reports and declarations of the Directors-General: better information but inadequate reservations

5.39. The Court examined the information presented by the structural measures Directors-General in their annual activity reports and associated declarations for 2004. The Commission again recognises the risk that the management and control systems in the Member States are not implemented with sufficient rigour to guarantee that the underlying operations for the programme period 2000 to 2006 are legal and regular.

5.40. The Director-General of DG REGIO states that he has reasonable assurance of the legality and regularity of expenditure. He confirms the two reservations made in 2003 about the management and control systems in Greece, respectively for the ERDF and the Cohesion Fund. For the ERDF in Greece, the procedure giving rise to a suspension of interim payments was launched in December 2004.

5.41. As an improvement compared to last year, the reservations made by DG REGIO have been quantified, especially concerning the payments made in 2004. The reservations are based on desk controls of the systems descriptions submitted to the Commission and on audits in the Member States. It should be noted that DG REGIO carried out only eight systems audits on 2000 to 2006 programmes (compared to the 15 scheduled) in 2004, with limited substantive testing of projects.

5.42. The audits performed by DG EMPL in the Member States by the end of 2004 represent 70% of the total ESF contribution for the programmes (EU15, 2000 to 2006 period). However, the DG performed insufficient checks of projects to support the conclusions made on the operation of the management and control systems. The declaration of the Director-General includes a reservation for those management and control systems for which serious weaknesses were identified. This identification in the declaration constitutes an improvement compared to last year, although it is not quantified.

5.41. Certain audits planned by the Directorate-General for Regional Policy for 2000 to 2006 programmes had to be carried over to 2005 because of a particular staff shortage in the last part of the year and the need to concentrate resources on completing closure audits on 1994 to 1999 programmes. The 2000 to 2006 system audit enquiry provides for substantive testing by on-the-spot audits of a sample of projects to be done in a second phase of the audit starting in 2005. The Director-General’s assurance in a given year is not based solely on the audit work carried out in the course of the year concerned, but on the assurance built up over previous years’ audit work under the Directorate-General’s audit strategy, as well as the assurance provided from the audit work of Member States.

5.42. The systems audits of the Directorate-General for Employment, Social Affairs and Equal Opportunities systematically cover also the verification of a large number of project files at the level of the responsible authorities. These tests make it possible to form a precise opinion of the way in which decisions approving projects are taken and the way in which declarations of expenditure are analysed and checked. The audit methodology applied by the Directorate-General for Employment, Social Affairs and Equality of Opportunities aims to make efficient use of the resources available and to form an opinion on a maximum number of systems involving a large number of projects.

The validity of the audit work carried out by the Directorate-General for Employment, Social Affairs and Equality of Opportunities is shown by the fact that the improvements in the systems requested have been made by the Member States and significant financial corrections have been carried out (by the Member States themselves or by the Commission each time where necessary); this has increased the degree of assurance. Thus, for the period 2000 to 2006, ignoring the procedures under way, corrections involved 266 million euro.
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5.43. For DG FISH, the Court noted an improvement in the level of detail and clarity of the information provided in the annual activity report in comparison to previous years. However, the report did not include complete information on the status of actions required to address recommendations arising from audits both by the Court and by the DG’s internal audit unit.

5.44. For DG AGRI, there remains a reservation for EAGGF-Guidance expenditure for 2000 to 2006, as there was in 2003. Although the DG has made progress in clearing the issues underlying the original reservation, and there is no longer a general reservation on EAGGF-Guidance expenditure, there remains an insufficient basis for giving assurance on the expenditure in 2004 for a certain number of programmes. The report of the Director-General gives a clear indication of the amount subject to the reservation.

5.45. Similarly to 2003, no reservation is made by the structural measures Directors-General for the 1994 to 1999 programme period (56), although - for example - the ex post audits performed by DG REGIO for this period show a significant level of error in nine Member States (paragraph 5.34).

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The Directorate-General for Employment, Social Affairs and Equal Opportunities pointed out in its annual declaration how difficult it was to quantify the financial impact of reservations connected with systemic weaknesses in the Member States. Nevertheless, the Directorate-General for Employment, Social Affairs and Equal Opportunities, on the basis of the Commission guidelines (C(2001)476 final), feels that the weaknesses identified by the systems audits would point to a maximum potential risk of 261 million euro, i.e. 3.4 % of the payments made under the ESF in 2004. Formal suspension and/or financial correction decisions may be taken after the contradictory procedures with the Member States. In several cases the Member State has improved its systems and/or made the necessary financial corrections itself. The systemic weaknesses detected by the Directorate-General for Employment, Social Affairs and Equal Opportunities and the corrective measures taken prompted the Director-General to maintain his reservation in his declaration.

5.43. The Directorate-General for Fisheries and Maritime Affairs acknowledges the observations of the Court and will take them on board to further improve future Annual Activity Reports.

5.45. The Commission considers that the absence of a reservation is justified given the rigorous procedures applied in the Directorates-General and the closure audits which have been and are being carried out to verify the reliability of the closure statements. Where following the completion of the follow up of audit findings with Member States a significant error level is determined, financial corrections are applied to the programmes concerned.

Follow-up of observations from previous Statements of Assurance: further action to be taken by the Commission

5.46. The Court reviewed the action taken by the Commission concerning observations made under recent specific assessments in the context of the Statement of Assurance. Annex 2 gives an

5.46. The Commission provides detailed replies to the observations of the Court on the Commission’s follow-up of previous general observations in Annex 2.

(56) Annual Report concerning the financial year 2003, paragraph 5.62.
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indication of further actions required from the Commission concerning the key observations made by the Court. As regards the specific problems identified by the Court’s tests of projects, although the Commission has generally given a satisfactory follow-up to these problems, in some cases there have been significant delays in taking a final position or launching any necessary recovery procedures (57). One of these cases relates to a finding by the Court in its Statement of Assurance for 1998.

Conclusions and recommendations

Conclusions

5.47. The Commission has continued its efforts to improve its internal control environment. Nevertheless, some further measures are required in the application of the internal control standards (see paragraphs 5.14 to 5.18).

5.48. The Court found some weaknesses in the management and control systems across all the programmes in its sample for both the 1994 to 1999 and the 2000 to 2006 periods. Concerning the 2000 to 2006 period, as in last year’s Annual Report, the Court’s findings this year again show that most of the systems examined need varying degrees of improvement in order to fully comply with the fundamental regulatory requirements for effective day-to-day management checks and/or independent sample checks of operations (58). The Court also detected numerous errors of legality and regularity in the expenditure included in the declarations leading to payments by the Commission in 2004 (see paragraphs 5.19 to 5.27 and 5.35 to 5.36).

5.47. The Commission is taking action to improve effectiveness where necessary.

5.48. The Structural Funds DGs have addressed the risk of systems weaknesses in the Member States for the 1994 to 1999 period through their respective strategies for the closure of the programmes and in particular their treatment of the closure statements issued by the independent bodies. The Commission’s audit strategy for 2000 to 2006 focuses on verifying the effective functioning of the key elements of the control systems in Member States. Shortcomings in the day-to-day management checks and delays in the independent audits have been found in some programmes or regions also. For example, out of 103 ESF programmes audited in (EU-15) 49 have led to recommendations concerning the implementation of management checks. In such cases the Commission has taken action to ensure that action plans are implemented by the national authorities to remedy the problems including the exclusion of irregular expenditure already declared where justified. The Commission is using its powers to suspend payments and make corrections when necessary. The Commission will in 2005 issue a note on good practice on management checks based on its audit work in order to promote further the effectiveness of this key control.


(58) Annual Report concerning the financial year 2003, paragraphs 5.14 to 5.27, 5.47 to 5.56 and 5.67 to 5.69.
5.49. The closing of Structural Fund programmes and Cohesion Fund projects from the 1994 to 1999 programme period has been a lengthy and laborious process which was still not completed at the end of 2004. Member States were slow to respond to enquiries from the Commission, but the Commission also failed to take timely action in some cases. The Court found that the Commission closed some programmes although the closure statements submitted by the Member States did not contain complete information (see paragraphs 5.28 to 5.34).

5.50. Despite some improvements in the information provided in the annual activity reports and declarations of the Directors-General for structural measures, further effort is required, notably concerning the scope and impact of the reservations (see paragraphs 5.39 to 5.45).

5.51. The action taken by the Commission to follow up previous observations of the Court has been generally satisfactory, although some delays have been noted (see paragraph 5.46).

Recommendations

5.52. For structural measures, as an area of shared management, the necessary improvements in management and control require a joint effort by the Commission and the Member States. The Commission should in particular, in cooperation with the Member States:

— ensure a more rigorous approach to checking the legality and regularity of expenditure. It is especially important that the front line checks — the day-to-day management checks — are strictly applied,

— ensure that the lessons learned from the closing of programmes for the 1994 to 1999 period are applied for the 2000 to 2006 and subsequent periods. This requires that the Member States ensure the submission of adequate closure documents in due time and that the structural measures Directorates-General apply a coherent and effective approach to the examination of the final payment requests.

5.49. The Commission considers that the closure process has generally been carried out to a good standard despite some delays. The thorough scrutiny of closure documents and the other parts of the closure strategy have reduced the risk of irregular final payments. The lessons learnt will stand the Commission and the Member States in good stead for the closure of the current generation of programmes. The cases of shortcomings have to be considered in the context of the high number of programmes to be closed and the complexity of the process.

5.50. The Directorates-General concerned are working together to develop a more consistent and documented approach to the reservations.

5.52. The Commission approved on 15 June 2005 a communication on the ‘roadmap to an integrated Community internal control framework’, designed to identify any gaps in the current and future regulatory requirements and the actions required to make the management and control systems for shared management expenditure in particular more effective. The ‘roadmap’ will be discussed with the discharge authority in the autumn of 2005 in order to reach a ‘common understanding’ of the action required.

— The Commission focuses its audit work on this key element in national systems. It refers to the proposed compilation of good practices in this area (see point 5.48).

— The Commission agrees that lessons should be learned, and is issuing guidance on the closure of 2000 to 2006 period with that objective. Nevertheless, the process of closure of 1994 to 1999 programmes was closely coordinated between the Directorates-General. It refers to its reply at paragraph 5.49.
5.53. The Commission should also make further efforts to improve the effective implementation of its supervisory duties. Its ability to properly monitor structural measures expenditure would be enhanced by increased coordination between the responsible Directorates-General in matters of management and control.

5.54. The Court notes that proposals for new framework regulations for the 2007 to 2013 programme period have been produced by the Commission in 2004. The Court has issued an Opinion on these proposals (\textsuperscript{59}). The adoption of the regulations and detailed rules for their implementation as regards the management and control systems before the start of the programme period (which was not done for 1994 to 1999 and 2000 to 2006) would provide an opportunity to ensure that the systems are put in place and reviewed ahead of the approval of programmes and commitment of expenditure.

The implementation of the Instrument for Structural Policies for pre-accession: the Commission has identified shortcomings in the management and control systems

5.55. The Court performed a review of the implementation of the pre-accession instrument ISPA. The examination was carried out at the Commission. The Commission’s management of payments was examined on the basis of an assessment of the checks made by the Commission and a review of the declarations of expenditure submitted by the applicant countries for eight selected payments made in 2004 (Bulgaria five payments and Romania three payments). The Court’s review did not give rise to particular observations.

5.56. The Court notes that the Commission interrupted payments to Romania several times during 2004 and that the Director-General maintained the reservation expressed in 2003 for Romania due to important shortcomings in the set-up and functioning of the management and control systems.

FOLLOW-UP TO OBSERVATIONS IN SPECIAL REPORT NO 3/2002 CONCERNING THE COMMUNITY INITIATIVE EMPLOYMENT — INTEGRA

5.57. The Court’s Special Report examined the effectiveness of management processes, namely, the targeting and selection of projects, and the monitoring, evaluation, and dissemination of information, in relation to the Community Initiative Integra.

5.58. A principal conclusion of the Court's report was that systematic weaknesses existed regarding evaluation and monitoring. In consequence, it was not possible to establish the extent to which the Integra initiative had resulted in new knowledge concerning the combating of exclusion from the labour market and whether such knowledge had been effectively disseminated to political decision-makers.

5.59. The final evaluation report on Integra, which was published in 2003, corroborated the Court's findings in relation to weaknesses in the programme's evaluation structures and the absence of an adequate feedback mechanism. These weaknesses, according to the evaluation, resulted in a probable loss of knowledge being transferred between implementing organisations.

5.58. The Commission has moved to ensure that the monitoring and evaluation of experimental programmes such as Integra is improved. In Equal, the successor programme to Integra, harmonised criteria have been developed for evaluation and monitoring, including follow up via thematic networks and groups, with the specific goal of validating the results of the programme. A clear and realistic timetable for evaluations has been agreed between the Commission and the Member States to ensure that the results needed are provided at the correct time, and that these results are brought to the attention of the key people responsible for policy formation in the fields concerned.

5.59. The Commission, through its procedures for constant feedback, monitoring and evaluation of the implementation of Structural Fund programmes, had been aware of the weaknesses inherent in the design of Integra even before the end of its period of operation. In its design of the Equal Community Initiative (2000 to 2006) the Commission had moved to improve those areas identified as weak in the previous programmes. The Equal Initiative includes in its design an obligation for the Member States to describe the lessons learnt from the Employment programme.

5.60. The Court's Special Report examined the Commission's management of EU policy concerning local employment creation and its financial management of innovative projects in this area.

5.61. The Court's main recommendations were that:

(a) a comprehensive assessment of the likely added value of local employment policy should be undertaken on all policy implementation levels;

(b) Commission-managed actions in the area of innovative projects should be rationalised, along with a tightening of financial management procedures to ensure the regularity and cost effectiveness of funding.

5.62. The Commission carried out a number of comprehensive evaluations and studies pertaining to EU local employment policy. In 2003 it produced a report of a study into the availability of data for the measurement of employment performance at local level, while in 2004 a horizontal evaluation of local employment development, assessing the added-value of EU local development policy, was carried out.
5.63. Additional steps were also taken to tighten financial management procedures concerning innovative actions. These included an increase in on-the-spot audits of projects by the Commission in 2003, and a rationalisation of the funding provision in this area.

5.64. The Court considers that these actions constitute a satisfactory follow-up to its recommendations and that they will positively contribute to the cost effectiveness of Community funding in the policy area of local employment creation.

5.64. The Commission welcomes the favourable comments from the Court on its follow-up to the special report on local actions for employment.
### ANNEX 1

#### Structural measures

**Management and control systems**

Assessment by the Court of implementation of Commission Regulation (EC) No 438/2001 for the management and control systems in the Member States visited.

<table>
<thead>
<tr>
<th>Key Audit Areas</th>
<th>1</th>
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<tbody>
<tr>
<td><strong>Member State/Region/Fund</strong></td>
<td><strong>Clear definition, allocation and separation of functions (Article 3)</strong></td>
<td><strong>Satisfactory day-to-day procedures to verify legality and regularity of co-financed operations (Article 4)</strong></td>
<td><strong>Sufficient audit trail (Article 7)</strong></td>
<td><strong>Adequate recovery procedures (Article 8)</strong></td>
<td><strong>Assurance of reliability of certificates of expenditure (Article 9)</strong></td>
<td><strong>Progress of checks to cover at least 5% of total eligible expenditure (Article 10)</strong></td>
<td><strong>Adequate organisation of 5% checks (Articles 10-12)</strong></td>
<td><strong>Independence and auditing standards of body issuing declaration at closure of programme (Article 13)</strong></td>
<td><strong>Examination of management and control systems in preparation for providing declaration at closure of programme (Article 14)</strong></td>
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<td>Italy (Puglia) EAGGF Guidance</td>
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(a) Works well, few or minor improvements required

(b) Works, but improvements necessary

(c) Does not work

For details see paragraphs 5.19-5.27.

(1) Procedures not tested as they have not had to operate.

(n/t) Not tested.
## ANNEX 2

### Follow-up of key observations in recent Statements of Assurance

<table>
<thead>
<tr>
<th>Key observation by the Court</th>
<th>Court summary of action taken by the Commission</th>
<th>Comments by the Court</th>
<th>Commission's reply</th>
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<tr>
<td>Weaknesses in management and control, persistent errors in payments</td>
<td>The Commission systems the implementation of the management and control system by the Member States, including audits of limited numbers of programmes. The Commission has provided some guidance and has used its powers to suspend payments in cases where system weaknesses may pose a risk of improper use of Community funds.</td>
<td>The Commission and the Member States should ensure the development of more robust management and control systems. In particular, a more rigorous approach to the chocking of expenditure is required.</td>
<td>As far as the 1994 to 1999 programmes are concerned, the system weaknesses are addressed by the closure strategy (see below). For the current period the Commission is continuing its efforts to bring about the necessary improvements, through its own audit work, coordinated with that of Member States, through action plans backed up by the power to make suspension of payments and financial corrections. It also disseminates good practices, for example in the crucial area of management checks referred to by the Court, on which it is planned to issue examples of good practice in 2003.</td>
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<td>Delays and problems in closing 1994 to 1999 programmes</td>
<td>The Commission has checked the closure documents and performed audits in some cases, leading to the proposal of financial corrections. A significant number of programmes remained to be closed at the end of 2004.</td>
<td>The Court’s audit demonstrated that the controls operated by the Commission do not eliminate the risk of Community co-financing of ineligible expenditure. The Court should ensure timely examination of documentation submitted by the Member States. The Commission and Member States should apply the lessons learned from the 1994 to 1999 closure process for the closure of 2000 to 2006 programmes.</td>
<td>The Commission’s close strategy – involving pre-closure compliance audits, checking of declarations by the independent body accompanying final payments and ex-post audits of closed programmes followed by financial corrections – has significantly reduced the risk of undue payments. The closure process has been carried out in a good standard and generally within a maximum period of six months. The number of programmes and the complexity of the issues checked. Lessons can nevertheless be learnt and will be applied in the next closure. A guidance note is currently being prepared.</td>
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<tr>
<td>Limitations in the Commission’s assurance on the operation of the management and control system</td>
<td>The Commission has continued its assessment of the systems and its programme of audits in the Member States.</td>
<td>The Commission’s assurance has become broader but the management and control systems do not provide sufficient assurance of the legality and regularity of expenditure.</td>
<td>The approach of the Structural Funds Directorate-General is to build up assurance through audit work carried out in accordance with their audit strategies and through increased cooperation with national audit bodies. Procedures are applied to remedy deficiencies or to prevent irregular expenditure.</td>
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<tr>
<td>Improvements have been noted, but the Commission’s follow-up to the Court’s audit findings is not always timely, appropriate or complete</td>
<td>The Commission continues to make checks in the Member States where system weaknesses are declared by the Court.</td>
<td>The Commission should ensure a comprehensive follow-up, avoiding any undue delays.</td>
<td>The Commission has introduced computer applications to monitor follow-up and help ensure that it is comprehensive and timely.</td>
</tr>
</tbody>
</table>

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**Notes:**
- The table summarizes key observations made by the Court and the actions taken by the Commission in response.
- The Commission’s reply highlights efforts to address system weaknesses and improve follow-up procedures.
- The table includes references to specific paragraphs in the Annual Reports for detailed information on the observations and actions taken.
CHAPTER 6

Internal policies, including research

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INTRODUCTION

6.1. The budgetary area of Internal Policies, including Research (IP) covers a wide range of activities contributing to the development of the single market leading to 9 010 million euro commitments (see Graph 6.1) and 7 255 million euro payments (see Graph 6.2) in 2004. More than half of these appropriations related to Research and Technological Development (RTD).

6.2. The majority of the IP actions are directly managed by the Commission (1). As a general rule, IP are implemented through a variety of multi-annual programmes allocating grants to private and public beneficiaries for the completion of specific actions. Some actions, such as research, are complex in nature. The grants are usually paid through advances followed by successive interim and final payments.

Graph 6.1 — Breakdown of commitments by budgetary area in 2004

[Diagram showing the breakdown of commitments by budgetary area, with the largest portion dedicated to Research and Technological Development (67%), followed by Energy, Euratom and the environment (4%), Other structural operations (5%), Training, youth and social operations (17%), and Consumers, internal market, industry and networks (17%).]

Source: 2004 annual accounts.

(1) The main exception is the European Refugee Fund, for which the management is shared with the Member States; see Annual Report 2003, paragraph 6.15.
SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Audit objectives and scope of the audit

6.3. To contribute to the Court’s Statement of Assurance on the general budget, the audit assessed the extent to which the Commission’s internal controls give assurance on the legality and regularity of the underlying transactions. The audit focused on (7):

(a) the operation of selected supervisory and control systems:

— eight of the Commission’s 24 Internal Control Standards for three Directorates-General: Research (DG RTD), Information Society and Media (DG INFSO) and Health and Consumer Protection (DG SANCO),

(7) As in the Internal Policies area the major EU-funded programmes are managed directly by the Commission. The National Audit Institutions in general do not cover this area.
THE COURT’S OBSERVATIONS

— management and control systems of the sixth framework programme (FP6) for Research and Technological Development (RTD) (1), of the European Refugee Fund (ERF) in the area of Justice, Freedom and Security (2) and of Community actions in the area of Public Health and Consumer Protection (SANCO) (3);

— reports of the Commission’s ex post financial audits;

(b) tests of a sample of commitments and payments authorised in 2004;

(c) the Annual Activity Reports and Declarations of the Directors-General (6).

Evaluation of supervisory and control systems

Risk analyses

6.4. In the IP area, payments are mainly based on the reimbursement of the costs reported by the beneficiary. Under this system, the principal inherent risk for legality and regularity of underlying transactions is that beneficiaries overstate their cost declarations. Unless detected by the Commission’s internal controls, this can lead to over-payments. This risk is amplified due to a multiplicity of contractual provisions, insufficiently clear definitions of eligible costs and a lack of sanction mechanisms.

6.4. The annual activity reports by the Directors-General confirm that the frequency of errors in declarations presented by the beneficiaries is indeed a problem. These errors sometimes relate to over declarations and sometimes to under declarations. Specific measures are continuing to be taken in this connection.

With regard to FP6, simplified rules should also improve the situation in the future (see point 6.44).

(1) FP6 supports direct and indirect RTD actions that address targeted scientific areas and promote the development and coordination of national research policies in the European Union. FP6 is jointly managed by five Directorates-General of the Commission (Directorates-General for Research, for Information Society and Media, for Energy and Transport, for Enterprise and Industry and for Fisheries and Maritime Affairs). During 2004, the total budget of FP6 which covers the period 2002 to 2006 was increased from 17 500 to 19 235 million euro, following the enlargement of the European Union to 25 Members. The governing Decisions are: No 1513/2002/EC of the European Parliament and of the Council (OJ L 232, 29.8.2002, p. 1) and Council Decision 2002/668/Euratom (OJ L 232, 29.8.2002, p. 34).


(4) Directorate-General for Health and Consumer Protection is responsible for carrying out Community activities in the area of Public Health and Consumer Protection, as well as food safety, veterinary and plant health measures.

6.5. The controls performed by the Commission consist mainly of checks on the cost declarations prior to the payment (ex ante controls) and financial audits at the final beneficiary level after the payment was made (ex post financial audits). In-depth ex ante controls could reduce the risk of over-payments. The risk of non-detection remains significant as certain types of errors can only be detected by ex post financial audits.

6.5. Following action 1 in the 2001 summary report by the Commission, ex ante controls were stepped up. In particular, on the basis of risk analysis documentary evidence in support of the declaration of expenditure can be demanded from the beneficiary. The extra ex post audits put in place under the same action plan not only reduce the risk of errors in the declarations submitted but also act as a preventive measure. The introduction of audit certificates should also be noted.

Implementation of the Commission’s Internal Control Standards

Scope of the audit

6.6. The implementation and functioning of the Internal Control Standards is essential for the IP area given that most of the funds concerned are directly managed by the Commission itself.

6.7. The Court reviewed the implementation of eight (7) out of 24 Standards in DG RTD, DG INFSO and DG SANCO. The scope of the audit was to verify whether the minimum requirements of Internal Control Standards (baseline requirements) were in place.

Further improvements required on the implementation of the Internal Control Standards

6.8. In general, the baseline requirements for the selected eight Standards at DG RTD, DG INFSO and DG SANCO were complied with, but further improvements are needed particularly in the cases below:

— The audit at DG RTD revealed that Standard 11 ‘Risk management’ was not yet fully complied with in 2004. Nevertheless, steps have been taken to facilitate compliance with this standard in 2005.

— In 2004 DG Research, in accordance with ICS 11, analysed the risks connected with its activities, namely: an ex post analysis of the management risks by the inspectors at the level of each directorate and analysis of the risks by the internal audit capability for the preparation of its annual audit plan. Moreover, in 2005, these two analyses will be supplemented by a strategic risk analysis started in 2004.

THE COURT’S OBSERVATIONS

— The audit confirmed the observation made in the Annual Report 2003 (8) regarding the insufficient compliance with Standard 12 ‘Adequate management information’. The management information available at DG RTD does not provide certain data about FP6 which the Court considers essential to ensure a proper monitoring of such a programme (e.g. basic data on contract management) (9).

— DG RTD has taken action to improve this situation in 2005 and has set up a working group with a view to make an inventory of the scoreboards developed at DG and Directorates levels and to make recommendations in order to improve and harmonise the existing tools. In addition, since March 2005, contract data regarding FP6 is included in the monthly scoreboard report.

— At DG SANCO, Standard 22 ‘Internal audit capability’ was not complied with. Two out of three posts were vacant for part of 2004 in the internal audit unit, which hindered the execution of the annual audit work plan.

— Staff shortages had in fact an impact on the planned audit schedules. DG SANCO has taken the necessary measures to minimise the impact, although some adjustments of the audit programme were unavoidable.

— DG SANCO complied only partially with Standard 18 ‘Recording exceptions’ since the procedure in place was limited to exceptions regarding financial and contractual procedures.

— SANCO will establish further guidelines for dealing with exceptions to non financial procedures, in particular, as regards the level of authorisation, formal requirements for recording and follow up actions.

THE COMMISSION’S REPLIES

— The audit confirmed the observation made in the Annual Report 2003 (8) regarding the insufficient compliance with Standard 12 ‘Adequate management information’. The management information available at DG RTD does not provide certain data about FP6 which the Court considers essential to ensure a proper monitoring of such a programme (e.g. basic data on contract management) (9).

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— SANCO will establish further guidelines for dealing with exceptions to non financial procedures, in particular, as regards the level of authorisation, formal requirements for recording and follow up actions.

Appraisal in selected areas of activity

6.9. The Court examined the management and control procedures of the sixth framework programme for Research and Technological Development (FP6), for the European Refugee Fund (ERF) and for Community actions in the area of Public Health and Consumer Protection (see Annex 2). The operation of the most important controls was verified based on a sample of transactions (10) (see paragraphs 6.25 to 6.35).

Sixth Framework Programme for Research and Technological Development (FP6)

Common IT system still not fully operational

6.10. The use of a common IT system is a key factor for the effectiveness of the Commission’s internal controls (11). The Commission initiated in 2002 the development of such a system for


(9) See recommendations made by the Court in its Special Report No 1/2004 on the Management of indirect RTD actions under the fifth framework programme (FP5), paragraph 135.

(10) For FP6: a sample of 14 payments selected to ensure coverage across sub-programmes and services. For ERF: A sample of payments for eight Member States, extending the verification to the final beneficiary for interim payments in three Member States. For Public Health and Consumer Protection: a sample of 20 payments at Commission level, and in five cases extending the verification to the final beneficiary level.

(11) See recommendations made by the Court in its Special Report No 1/2004 on the Management of indirect RTD actions under the fifth framework programme (FP5), paragraphs 124 to 126.
the different stages of the management of indirect RTD actions (proposal evaluation, negotiation and selection, contract and project management). In 2004, two years before the end of the FP6 programming period, neither a common nor an integrated IT system was fully operational, despite the Commission’s declared intention to do so (12). This situation (already detected during 2003 (13)) affects the efficient operation of the internal controls concerning all management areas of FP6, especially those related to the authorisation of commitments and payments and the production of management indicators in relation to Internal Control Standard 12. This was confirmed by a proposal for qualification in one of the Authorising Officers’ declarations in relation to the IT system and by the difficulties encountered by the Commission in providing detailed data on FP6 actions.

Concerning specifically the authorisation of FP6 commitments and payments workflow tools exist, either centrally or locally, to ensure that the appropriate approvals are given.

The question relating to Standard 12 concerns DG RTD and is dealt with in 6.8.

Obligation to provide audit certificates

6.11. One of the main modifications introduced by FP6 in order to reduce the risk of errors at final beneficiary level is the requirement to have the costs declared to the Commission certified by an external auditor (14). These certificates are part of the Commission’s control systems. The audits carried out by the Court detected ineligible costs (15) which had not been identified in the corresponding audit certificates submitted to the Commission to support the payment request.

6.11. The principal function of audit certificates is to provide additional assurance to the Commission regarding the reality and accuracy of costs declared. However, it cannot realistically eliminate all possible errors. The effectiveness of audit certificates in detecting errors is likely to improve with experience and the Commission intends to accelerate the process of improvement through targeted information to beneficiaries and auditors and a continuous assessment of the contribution of the audit certificates in the general control system.

European Refugee Fund (ERF)

Obligatory checks of actions by the Member State not fulfilled

6.12. The Member States should ensure, by checks covering at least 20 % of the total eligible expenditure, that the action is managed in accordance with the applicable Community rules, and that the funds are placed at its disposal in accordance with

6.12. The Commission assists the Member States in improving the systems for monitoring the European Refugee Fund (ERF) in particular during monitoring visits and on-the-spot controls. In addition, the Commission will organise work meetings on the themes of control systems and good management practices: programming actions, monitoring projects, checking expenditure, etc.

The Commission feels that on-the-spot inspection visits is a good practice even if the ERF rules do not explicitly provide for it. Since the 2004 programme came into force, the Member State in question checks all projects on the spot.


(14) Article 14 of Regulation (EC) No 2321/2002 of the European Parliament and of the Council of 16 December 2002 concerning the rules for the participation of undertakings, research centres and universities in, and for the dissemination of research results for, the implementation of the European Community sixth framework programme (2002 to 2006). The cost for the certification is reimbursed in full by the Community fund concerned.

(15) The number of audits certificates issued for FP6 in 2004 was about 10. The ineligible costs concern the two cases audited by the Court. Furthermore, on one of these two cases auditors fail to detect the fact that the advance payment had been invested in mutual funds and that the related interest was not reported. The amounts were not really significant, but this reflects a limitation of the certification process.
THE COURT'S OBSERVATIONS

the principles of sound financial management (16). Contrary to the requirements of the underlying rules, in one Member State visited, checks on supporting documents are not followed by on-the-spot controls of the actions. This confirms the observations in the Annual Report 2003 (17) relating to ‘weaknesses of control systems identified in the Member States’.

Delegation of tasks not in line with Financial Regulation in one Member State

6.13. As already discovered by the Commission during a monitoring visit to one Member State, certain core tasks of the management of the ERF actions had been delegated by the national authority to a private company (18). This is not in conformity with the Financial Regulation as regards delegation of tasks to third parties. The corrective action recommended by the Commission was implemented late.

Non-eligibility of expenditure

6.14. Last year (19) the Court identified weaknesses in the management of the repatriation measures related to the non-respect of eligibility criteria. This year additional questions arose regarding the non-respect of the eligibility of the target groups, which can only be solved by changes in the legal framework (see paragraph 6.34).

6.13. The excessive nature of the delegated tasks was identified by the Commission during a monitoring visit and immediately reported to the national authorities. The kind of tasks delegated was adjusted during the new contract procedure when services were being renewed.

Generally speaking, the Commission tried to assist Member States in applying strictly the existing rules on the eligibility of the target groups and it analyses expenditure declarations with great care. For instance, following an ex post control in a Member State, a financial correction was applied with regard to ineligible expenditure for a reason of that kind.

The Commission feels that the eligibility criteria are applied in the case of asylum seekers whose requests have been rejected. (see reply to 6.34).

Moreover, the legal framework relating to the concept of country of origin was clarified in Council Directive 2004/83/EC and in the new legal basis of ERF2 adopted in December 2004.

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(18) Delegated tasks included: signature of contracts, recovery of funds, payments without prior authorisation by the national authority, which is in contradiction with Article 57 of the Financial Regulation: The tasks which may be entrusted by contract to external private-sector entities or bodies other than those which have a public-service mission are technical expertise tasks and administrative, preparatory or ancillary tasks involving neither the exercise of public authority nor the use of discretionary powers of judgment.

6.15. A large part of the budget for the Public Health Programme (20) is spent on cofinancing projects selected following annual calls for proposals. In the area of Consumer Protection (21), an annual call for proposals for specific projects is issued. However, most of the annual budget is implemented via direct contracting for studies or services, and actions implemented jointly with Member States. Both areas are the responsibility of DG SANCO.

Analysis of procedures

6.16. The management and control of the implementation of these activities is mostly carried out by the individual directorates. However, at the central level of the Directorate-General, an additional ex ante verification of financial transactions is performed on a sample basis, a ‘Committee of Public Procurement’ issues opinions on the conformity of the tendering procedures and an ex post financial control cell carries out audits at the final beneficiary level. The internal audit function provides opinions to the Director-General on the quality of management and internal control systems.

6.17. The Court analysed the procedures introduced in 2004 and found them to be adequate. However, errors detected in testing the underlying transactions (see paragraph 6.29) point to the fact that the procedures were not continuously and consistently applied in the past. The Financial Regulation (FR) was not fully complied with, in particular:

— the Financial Regulation provides that all payments should be subject to verification. As regards advance payments, there was no evidence of a systematic a priori verification made by the authorising officer;

— the procedures do not include the drawing up of an estimate of the amounts receivable as interest on pre-financing payments, as required by the FR (see paragraph 6.28).

6.17. See 6.29.

— SANCO’s financial circuits are designed in compliance with the Financial Regulation and take into account the risks involved in the different financial transactions. In the case of advance payments, it is the responsible Authorising officer who exercises personally the necessary verifications before authorising the expenditure. The documentation of these controls will be improved.

— The Commission has recognised the problem of proportionality and proposes to change the existing FR and IR to introduce thresholds of pre-financing payments below which no estimate of amounts receivable needs to be established or the interest effectively yielded does not need to be recovered. In the meantime SANCO will bring the procedures as regards the estimate of revenue for interest in line with the Financial Regulation.

(20) The current Public Health Programme with a total budget of 312 million euro for the period 2003 to 2008 replaced eight different action programmes implemented prior to 2003. The projects aim at improving information about public health issues, enhancing the capability of responding to health threats or addressing health determinants.

(21) The framework decision for financing Community actions in support of Consumer Policy sets aside a budget of 72 million euro for the years 2004 to 2007.
THE COURT’S OBSERVATIONS

Analysis of the Commission ex post financial audits in the IP area

6.18. In Internal Policies programmes, most of the grants are paid directly to the final beneficiary with no other public co-financing. Therefore assurance needs to be obtained by carrying out ex post financial audits at the beneficiary level. These audits, either carried out by the audit services of the different Directorates-General or by external audit firms (EAF) on behalf of the Commission, focus on the cost statements that beneficiaries submit for reimbursement. In addition, in some budget areas, the Commission required beneficiaries to submit a certificate (see paragraph 6.11) from an independent auditor in support of the cost statements (22).

6.19. The Court’s audit covered:

— the analysis of the evolution of the number, the results and the coverage of audits compared to previous years;

— the analysis of audit results on a sample of audit reports from EAF;

— a review of a sample of Commission audit reports concerning indirect research contracts and measures funded by DG ENV.

Evolution of audits carried out

6.20. The Court’s analysis revealed that:

— whereas some Directorates-General have increased their level of audit activities, the overall level has been reduced in 2004 (Table 6.1), from 552 completed audits in the previous year to 496, (which corresponds to 2% of open contracts), but the recoverable amounts actually increased (23);

— audits made by five Directorates-General in the last six years suggest that the amount recoverable following a financial audit seems to be positively correlated with the number of audited contracts (see Graph 6.3). Therefore it is worth noting that the Commission’s own stated target to audit 10% of all contractors under FP5 has not been achieved (see Table 6.2) (24).

(22) This measure is applied in the Sixth Framework Programme for Research and for the LIFE programme. In the RTD area the certificate is normally necessary only for FP6 final payment requests of each instalment of the contracts. In 2004 only very few final payments under the sixth framework programme had been effectuated yet.

(23) Excluded the 95.5 million euro recoveries for veterinary actions in 2003.

Table 6.1 — Internal Policies area — Audits by (or on behalf of) the Commission completed in 2004 (1)

<table>
<thead>
<tr>
<th>Directorate-General</th>
<th>Number of completed audits</th>
<th>Number of audited contracts</th>
<th>Number of open contracts</th>
<th>Value of audited contracts (million euro)</th>
<th>Value of open contracts (million euro)</th>
<th>Adjustments of the eligible costs in favour of the Commission as a result of the audits (adjustments in favour of the contractors not taken into account)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGRI — Agriculture</td>
<td>12 (7)</td>
<td>5</td>
<td>19</td>
<td>6</td>
<td>268</td>
<td>245</td>
</tr>
<tr>
<td>EAC — Education and Culture</td>
<td>126</td>
<td>75</td>
<td>173</td>
<td>80</td>
<td>19 424</td>
<td>15 884</td>
</tr>
<tr>
<td>EMPL — Employment and Social Affairs</td>
<td>17</td>
<td>25</td>
<td>19</td>
<td>27</td>
<td>1 559</td>
<td>1 639</td>
</tr>
<tr>
<td>TREN — Energy and Transport</td>
<td>25</td>
<td>59</td>
<td>37</td>
<td>89</td>
<td>1 630</td>
<td>1 508</td>
</tr>
<tr>
<td>ENTR — Enterprise and Industry</td>
<td>28</td>
<td>43</td>
<td>41</td>
<td>64</td>
<td>1 463</td>
<td>1 684</td>
</tr>
<tr>
<td>ENV — Environment</td>
<td>23</td>
<td>42</td>
<td>52</td>
<td>73</td>
<td>1 711</td>
<td>1 748</td>
</tr>
<tr>
<td>FISH — Fisheries and Maritime Affairs (2)</td>
<td>31</td>
<td>18</td>
<td>64</td>
<td>41</td>
<td>216</td>
<td>238</td>
</tr>
<tr>
<td>JLS — Justice, Freedom and Security</td>
<td>8</td>
<td>8</td>
<td>30</td>
<td>47</td>
<td>923</td>
<td>901</td>
</tr>
<tr>
<td>SANCO — Health and Consumer Protection (7)</td>
<td>0</td>
<td>8</td>
<td>0</td>
<td>12</td>
<td>nd</td>
<td>522</td>
</tr>
<tr>
<td>INFSO — Information Society and Media</td>
<td>74</td>
<td>95</td>
<td>197</td>
<td>230</td>
<td>2 859</td>
<td>2 320</td>
</tr>
<tr>
<td>RTD — Research</td>
<td>208</td>
<td>118</td>
<td>258</td>
<td>167</td>
<td>8 229</td>
<td>7 696</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>552</td>
<td>496</td>
<td>890</td>
<td>836</td>
<td>38 282</td>
<td>34 385</td>
</tr>
</tbody>
</table>

(1) Definitions used in this table:
— Number of audits completed: number of financial audits concerning any individual beneficiary where a final audit report was issued during the year 2004.
— Number of open contracts: number of contracts signed in the year that have not yet been completed plus the total number of contracts that were open at the beginning of the year that were not completed during the year. Completed contract = contract where the terms of the contract have been fulfilled, all financial and technical reviews have been completed and the final payment has been made.
— The word ‘contract’ denotes both contracts (either a shared-cost action or a contract awarded through the public procurement procedures) and subsidies (where a financial agreement has been reached).
— Value of audited contracts: the actual value of only the contracts audited on-the-spot for the contractor audited (not the total value of the contract but the audited participant’s share of it, and only those contracts audited on-the-spot at the contractor and not their total contracts with the Commission).

(2) Conprising research measures, data collection measures (DG FISH has started auditing these measures in 2004) and fishery control measures.
(3) The number of audits includes 2 audits of ‘Idea’ (identification of animals) in the Netherlands and Spain of budget heading B1-3 6 0.
(4) The amounts are indicative at the time of reporting.
(5) The amount corresponds to the outstanding sums of the open contracts.
(6) The amounts that were recovered in 2004 as the result of the audits conducted in 2003 will be reported in 2005 when the final audit reports will be issued.
(7) Includes only Public Health and Consumer Protection areas. The value of audited contracts is the amount of the EU funding. Amounts recoverable are the EU part of ineligible costs.
(8) DG TREN: This amount corresponds to the figure before the application of the co-financing rate. The recoverable amount after the application of the co-financing rate is 0.82 million euro.
(9) DG TREN: This amount corresponds to the figure before the application of the co-financing rate. The recoverable amount after the application of the co-financing rate is 7.1 million euro.

Source: European Commission.
### Table 6.2 — Directorates-General operating the RTD framework programmes — Summary table of FP5-related audits closed (2001 to 2004)

<table>
<thead>
<tr>
<th>Directorate-General in charge</th>
<th>Total number of FP5-related audits closed</th>
<th>Total number of FP5 contracts audited</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2001</td>
<td>2002</td>
</tr>
<tr>
<td><strong>DG RTD</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal</td>
<td>1</td>
<td>25</td>
</tr>
<tr>
<td>External</td>
<td>1</td>
<td>88</td>
</tr>
<tr>
<td>Total DG</td>
<td>2</td>
<td>113</td>
</tr>
<tr>
<td><strong>DG INFSO</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>External</td>
<td>0</td>
<td>8</td>
</tr>
<tr>
<td>Total DG</td>
<td>0</td>
<td>12</td>
</tr>
<tr>
<td><strong>DG TREN</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>External</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>Total DG</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td><strong>DG ENTR (1)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>External</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Total DG</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td><strong>DG FISH</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal</td>
<td>1</td>
<td>15</td>
</tr>
<tr>
<td>External</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total DG</td>
<td>1</td>
<td>15</td>
</tr>
<tr>
<td><strong>Total Internal</strong></td>
<td>2</td>
<td>44</td>
</tr>
<tr>
<td><strong>Total External</strong></td>
<td>1</td>
<td>108</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>3</td>
<td>152</td>
</tr>
</tbody>
</table>

(1) Note that 17 audits closed by DG ENTR in 2003 (covering 20 FP5 contracts) have been transferred to and closed by DG INFSO in 2004. The number of audits closed by DG ENTR during 2003 (together with the number of contracts audited) has been modified accordingly.

Note: Total number of FP5 contractors (EC and Euratom) is 23 375. Therefore, Commission’s FP5 target is 2 337 audits closed.

However, the number of 23 375 has to be refined as it contains duplications of contractors.

It contains a substantial number of less important contractors, i.e., contractors with a contribution of less than 20 000 euro.

Source: Commission.
Audits carried out by external audit firms: scope and timing

6.21. The results of the audits carried out by external audit firms on behalf of the Commission were examined in order to assess whether they constitute a valid source of information for the appraisal of the legality and regularity of underlying transactions. A sample of 31 files of audits were examined in the Directorates-General concerned (DG RTD, DG TREN, DG INFSO and DG ENTR).

6.22. The contractual mandate of the external audit firms is limited to the verification of the cost statements at the level of the beneficiary. Other issues impacting the legality and regularity of the transactions, such as the achievement of contractual objectives or the timely provision of contractually agreed deliverables by the beneficiary which could be verified in some cases by the external auditor, are not covered by such audits.

6.23. The analysis of a sample of audit reports showed an average delay of 416 days between the initiation and the completion of the audit. While a certain delay is inevitable to complete the audit process, some of the delays observed are excessive (ranging from 94 to 770 days) (25) (see Table 6.3). Given that nearly all audits identified errors in cost statements, such long delays prevent the timely recovery of unduly received grants or, vice versa, the timely payments from the Commission to the beneficiaries.

6.22. The achievement of (scientific/technical) objectives is monitored by the Commission’s scientific officers who assess the periodic reports from the beneficiaries. Scientific reviews are also done by a panel of independent experts who check if the scientific deliverables comply with the contractual provision. Financial auditors have not the required expertise to assess the scientific deliverables so that their work is limited to verifying if the amounts are claimed in accordance with the financial provisions of the contract.

6.23. The procedure is that, when batch audits are launched, all selected contractors are informed by the Commission that an audit will be carried out by the EAF on behalf of the Commission. The actual audit field work starts more than three months (on average 100 days) later in function of the planning of the EAF. Such time should be deducted from the audit productive time. The completion of the report is followed by the consultation period of 30 days with the contractor (Article 26.3 of the Annex II of the FP5 model contract). The time frame between initiation and completion of an audit therefore ranges in the order of 12 to 15 months (365 to 450 days). In rare cases where the resolution of complicated audit and contractual issues is required or when new declarations of costs are re-introduced, this period may be exceeded.

The completion time of batch audits through the external auditors typically ranges between 9 and 12 months (270 to 365 days) in line with the contract with the EAF. The contractual arrangements with the auditors give room for the application of financial penalties for the non-completion of the agreed work within the agreed time frame (1.5 % of contract value for each month of delay). The Commission has systematically applied these penalties.

(25) Similar observations were already noted in the Court of Auditors’ Annual Report 2002 paragraph 6.52 concerning DG RTD and 2003 for DG EAC’s audits (see paragraph 6.33).
Table 6.3 — Number of days for completion of Commission financial audits

<table>
<thead>
<tr>
<th>DG</th>
<th>Number of audits in the sample</th>
<th>Average of number of days</th>
<th>Total delays</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>From informing the contractor to the auditor report</td>
<td>From the auditor report to the implementation decision (i)</td>
</tr>
<tr>
<td>INFSO</td>
<td>10</td>
<td>357</td>
<td>149</td>
</tr>
<tr>
<td>RTD</td>
<td>12</td>
<td>334</td>
<td>47</td>
</tr>
<tr>
<td>TREN</td>
<td>7</td>
<td>244</td>
<td>148</td>
</tr>
<tr>
<td>ENTR</td>
<td>2</td>
<td>168</td>
<td>101</td>
</tr>
<tr>
<td>4 DGs</td>
<td>31</td>
<td>310</td>
<td>106</td>
</tr>
</tbody>
</table>

(i) This delay includes the contradictory period with the contractor. The implementation decision is the basis for starting corrective actions; the audit results are distributed to operational units for implementation.

Source: Court of Auditors Analysis.

Inadequate follow-up procedures for ex post financial audits at the Directorate-General for Environment

6.24. The Court’s analyses of audit reports and files at DG ENV, established by the audit unit of this Directorate-General, leads to following observations (26):

— recovery orders are launched too late: In 2003, the Commission’s own auditors recommended the recovery of 391 000 euro. By November 2004, only 54 % of this amount had actually been recovered from the beneficiaries, due in part to a pending OLAF investigation. Although the average delay between the receipt of the final audit report and the establishment of a recovery order went down from 152 days in 2003 to 138 in 2004, this delay is still excessive. In contrast, the beneficiaries paid on average within 50 days from the issue of the recovery order,

— inadequate monitoring of contracts: most of the Commission files that were examined did not show any evidence that feedback had been sent from the technical units to the audit units regarding the follow-up actions. Where problems have been noted by the technical units or documented in the audit reports, there is a long delay before the services concerned decide on an adequate action such as undertaking verification at the beneficiary, reducing the final payment or launching a recovery order. In one case, the decision to launch an audit on the spot was taken only 16 months after the final payment was made,

6.24.

— Finalised ex post audit reports are sent to the operational unit(s), who inform the beneficiary of the results of the audit and invite them to provide with further comments or additional documentation. Only when the beneficiary has replied, the Authorising Officer by Sub-delegation takes the decision as regards the issuing of a recovery order. As prescribed by the Financial Regulation, a prior information letter must also be sent to the beneficiary before issuing the recovery order and debit note. Taking into account this consultation process, a delay of several weeks between the receipt of the audit report and the taking of corrective action is unavoidable.

— It is agreed that the follow-up of audit findings needs to be subject to a more formal and measurable procedure in DG ENV.

The ex post audit unit has set up since the end of 2004 a monitoring format and method in order to remind technical units on a regular basis to send information on action taken on the basis of audit reports.

(26) The analysis covered a sample of 58 reports established in 2003 and 2004, including 90 projects. The corresponding projects contracts were signed between 1994 and 2003 (of which the majority between 1998 and 2001).
THE COURT’S OBSERVATIONS

— for contractors receiving EU funds through more than one contract, where an audit reveals errors that can be considered as systematic, there are no procedures foreseen to inform the other Commission services concerned or undertake audits of the other contracts (27).

Results of the test of underlying transactions in the IP area

6.25. A review of the Commission files was performed on a general sample of 107 payments (28) and eight commitments selected in the IP area; for 25 interim and final payments of this sample, the audit was extended at final beneficiary level. The findings corroborate the weaknesses identified in the systems (see paragraphs 6.9 to 6.17).

At Commission level errors were frequent but not material.

6.26. The review of Commission files revealed that 58 out of the 107 payments were affected by issues of legality and regularity (29). Most of the irregularities were already identified last year (30) and the most frequent relate to:

Payments delayed for periods exceeding one month

6.27. The Financial Regulation was not complied with for 20 % of payments, which were made late and in most cases the delay exceeded one month (31). The Commission did not assess the amount of interest due for late payments and did not enter a provision for this liability into its accounts.

(27) As already noticed in the Annual Report 2003, paragraph 6.33, for audits conducted by DG EAC. This weakness exists similarly for the audits undertaken by external audit firms in the Research DGs.

(28) A general sample of 67 payments taken at random in the IP area plus specific samples representing a total of 40 additional payments: for FP6 (four payments), for Justice, Freedom and Security area (16 payments including eight payments for ERF), for Public Health and Consumer Protection (20 payments).

(29) In the general sample of 67 payments the observations raised consisted of: late payments by the Commission (15 cases), late payments by the coordinator of the project to the other participants (five), errors not detected by Commission controls (10), no estimate of interests generated by prefinancing payments (nine), issues regarding the award procedure (five), issues regarding the contract or the Commission decision (four)…


(31) In the general sample of 67 payments, the delays for the 15 late payments were spread as follows: below one month (six occurrences), above one month (three), above two months (two), above three months (two), above five months (two).

THE COMMISSION’S REPLIES

— With the implementation of the accounting reform (and in particular the creation of a register on contracts and legal entities), the development of a more general information exchange network could be envisaged at Commission level.

6.27. The Commission accepts that payment times are sometimes too long and should be shortened. In many cases referred to by the Court in footnote 31, it has explained the reasons for this.

The Commission has decided to tackle the problem and measures have been taken both in the internal financial circuits and in the operational methods with those involved. Because of the extremely low level of interest claimed on late payments it is not necessary to enter a provision.
Non-compliance with the Financial Regulation regarding the interest generated by prefinancing payments

6.28. The Financial Regulation requires that the interest yielded by the advance payment of Community funds should be estimated and entered into the Community budget (32). In most programmes the preliminary estimates are not carried out in a consistent way or are not calculated at all. Moreover, the current definition of interest in the contracts is too vague to permit the Commission services to estimate properly the interest generated (33).

6.28. The Commission has recognised the problem of proportionality and proposes to change the existing FR and IR to introduce thresholds of pre-financing payments below which no estimate of amounts receivable needs to be established or the interest effectively yielded does not need to be recovered. With regard to the definition of interest, the Commission feels that it is sufficiently clear and the the beneficiaries are required to declare it.

Failure to respect the procedures for the award of grants

6.29. Out of 43 grant award procedures reviewed four were not regular due to the composition of the Evaluation Committee, the ineligibility of the beneficiary, the absence of a financing decision taken by the institution or the award of a grant outside any call for proposals. In another five cases concerning the award of grants for Public Health actions, it could not be established that for the funded projects complete proposals had been submitted within the deadline, and in six cases the procedure and results of the proposal evaluation were not adequately documented.

6.29. In the area of research, the case noted by the Court concerns the awarding of the grant to an applicant who had declared he had obtained his diploma before he actually got it. The situation is being regularised.

High number of errors at final beneficiary level

6.30. On average, costs reported for the seven FP5 actions audited at final beneficiary, representing an amount of 6 million euro, were overstated by more than 12% due to ineligible costs or absence of supporting documentation. This rate of over-declaration is higher than the average rate of 3.1% resulting from the audits undertaken by the Commission (see Table 6.1). For FP5, the Commission’s 286 financial audits resulted in an average rate of overdeclaration of 4.6%.

6.30. With regard to two of the seven cases audited by the Court, the Commission accepts the comments made and is going to take corrective measures. In four cases, consultations with the beneficiaries are in progress. In one case, the Commission does not agree with the Court’s interpretation.

6.31. When over-declarations of costs were detected, the Court also noted that the checks carried out by the Commission on the cost statements presented by the beneficiaries before the payment were in most cases limited to a simple arithmetic check, as opposed to the reconciliation of cost statements to a sample of supporting documents (like time recording or supporting invoices). This kind of checks on selected documents would have

High number of errors at final beneficiary level

6.31. Payments are made on the basis of cost declarations submitted by the beneficiaries. Some Directorates-General perform already plausibility checks on these declarations and request supporting documents for a subset of the costs.

In order to further strengthen the desk control function in the area of research, DG INFSO and ENTR launched a pilot exercise of in-depth desk controls in 2003, which was executed throughout 2004, and is being evaluated in 2005, in particular from a cost/benefit angle. In the context of these in-depth desk controls, further information was requested, e.g. time sheets, supporting documentation on hourly rates and travel expenses. Thus additional assurance could be gained, although the scope and dimension of desk controls remain by definition limited.


(33) This was also confirmed by the analysis of supervisory and control systems for the sixth framework programme.

made it possible to detect inconsistencies or even errors in the
cost statements. It would also help the beneficiaries to comply
with their obligations to properly document their expenses.

Frequent absence of justification for personnel costs charged on
the project

6.32. In most IP programmes, personnel and related costs rep-
resent the major category of the costs reimbursed:
— for RTD actions, beneficiaries are required to record and cer-


6.32.

tify the time charged on the project. In 50% of the cases
audited by the Court, the system put in place by the benefi-
ciary did not meet the contractual requirements or in some
cases did not exist at all. In addition to the lack of relevant
audit evidence, this also means that important information is
missing for checking the necessity of costs incurred to carry
out the work defined in the description of work. The exist-
ence of a time recording system is verified mainly by ex post
audit at the beneficiary level,
— in the area of Public Health and Consumer Protection, most
of the beneficiaries audited on the spot (four out of five) were
unable to provide sufficient evidence that all personnel costs
declared had been actually incurred and were relevant for the
project. This is in part due to the absence of an explicit pro-
vision in the grant agreements which would require benefi-
ciaries to record time and keep accounts attributing costs to
a specific project. In consequence, the amount of personnel
costs declared to and co-financed by the Commission is fre-
quently only an estimate.

Other issues

Sixth Framework Programme for Research and Technological
Development

6.33. Errors detected by the testing of transactions at Commis-
sion and final beneficiary levels reflecting weaknesses of the con-
control system were:
— the Commission charged payments related to actions under
previous framework programmes (FP4 and FP5) to opera-
tional budgetary appropriations of FP6. This is not consist-
ent with the principle of specification of the budget (35). The
majority of the cases detected (36) had been financed using
the budgetary appropriations accruing from contributions to
FP6 from non-European Economic Area countries,

6.33.

— The contractual provisions foresee that all costs claimed from the
Commission for reimbursement need to be adequately substantiated
by the contractors. For FP5, the practice of the Commission’s audit-
ing services is to take into account the seriousness of the non-
compliance with contractual provisions before deciding on sanctions
to be applied.

— Putting a stricter obligation on the beneficiaries to keep analytical
accounting would add an important administrative burden on some
of them but would not necessarily provide a greater assurance to the
Commission. Instead, DG SANCO is investing more effort in the
description and analysis of the proposed projects. Projects are now
subdivided into work packages which are easier to evaluate and rec-
ognize. It increases the accuracy and consistency of the agreed bud-
ggets of the projects with the resources estimated necessary for their
successful achievement.

Clear instructions are available, especially through internal control
standard 15. In this respect, the checklists for commitments foresee
a verification of the budget heading, financial year, budget article

(35) Appropriations are earmarked for specific purposes. See Article 21
to 26 of the Financial Regulation.
(36) 26 cases for DG TREN amounting to 10 million euro.
THE COURT’S OBSERVATIONS

— the coordinator of a research action transferred its contractual duties to a third party without any legal base and without the Commission’s approval, with the consequence that related costs (37) are not eligible.

— the coordinator of a research action transferred its contractual duties to a third party without any legal base and without the Commission’s approval, with the consequence that related costs (37) are not eligible.

— The Commission will carefully examine the scientific and administrative implications of the request by the coordinator to integrate the third party to the contract when such a request is received, but this would have the consequence that the corresponding costs would become eligible to the contract. An audit on the spot might then be envisaged to further verify the underlying expenses declared.

This situation could not have been detected by the Commission when the payment was made, as no audit certificate was requested with interim payments, but it would have come probably to light at the time of the final payment, where the audit certificate is compulsory.

European Refugee Fund

6.34. The audit of payments at national level revealed ineligible expenditure:

— contracts concluded by one national authority concerning repatriation measures included also asylum applicants who have exhausted all appeal procedures and whose application and appeal were eventually refused by the Member State where they had applied for asylum. These persons do not fall within the target groups specified in Council Decision 2000/596/EC (38) and the corresponding expenditure cannot be eligible for the ERF,

— contrary to the legal requirements that only expenditure related to voluntary returns to the country of origin are eligible, one national programme also financed some voluntary departures to third countries due to specific cases.

— The Commission considers that expenditure incurred for the voluntary return of asylum seekers whose requests had been rejected is eligible for cofinancing under the European Refugee Fund.

— With regard to certain cases referred to by the Court, the legal basis of the ERF, which refers to the concept of the ‘country of origin’ is interpreted as covering specific situations which go beyond a strict reference to ‘country of nationality’. This is the case of stateless persons where a narrow interpretation is nonsensical; moreover, the Geneva Convention introduced the concept of country of habitual residence. Likewise, other specific circumstances closely linked to the protection of persons can justify a wider interpretation as, for example, the case of the former Yugoslavia.

Public Health and Consumer Protection

6.35. Substantive tests performed on the sampled actions revealed that in six cases the beneficiary had not respected the contractual reporting requirements by submitting reports late or not providing the required level of detail within the contractual deadlines (reports being one base for launching the Commission’s payments).

6.35. DG SANCO accepts this delay in most of the cases on condition that reasonable assurance exists that it will finally benefit the quality of the report. In cases where reports are received not providing the necessary quality standard no payment will be done until the required quality has been delivered.

(37) Costs amounting to 270 000 euro.
(38) Article 3 of Council Decision 2000/596/EC.
THE COURT’S OBSERVATIONS

Review of the Annual Activity Reports and the Directors-Generals’ Declarations

Scope of the review

6.36. The Court analysed the Annual Activity Reports and the Declarations of 11 Directors-General (39). The Court analysed in more detail the consistency of the information contained in the 2004 Annual Activity Reports for three Directorates-General (40), comparing it with the results of the audits on the supervisory and control systems carried out.

Weaknesses in the formulation of reservations by Directors-General persist

6.37. The analysis confirmed a further improvement in the structure, presentation and quality of the reports and the Declarations of Directors-General.

6.38. All Directorates-General in the Internal Policies area stated that they had reasonable assurance that the internal control procedures put in place gave the necessary guarantees concerning the legality and regularity of the underlying transactions.

6.39. Out of the 11 Directorates-General, six included one or more reservations to their declaration (41). The Court found that all reservations made were justified and the underlying reasons were mostly well explained. However, for two Directorates-General that did not make any reservations, the Court considers that following reservations would have been justified:

— following the analysis of the report of DG EAC, the Court considers that a reservation should have been made regarding the assurance that the Directorate-General can give in relation to programmes managed by National Agencies in Member States (42). The audit of about one third of all

— On the basis of the systems audits which were launched in 2004 in accordance with the action plan accompanying the 2003 reservation, the Director-General of EAC did not consider it appropriate to maintain in 2004 the earlier reservation of principle which was prompted mainly by the uncertainty connected with the absence of such controls.

Moreover, following these audits in 2004 (which intentionally included agencies where it was thought shortcomings might exist), the agencies audited which showed weaknesses began improving their operating methods; with regard to the three agencies which presented significant deficiencies, the Commission took ad hoc measures before the end of the financial year.

Given these reactions as well as the volume of funds involved in the three agencies with significant deficiencies, the DG, referring to the results of the controls in the AAR, did not consider it appropriate to extend the 2003 reservation.

(39) DG RTD, DG INFOSO, JRC, DG TREN, DG ENTR, DG JLS, DG EAC, DG ENV, DG SANCO, DG COMP, DG MARKT.

(40) DG RTD, DG INFOSO, DG SANCO.

(41) DG RTD, DG INFOSO, JRC, DG JLS, DG ENTR, DG TREN.

(42) For some parts of the programmes Socrates, Leonardo and Youth the Commission delegates the implementation to National Agencies in the Member States. This procedure is named ‘Indirect Centralised Management’.
THE COURT'S OBSERVATIONS

National Agencies for EAC programmes (43) revealed that in about half of the National Agencies audited, weaknesses and recurring difficulties requiring an action plan were found. In about 10 % of the National Agencies audited, significant and obvious shortcomings were detected that led the Commission to take measures to safeguard its financial interests. More than 50 % of the budget of DG EAC is implemented through indirect centralised management,

— the internal audit function of DG SANCO had advised a reservation regarding the risk of errors in grant management in the Public Health area in his contribution to the 2004 report. The need for such a reservation has been confirmed by audits carried out by the Court regarding the Community actions in the area of Public Health and Consumer Protection that revealed a high incidence of errors in the management of grants in the Public Health area (44). The Court is therefore of the opinion that a reservation should have been made or that at least the reasons for not making this reservation should have been explained in the Annual Activity Report.

THE COMMISSION'S REPLIES

DG SANCO has carefully considered the issue of the materiality of the findings of the grant management audit carried out by its Internal Audit Capability. It was concluded that important improvements were made and were on going and that although all issues had not been solved or were still pending in 2004, they were known and sufficiently under control. Whereas the Court of Auditors mainly focuses on the regularity and legality of the underlying transactions, the Directors' General opinion is based on the overall assurance provided by the different control systems that the important risks (impact and likelihood) are sufficiently managed or controlled to prevent them from materialising and harming the Commission.

Follow-up of previous observations in the context of DAS

6.40. Regarding ex post audits of final beneficiaries participating in RTD framework programmes, the Commission is reconsidering its intention to reach the target of auditing 10 % of the FP5 contractors in 2006/2007 (see paragraph 6.20) and has adopted a common FP6 audit approach. FP6 measurable audit objectives still need to be defined and an FP6 audit framework contract has yet to be agreed with an external audit firm (see Annex 1.1.a).

6.40. The Commission refers to its comment in relation to point 6.20 above but also underlines that an important audit activity on FP5 contracts is still going on at present, as the Research DGs have launched in 2005 together some 280 additional audits. These audits will be carried out by the external audit firm with whom a framework contract for auditing services was concluded towards the end of 2004.

The role of the external audit units in FP6 by comparison with FP5 needs to reflect the introduction of audit certificates. External audit must first verify the functioning and the reliability of the audit certificate system and follow-up on specific audit requests expressed by the operational services, rather than provide the assurance on cost declaration on a specified number of contractors as has been the case for FP5. The Commission’s audit objective for FP6 will need to take account of this development.
6.41. Regarding the TEN-T programme, key aspects previously observed relate to ex post audits of TEN-T actions and verification of eligibility of costs. DG TREN should take further action to reach its audit target, to define model cost statements or financial progress reports and to clearly distinguish between the scope of the two main forms of aid, i.e. studies and works (see Annex 1.1.b and 1.2).

6.41. DG TREN has audited 50% of the total amounts related to final payments, which largely exceeds the target of 35%.

As a result of the risk assessment and the geographical coverage that were at the basis of the audit selection process, the target to audit 20% of the projects finalised in 2003 has not been fulfilled completely in 2004.

This target will be re-evaluated for 2005 and adapted if necessary.

DG TREN has now developed a standard cost statement which has to be certified and a form for the technical and financial evaluation. Both of them are annexes to the financial decisions 2005.

Clear definitions of works and studies are contained in the application forms and in the draft for the new TEN Regulation COM(2004) 475 (Article 2, paragraphs 5 and 6).

Conclusions and recommendations

6.42. The evaluation of the supervisory and control systems revealed that, despite progress achieved, not all baseline requirements of the Internal Control Standards in the IP area are fully operational yet (see paragraphs 6.6 to 6.8), and specific weaknesses exist in the systems of FP6, ERF and SANCO (see paragraphs 6.9 to 6.17).

6.42. The Commission endeavours to ensure that the European Refugee Fund is applied uniformly in the Member States. It should also be recalled that the points raised by the Court of Auditors relate to only one Member State; corrective measures have already been taken.

The Commission is continuing its efforts to improve its management systems, in particular its implementation of internal control standards (see point 6.6 to 6.9).

6.43. The weaknesses detected in the supervisory and control systems and by the results of the Court’s substantive testing point to the importance of the ex post audit function as an effective element of the Commission’s internal control system. Thus it is not justified to reduce the number of audits, which has been the case in some areas of IP in 2004 (see paragraph 6.20). Also, as reported already in the previous years, the follow-up of audits, in particular recovery of the Community funds is often too slow (see paragraphs 6.23 and 6.24).

6.43. The Commission will have to reconsider its overall target of auditing 10% of the FP5 contractors, because the final number of auditable FP5 contractors is considerably higher than anticipated, see answer to point 6.20. Timely implementation of corrective actions is closely monitored.

6.44. As in the previous years, the testing of transactions in the Internal Policies area for 2004 revealed a high incidence of errors at beneficiary level, that affected the legality and regularity of transactions. No major improvement has been noted in that area, which also corroborates with the Commission’s own audit findings. Cases of over-declaration of costs, declarations of ineligible expenditures and non-respect of payment delays were noted in all Internal Policies areas examined by the Court. These errors stem often from complicated governing rules and guidelines as well as from instructions which are not sufficiently clear or detailed (see paragraphs 6.25 to 6.35).

6.44. It is no longer possible to change the legal and financial framework applicable to FP5 projects examined here. Nevertheless, the Commission has endeavoured, particularly in the context of the inter-service group set up by the AAR 2001 Action Plan, to improve the management of projects by Commission services and by contractors. For FP6 and FP7, simplifications have been introduced or are proposed. Progress has been made and these issues continue to be carefully followed up.
6.45. Annual Activity Reports in 2004 improved in structure, presentation and content compared to 2003. The reservations made in the declarations by the Directors-Generals were justified. However, in two cases (see paragraphs 6.36 to 6.39) additional reservations would have been called for.

6.45. In the first case, on the basis of the monitoring of the action plan put in place in connection with the 2003 reservation, it no longer seemed necessary to maintain a reservation in 2004 about a management method on which appropriate comments have, however, been made in the body of the 2004 report. As regards the second case, the Director-General considered that the issues identified were adequately controlled and did not call for a reservation.

Overall conclusion

6.46. Despite progress being made in certain areas, the audit findings related to the supervisory and control systems and the results of testing underlying transactions in the Internal Policies area do not provide sufficient assurance on the legality and regularity of underlying transactions. As in previous years this conclusion is supported by the Commission’s own audit findings and the reservations made by the Directors-General.

6.46. The Commission is continuing to try to reduce the frequency and impact of errors in declarations made by the beneficiaries. Internal controls are being improved as called for in the Commission communication ‘on a roadmap to an integrated internal control framework’. With regard to FP7, one aim of the Commission proposal is to simplify systems.

6.47. The Commission is recommended to continue its efforts in order to reduce the risk of errors:

— to change the legal framework in order to simplify cost reimbursement systems by extending the use of ‘lump-sum’, ‘unit-scales’ and ‘flat-rate’ payments (45),

— generally speaking, the proposals for revision of both the Financial Regulation and the Implementing Rules are designed to simplify rules and procedures, in particular, with regard to small grants. It is planned that the revised Financial Regulation and Implementing Rules will come into force on 1 January 2007.

In this case, the rules of participation to be proposed for FP7 will be able to take advantage of the new possibilities opened up by the revised FR.

— to clarify procedures and instructions governing the different programmes,

— to use the errors detected by the ex post audits for improving the management and control systems,

— to take prompt action in cases where audits reveal potential for recovery,

— to ensure the effective implementation of Internal Control Standards.

— generally speaking, the proposals for revision of both the Financial Regulation and the Implementing Rules are designed to simplify rules and procedures, in particular, with regard to small grants. It is planned that the revised Financial Regulation and Implementing Rules will come into force on 1 January 2007.

— part of the simplification efforts of the Commission include the clarification of procedures.

— efforts in this respect will be continued by the DGs concerned.

— the implemented procedures foresee timely action regarding the recovery of unduly paid amounts. This is subject to regular management reports.

— ensuring effective implementation of ICS is a permanent action. This objective will be pursued by the Commission’s services avoiding an excessive administrative burden.

THE COURT’S OBSERVATIONS

FOLLOW-UP OF SPECIAL REPORT No 11/2003 ‘LIFE’


6.49. The Court’s main recommendations were to:

— better define the programme objectives and clarify the link with Community environmental strategy,

— improve the management organisation by generalising the use of outside experts, reinforcing complementarity with other Community measures and reviewing eligibility rules,

— reinforce monitoring, control and evaluation, through better use of external auditors, and implement strategies for the dissemination of results.

6.50. Most of the Court recommendations have been addressed; however

— the programme’s objectives have still to be better defined,

— whilst the number of audited LIFE contracts increased in the years following the publication of the Special Report, the audit visits are still of a financial nature and do not assess the achievements,

— the Commission has still to set-up a sound financial management practice for the evaluation of the project results.

6.50. The Council and European Parliament adopted Regulation (EC) No 1682/2004 on 15 September 2004 extending the Life III programme until 31 December 2006. This sets out more clearly the programme’s objectives (1).


(1) Specifically, for example, Article 1(2)(b) indicates that guidelines shall be established by the Commission (that) indicate priority areas and objectives for demonstration projects.
ANNEX 1

Internal policies (including research) — Assessment of key aspects previously observed

<table>
<thead>
<tr>
<th>Observations</th>
<th>Action taken in 2004</th>
<th>Action to be implemented</th>
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<tbody>
<tr>
<td><strong>1.a Supervisory and control systems — ex post audits of final beneficiaries participating in RTD framework programmes</strong></td>
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<tr>
<td>In 1998 the five Directorates-General operating the RTD framework programmes jointly formulated an audit approach, setting themselves for FP5 a target of auditing 10% of the contractors (see Annual Report 2001, 2002 and 2003 paragraph 6.30). These audits are to a large extent carried out by external audit firms on behalf of the Commission. The Court found that:</td>
<td>As the total number of FP5 contractors amounts to 23,375, the target amounts therefore to 2,337 contractors audited.</td>
<td></td>
</tr>
<tr>
<td>— the definition of ‘auditable population’ used by the Commission results in significantly less than 10% of indirect RTD actions or cost declarations being audited during the programme period (see Annual Report 2002);</td>
<td>Because the final number of auditable FP5 contractors is considerably higher than anticipated, the Commission indicated that it will have to reconsider the overall target of auditing 10% of FP5 contractors by 2006/2007.</td>
<td>Audit activities out the Commission should be strengthened to achieve audit target for FP5.</td>
</tr>
<tr>
<td>— the Commission is unable to achieve its own target of audit coverage (see Annual Reports 2001, 2002, 2003);</td>
<td>In 2004, completion of 317 audits, 296 of which were related to FP5 indirect RTD actions. Total number of FP5 audits closed (756) still falling short of target.</td>
<td>Commission should define for FP6 measurable objectives, which can realistically be achieved.</td>
</tr>
<tr>
<td>— the Commission has not adopted a common audit approach for FP6;</td>
<td>Adoption of a common audit approach for FP6 in 2004. Definition of measurable audit objectives for FP6, which can realistically be achieved, still outstanding.</td>
<td>A new framework contract for FP6 should be signed to provide adequate external support to the Commission to implement its audit approach for FP6.</td>
</tr>
<tr>
<td>— the continuity of the Commission’s audit activity depends on providing for the possibility to subcontract ex post financial audits (expiry of framework contract with external audit firm in 2003).</td>
<td>Award procedure for a new framework contract (for FP5 indirect RTD actions). Framework contract with External Audit Firms signed in November 2004. Award of contract for the audit of FP6 indirect RTD actions still in progress.</td>
<td></td>
</tr>
</tbody>
</table>

| **1.b Supervisory and control systems — ex post audits of final beneficiaries participating in TEN-Transport actions** |                                                                                                             |                                                                                           |
| Regular on-the-spot checks for the monitoring of TEN-T actions are performed by the Commission. These controls are however not complemented by ex post financial and technical audits (where appropriate, carried out by DG TREN or external experts) (see Annual Report 2001 and 2002). The Court found that: | DG TREN has established a specific framework contract for auditing TEN-T actions. An audit planning has been established by DG TREN and for eight TEN-T financing decisions the audit has been closed. The audit of 24 decisions is ongoing and the audit of a further 20 decisions is planned. | The initiatives taken by DG TREN are welcomed. DG TREN should inform the Court of Auditors in advance of its audit planning and ensure that the auditors representing the External Audit Firm are sufficiently qualified to perform the audit work. The necessary measures should be taken to ensure that the target set by DG TREN of auditing each year at least 20% of the projects and 35% of total costs of projects finalised in the previous year is reached. |
| — TEN-T actions were not covered by Directorate-General for Energy and Transport’s audit programme. |                                                                                                             |                                                                                           |

| **2. Supervisory and control systems — Verification of the eligibility of costs for TEN-Transport actions** |                                                                                                             |                                                                                           |
| For TEN-T actions, eligible and ineligible costs are defined in the legal basis and the Commission Decisions (Annual Reports 2001 and 2002). The Court found that: | A new model Commission Decision has been adopted in 2004, including: | In addition to the measures undertaken in 2004, model cost statements or financial progress reports should be included in the model financing decisions which are of obligatory use by beneficiaries. The definition of studies and works needs to be further improved as the current definition does not clearly delimit the scope of studies and works. |
| — these definitions are insufficiently specific to establish the actual costs incurred by the beneficiary; | — a definition of eligible and ineligible costs; |                                                                                           |
| — these definitions differ from those applied to similar infrastructure projects co-financed through Structural Measures; | — a modified definition of studies and works; and |                                                                                           |
| — the use of different funding rates for studies and for works carries the risk that beneficiaries may maximise funding by wrongly allocating costs to studies; and | — a table indicating the ‘Breakdown of estimated eligible costs during the period of programmed activities’ which could be used by beneficiaries for the reporting of costs incurred. |                                                                                           |
| — the absence of standardised cost statements forms complications the Commission’s verification work. |                                                                                                             |                                                                                           |
ANNEX 2

**Supervisory and control systems**

Area: Internal Policies (including Research)
System: Sixth Framework Programme (FP6) for Research and Technological Development, European Refugee Fund (ERF) and Health and Consumer Protection (SANCO)

<table>
<thead>
<tr>
<th>System</th>
<th>FP6</th>
<th>Commission</th>
<th>Intermediate level</th>
<th>Beneficiary</th>
<th>Overall assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conception</td>
<td>B</td>
<td>—</td>
<td>B</td>
<td>B</td>
<td></td>
</tr>
<tr>
<td>Practical transposition in procedural stages</td>
<td>B</td>
<td>—</td>
<td>C</td>
<td>B</td>
<td></td>
</tr>
<tr>
<td>— compliance with standards</td>
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<tr>
<td>— taking into account of experience</td>
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<td></td>
</tr>
<tr>
<td>Actual operation</td>
<td>C</td>
<td>—</td>
<td>C</td>
<td>C</td>
<td></td>
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<tr>
<td>— compliance with standards</td>
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<tr>
<td>— taking into account of experience</td>
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<td></td>
</tr>
<tr>
<td>Results</td>
<td>B</td>
<td>—</td>
<td>C</td>
<td>B</td>
<td></td>
</tr>
<tr>
<td>— remedial effect</td>
<td></td>
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<td></td>
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<tr>
<td>— preventive effect</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Overall assessment</td>
<td>B</td>
<td>—</td>
<td>C</td>
<td>B</td>
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</table>

<table>
<thead>
<tr>
<th>System</th>
<th>ERF</th>
<th>Commission</th>
<th>Intermediate level</th>
<th>Beneficiary</th>
<th>Overall assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conception</td>
<td>B</td>
<td>B</td>
<td>B</td>
<td>B</td>
<td></td>
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<tr>
<td>Practical transposition in procedural stages</td>
<td>B</td>
<td>B</td>
<td>B</td>
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<tr>
<td>— compliance with standards</td>
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<td>— taking into account of experience</td>
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</tr>
<tr>
<td>Actual operation</td>
<td>C</td>
<td>B</td>
<td>C</td>
<td>C</td>
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<tr>
<td>— compliance with standards</td>
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<td>— taking into account of experience</td>
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<tr>
<td>Results</td>
<td>B</td>
<td>B</td>
<td>C</td>
<td>B</td>
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<tr>
<td>— remedial effect</td>
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<td>— preventive effect</td>
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<tr>
<td>Overall assessment</td>
<td>B</td>
<td>B</td>
<td>C</td>
<td>B</td>
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</table>

<table>
<thead>
<tr>
<th>System</th>
<th>SANCO</th>
<th>Commission</th>
<th>Intermediate level</th>
<th>Beneficiary</th>
<th>Overall assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conception</td>
<td>B</td>
<td>—</td>
<td>B</td>
<td>B</td>
<td></td>
</tr>
<tr>
<td>Practical transposition in procedural stages</td>
<td>B</td>
<td>—</td>
<td>B</td>
<td>B</td>
<td></td>
</tr>
<tr>
<td>— compliance with standards</td>
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<tr>
<td>— taking into account of experience</td>
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<td></td>
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</tr>
<tr>
<td>Actual operation</td>
<td>B/C (1)</td>
<td>—</td>
<td>B/C (1)</td>
<td>B/C (1)</td>
<td></td>
</tr>
<tr>
<td>— compliance with standards</td>
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<tr>
<td>— taking into account of experience</td>
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<tr>
<td>Results</td>
<td>B/C (1)</td>
<td>—</td>
<td>B/C (1)</td>
<td>B/C (1)</td>
<td></td>
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<tr>
<td>— remedial effect</td>
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<td>— preventive effect</td>
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</tr>
<tr>
<td>Overall assessment</td>
<td>B/C (1)</td>
<td>—</td>
<td>B/C (1)</td>
<td>B/C (1)</td>
<td></td>
</tr>
</tbody>
</table>

(1) B for Consumer Protection; C for Public Health.

A Works well, few or minor improvements required
B Works just well enough but improvements desirable/necessary
C Works, but not at a satisfactory level
CHAPTER 7

External actions

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<td>Supervisory and control systems</td>
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<tr>
<td>Special Report No 10/2004 concerning the devolution of EC external aid management to the Commission Delegations</td>
</tr>
<tr>
<td>Special Report No 4/2005 concerning the Commission's management of economic cooperation in Asia</td>
</tr>
</tbody>
</table>
INTRODUCTION

7.1. This chapter deals with the external aid financed from the general budget. The main areas of interest are financial and technical cooperation with Asia, Latin America, the Mediterranean countries, the western Balkans, the Commonwealth of Independent States, food aid/food security, humanitarian aid and NGO co-financing. The Directorates-General for External Relations and for Development are responsible for formulating policies for development cooperation and for formulating country/regional strategies and multi-annual programming, whereas the EuropeAid Cooperation Office (EuropeAid) is responsible for the implementation of development cooperation. The Directorate-General ‘Humanitarian Aid ECHO’ (DG ECHO) is responsible for both the formulation of policy and strategy as well as for the implementation of humanitarian aid. This chapter does not include the aid provided through the European Development Funds, as it is financed separately from the general budget (1). Table 2.1 shows the funds spent in 2004 for financial perspective heading 4 (commitments: 5 198 million euro; payments: 4 606 million euro).

7.2. In 2004 the devolution process, by which functions and tasks were redistributed from the Commission’s headquarters to its Delegations (see paragraphs 7.48 to 7.51) was completed for the thematic programmes (2). During 2004 the process of reorganising EuropeAid in Brussels continued, focusing on the support and monitoring of the Delegations under the devolved system.

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Scope and nature of the audit

7.3. The overall objective of the specific assessment was to provide a conclusion as to the legality and regularity of transactions in the External Actions field (heading 4 of the general budget financial perspective). The audit comprised a review of the supervisory and control systems which are designed to ensure the legality and regularity of transactions, supported by tests of transactions at the Delegations and implementing organisations, and a review of the Annual Activity Reports of the Director-General of EuropeAid and of the Director-General of DG ECHO.

(1) See separate report on the EDFs.
(2) Programmes financed by budget lines which are focused on certain themes (e.g. Food aid, NGO co-financing).
THE COURT’S OBSERVATIONS

7.4. For the projects audited by the Court, advance payments are made by the Commission to implementing organisations that can take various forms, such as NGOs, government ministries, international organisations, etc. The more frequent use of these intermediary organisations for the financial management and accounting of projects and the absence of national authorising officers are the main differences in the manner activities are implemented as compared to the EDFs.

7.5. This audit was carried out at Commission headquarters, at five Delegations (Bosnia, Cambodia, Kazakhstan, the Philippines and Syria) and at 17 implementing organisations. The areas mentioned in paragraph 7.1 were reviewed and tested. Reconstruction aid for Kosovo and some countries of the former Federal Republic of Yugoslavia is the subject of a separate annual audit of the European Agency for Reconstruction.

7.6. Regarding the supervisory and control systems, the Court focused its review on the internal control standards relating to the risk analyses made by the relevant services, the information structures and reporting in the context of financial monitoring and control, and the internal audit functions of EuropeAid and DG ECHO.

7.7. There were some delays in the transmission, to the Court of Auditors, of the reports prepared by the Delegations (EAMR) which are taken into account for the preparation of EuropeAid’s Annual Activity Report.

7.8. The Court was considerably delayed in organising one of its on-the-spot project visits in Cambodia because the implementing organisation, a UN agency, was reluctant to accept the Court’s right of access to information under the verification clause of the Financial and Administrative Framework Agreement between the European Community and the United Nations. Consequently, only limited work could be carried out.

Supervisory and control systems

Implementation of internal control standards

7.9. In 2002, both EuropeAid and DG ECHO completed the framework for the implementation of the internal control standards (ICSs) as defined by the Commission on 13 December 2000 (\(^\text{x1}\)). The introduction of the standards was supported by

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issuing or updating instructions and guidelines and extensive training programmes, in particular, on the administrative and financial procedures. In 2004, the requirement to comply with ICs was extended to the Delegations. According to EuropeAid, all baseline requirements as adapted for Delegations had been implemented by 31 December 2004. The Court’s audit confirms the Director-General’s indication in the Annual Activity Report that improvements are still needed at both Commission headquarters and Delegations (see paragraphs 7.17 to 7.27).

**Directorate-General ’Humanitarian Aid ECHO’**

**Risk assessment**

7.10. DG ECHO carried out a satisfactory risk self-assessment, rightly concluding that many risks in the area of humanitarian aid were beyond its control, with the exception of the quality of the implementing partners. Consistent with previous years, efforts to reduce the risks were therefore concentrated on the selection procedure for implementing partners together with a system of audits of those selected.

**Audit of implementing partners**

7.11. DG ECHO has a comprehensive approach of auditing the implementing partners. The audits assessed aspects such as the organisation, procedures and internal controls of the implementing partners, as well as the accounting and finance systems, the management culture and staff recruitment systems. This was complemented by detailed testing of expenditure of projects implemented by the partners.

7.12. In 2004, DG ECHO completed 130 audits, of which 70 had been realised at the headquarters of implementing partners. These 70 audits, which had been contracted out to external auditors, represent 344 projects that had been completed between 1998 and 2003. The remaining 60 audits related to projects audited in the field (28 reports), grants (19 reports) and DG ECHO offices (13 reports). The Court initially reviewed 20 audit reports, of which 13 were contracted out. The Court then verified the quality of these external audits by visiting three implementing partners’ European headquarters and testing two projects at each. This led to the following observations:

(a) the most frequent type of finding reported by the external auditors related to the lack of justification of expenditure in the form of supporting documents. This was the main reason for disallowing expenditure by the implementing partner. The Court’s visits to implementing partners confirmed the lack of supporting documentation as the principal source of errors, but also revealed that this is not always reported by the external auditors when included in their sample;
THE COURT’S OBSERVATIONS

(b) one case of non-respect of tendering rules was found by the external auditor, but most of the audits did not carry out an in-depth testing of tenders. The Court’s testing at implementing partners found errors in tenders at four of the six projects checked.

7.13. The implementing partners committed themselves to implement the recommendations made by DG ECHO’s programme of audits to improve their internal control systems. A total of 0.5 million euro was considered by the Commission not to be eligible expenditure and recovery orders were issued. These results show that audits of implementing organisations can be an effective instrument of DG ECHO’s supervisory and control systems.

7.14. The nature of both the observations, as far as they are made in these audit reports and the errors found during the Court’s own tests on the expenditure, corresponds largely to its audit findings when testing transactions at implementing organisation level (see paragraphs 7.31 and 7.32).

Internal audit capability

7.15. A single internal audit capability unit has the responsibility for both DG ECHO and EuropeAid. In 2004, it carried out workload assessments of DG ECHO’s units (see also paragraph 7.22 for this issue).

EuropeAid Cooperation Office at central level

Follow-up of 2003 observations

7.16. In its Annual Report on 2003 (paragraphs 7.18, 7.19, 7.21, 7.22 and 7.23) the Court observed that not all Directorates carried out audits of their Delegations, the headquarters’ services did not have information, on a continuous basis, on the audits launched by the Delegations, the internal audit capability unit had insufficient resources to carry out the type of work that would assist the Director-General in formulating his annual statement, there was no evidence of cooperation between headquarters’ services in doing ex post verifications and that information on recoveries and uncleared advances was not systematically monitored by EuropeAid. The main improvement in 2004 was that the ‘Programming, internal control and ex post control’ unit took sole responsibility for ex post verifications (see paragraph 7.23). On the other aspects, further improvements are needed as explained in the following paragraphs. See Table 7.1.

THE COMMISSION’S REPLIES

(b) Until mid 2004, the Commission’s testing of tendering procedures was limited to the verification of the existence of the winning tender. To respond to the weakness revealed, the Commission has extended the audit checks to include the verification of offers of organisations not succeeding in the tender process.

7.16. Since 2003, the Commission has taken further action necessary to develop its overall audit strategy and to more clearly define its overall strategy for supervision and control, including the function and tasks of the services at headquarters and delegations.

The reorganisation of EuropeAid services in March 2005 aims at further strengthening its role which has progressively evolved towards supervision, coordination and support to devolved management in the Commission delegations. Moreover, the Commission’s monitoring and control systems aim at ensuring the compliance of our partners with the contractual requirements, and the Commission intends to further develop the functions of its management information system.
Table 7.1

(a) Court’s assessment of supervisory and control systems in 2004

<table>
<thead>
<tr>
<th>Overall concept</th>
<th>DG Humanitarian Aid</th>
<th>ECHO</th>
<th>EuropeAid Cooperation Office</th>
<th>Delegations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Procedures and manuals</td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>—</td>
</tr>
<tr>
<td>Functioning in practice</td>
<td>A</td>
<td>B (1)</td>
<td>B (1)</td>
<td>B (1)</td>
</tr>
<tr>
<td>Internal audits</td>
<td>B (2)</td>
<td>B (2)</td>
<td>B (2)</td>
<td></td>
</tr>
<tr>
<td>Management reporting</td>
<td>A</td>
<td>B (1)</td>
<td>B</td>
<td></td>
</tr>
</tbody>
</table>

(1) Most elements function, but certain important ones remain to be improved.
(2) The internal audit unit focused on system analysis and did not yet test systems.

(b) Court’s assessment of external audits at the level of organisations implementing projects funded by EuropeAid

<table>
<thead>
<tr>
<th>Quality of audits</th>
<th>A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quantity of audits</td>
<td>B (1)</td>
</tr>
<tr>
<td>Definition of terms of reference</td>
<td>B (2)</td>
</tr>
<tr>
<td>Commission’s involvement in appointing auditors</td>
<td>B (2)</td>
</tr>
<tr>
<td>Inclusion of tender procedures in the audit scope</td>
<td>B (2)</td>
</tr>
<tr>
<td>Reporting of results of review of accounting systems</td>
<td>C</td>
</tr>
<tr>
<td>Evidence of the use and follow-up of audit reports</td>
<td>B</td>
</tr>
</tbody>
</table>

(1) Nevertheless the number of audits increased as compared to 2003.
(2) For external audits launched by the Commission, the terms of reference and involvement in appointing the auditors are satisfactory, but when the audits are launched by implementing organisations, improvements are necessary.

Key to indicators

<table>
<thead>
<tr>
<th>Rating of supervisory systems and controls</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Works well. Few or minor improvements necessary</td>
<td>A</td>
</tr>
<tr>
<td>Works, but improvements necessary</td>
<td>B</td>
</tr>
<tr>
<td>Does not work as intended</td>
<td>C</td>
</tr>
</tbody>
</table>

(c) Key areas followed up by the Court of Auditors in 2004

<table>
<thead>
<tr>
<th>Execution risk analysis</th>
<th>DG Humanitarian Aid ECHO</th>
<th>EuropeAid Cooperation Office</th>
<th>Delegations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported as in previous years.</td>
<td>Carried out analysis as in previous years.</td>
<td>Completed 2004 self-assessment in January 2005.</td>
<td>—</td>
</tr>
<tr>
<td>Reporting systems</td>
<td>Maintained good standards.</td>
<td>Reporting systems are improving as compared to 2003, but need further development: — CRIS-Audit module not linked to management information; — EAMRs incomplete.</td>
<td>Delegations reported three times during the year.</td>
</tr>
<tr>
<td>Concept of external audits and controls</td>
<td>Fully implemented.</td>
<td>Strategy document in 2004.</td>
<td>—</td>
</tr>
<tr>
<td>Implementation of external audits and follow-up</td>
<td>Audits carried out and followed-up.</td>
<td>More audits carried out; terms of reference and follow-up to be improved.</td>
<td>—</td>
</tr>
</tbody>
</table>
THE COURT’S OBSERVATIONS

Risk assessment

7.17. The 2004 risk self-assessment completed in January 2005 for the Annual Management Plan provided a general list of key risks at EuropeAid. However, it did not consider the implementing organisations as the level at which the highest financial risks exist (see paragraph 7.32).

Information and reporting

7.18. Most of the financial information which is used for monitoring purposes is obtained from EuropeAid’s Common Relex Information System (CRIS). The financial information focuses on decisions, contracting, commitments and payments made at Commission level.

7.19. In addition, since the management and implementation of the development actions is devolved to a large extent towards the Delegations, they are required to provide EuropeAid’s headquarters with External Actions Management Reports (EAMRs) which also include internal control issues. In a sample of 13 EAMR reports covering 2004 reviewed by the Court, the information on internal control standards was only provided in five of the reports and information on the findings of audits launched by the Delegation in one report.

Financial monitoring

7.20. The finance units of the four geographic Directorates managing devolved operations (4), carried out a varying coverage of audits of their Delegations in the form of a review of their financial systems for processing transactions, their contracting system and their supervisory and control systems, completed by an audit of transactions processed by the Delegations. Only two Directorates had a programme for the regular audit of Delegations. As indicated in last year’s annual report, such an approach should be extended to all Directorates.

THE COMMISSION’S REPLIES

7.17. This is not the only form of risk assessment undertaken by EuropeAid.

The financial risk at the level of the implementing organisations is considered at the moment of the identification and financing of projects and programmes, when an analysis of the constraints and conditions necessary for the successful implementation of the project/programme, including sustainability aspects (capacity of the final beneficiary) is carried out. Regular monitoring allows the Commission to take appropriate measures to correct or re-address projects.

7.19. With regard to the application of internal control standards in delegations, the EAMR ‘request’ the Delegations to report the main issues relating to the period and the measures to be taken. Likewise, the delegations are not asked to inform Headquarters of all the results of audits, but rather to highlight the key factors which could contribute to the legality and regularity of the underlying transactions.

7.20. As indicated in reply to paragraph 7.18 of last year’s report, all delegations were subject to a systematic verification exercise before devolution was held to be operational (2001 to 2004). A varying combination of checks, inspections and audits can be used to meet the different requirements of services as regards the monitoring of devolved Delegation’s activities.

EuropeAid intends to develop the use of best practice for these assessments, building on the experience acquired.

(4) Asia; Europe, the Caucasus and central Asia; the Mediterranean and the Middle East; Latin America.
7.21. In 2004, 143 audits of projects were launched by the various Directorates of EuropeAid as part of the 2004 audit programme. Most audits were still underway in early 2005. These audits were initiated in addition to those audits carried out on behalf of the Delegations outside the annual audit programme or contracted directly by implementing organisations. In most cases headquarters’ services did not have the information on a continuous basis on the audits launched by the Delegations. ‘CRIS-audit’, a module that should contain comprehensive information on audits, has been incorporated in EuropeAid’s CRIS financial information system but the data is not complete and should, as a matter of urgency, be linked to the corresponding project monitoring information for the purpose of enabling a continuous monitoring of legality and regularity requirements.

7.21. Delegations are required to report on audits launched by them in their External Assistance Management Reports (EAMR), the system has provided for headquarters to receive the information during 2004 on a regular basis.

It is now possible to link CRIS audit information to the corresponding project information.

Internal audit capability

7.22. In 2004, the internal audit capability unit carried out an update of its reviews of the internal control standards, making highly relevant recommendations on undertaking more detailed risk analyses and on improvements of the supervisory and control systems, and issued two reports regarding specific issues. The unit also finalised workload assessment reports of two Delegations. As already stated in the 2003 Annual Report, it is questionable whether these assessments should be carried out by the internal audit capability unit, considering the very limited staff resources available. The internal audit capability unit’s priority should be geared towards evaluating the systems which should ensure the legality and regularity of transactions and towards assisting the Director-General in formulating a well-founded annual statement in particular, on the quality of the control procedures and reporting systems, both at headquarters and Delegations.

7.22. The Commission Communication which set up Internal Audit Capabilities identified three objectives for them: two relate to the control of risk and internal control system and the third with making recommendations to improve efficiency and effectiveness of operation and ensure economy in the use of resources.

The workload assessments carried out by the IAC respond to this third objective. Human resource management had been identified as a risk by EuropeAid in its risk self-assessment and the Communication on deconcentration of January 2004 required Relex IACs to jointly audit workload assessments in deconcentrated delegations to ensure the number of staff can carry the new increased workload.

Ex post verifications

7.23. The ‘Programming, internal controls and ex post controls’ unit carried out ex post checks on a sample of EuropeAid payments made during the first nine months of 2004. The low level of errors found was confirmed by the Court’s own work on these types of transactions (see paragraph 7.29).
**Transaction controls**

7.24. EuropeAid's headquarters and Delegations carry out checks and controls on transactions processed at that level. In some cases, where the payment claims are accompanied by a report by an external auditor certifying the expenditure in question, or that have been the subject of a field audit by staff of the Commission, the Commission assesses whether underlying transactions undertaken by the implementing organisations are legal and regular in substance. In other cases, the Commission relies on documents provided by implementing organisations, and it checks that the payment claim is plausible within the terms of the contract or financing agreement and the budget foreseen.

7.24. Commission's monitoring and control systems aim at ensuring the compliance of contract partners with the contractual requirements as required by the financial regulations.

External audits provide an independent assurance on the quality of the management systems put in place for project implementation and on the eligibility of the expenses incurred. Provisions as regards audits (certification of the accounts for certain kinds of expenditure or for the totality of the expenditure) are contained in financing agreements and contracts.

Complementary checks and audits on the contract partners are carried out on the basis of risk assessments since, in many cases, a detailed examination of their overall internal control systems would be disproportionate on top of normal checks concerning legality and regularity of payments.

Financial procedures and controls have been set up with the aim of establishing a balance between the level of risk and the controls effected, taking into account the different management modalities.

**Supervisory and control systems at the level of the Delegations**

7.25. The Court visited five Delegations (Bosnia, Cambodia, Kazakhstan, the Philippines and Syria) to assess the supervisory and control systems and to audit a number of transactions for which EuropeAid was the Authorising Officer by delegation. The review of the supervisory and control systems at the Delegations indicated that the procedures carried out were generally sufficient to ensure that the commitments and payments processed by the Commission were legal and regular.

7.26. Generally, the use of and procedures for the appointment of external auditors are provided for in the project financing agreements. Such provisions were worded vaguely in the financing agreements whose external audit reports were reviewed by the Court. This left the implementing organisation with a wide scope for taking a variety of approaches for the selection of external auditors and the setting of their objectives.

7.26. Over recent years, the utilisation of standard contractual documents (contracts, grants and financing agreement) has contributed to improve the level of control by the Commission. Contract provisions for 'certification audits' have also been improved. For instance, in order to keep improving control over the selection of auditors by beneficiaries and implementing organisations, the Commission intends to introduce appropriate conditions concerning basic criteria for the selection of auditors in standardised terms of reference for audits that beneficiaries and implementing organisations have to comply with when they select and contract auditors.
THE COURT’S OBSERVATIONS

7.27. In the countries visited by the Court, 14 external audit reports (13 contracted by implementing organisations and one by the Commission) of the projects were reviewed, of which 12 related to projects audited on the spot by the Court. Written terms of reference did not exist for two of the 14 external audits. Regarding the remaining 12, the Court’s review, together with the results of the checks carried out at some projects which had been subject to these external audits, indicated that the external audit reports were of satisfactory quality in relation to what was foreseen in their specific terms of reference. However, only one, contracted by an implementing organisation, specifically stated that compliance with EU funding requirements had to be covered. Not surprisingly, the findings of this audit were confirmed by the Court’s own work, whereas in the case of eight out of the 12 external audit reports of projects checked on the spot by the Court, the Court detected errors not reported by the external auditors.

Audit of transactions

Audit of transactions carried out at Delegation level

7.28. For each Delegation visited, a sample of transactions was audited at that level. These comprised 30 payments (for a total of 8.4 million euro) and 10 tenders (for a total of 12.7 million euro).

7.29. The work carried out by the Court on payments made to implementing organisations revealed only a low level of errors.

Audit of transactions carried out at implementing organisation level

7.30. The Court visited 17 projects managed by the implementing organisations, where a sample of 237 transactions in total was checked with the aim of concluding on their legality and regularity and of verifying the functioning of their internal control systems.

7.31. The Court’s audits of the projects revealed, in three out of 17 implementing organisations visited on the spot, weaknesses in their internal controls due to a lack of a proper segregation of duties between the authorisation and accounting of payments.

7.32. A significant number of errors in terms of occurrence or material impact on expenditure, were found in transactions examined at the level of 11 of the projects audited. The most frequent types were non-respect of the prescribed contracting procedures (encountered in eight projects out of the 17 audited on the spot), insufficient supporting documentation (five out of 17) and ineligible expenditure (4 out of 17).

THE COMMISSION’S REPLIES

7.27. EuropeAid is issuing a revised version of the Practical Guide to EC External Aid contract procedures. The revised standard grant contract will contain terms of reference for the use of beneficiaries. These terms of reference will specifically address compliance with the contract terms including those relating to procurement and eligibility. Standard terms of reference of this type should be distinguished from terms of reference for audits launched by the Commission which can be drafted on a case-by-case basis.

7.31-7.32. The Commission, over the last years, has taken action to address deficiencies in the application of contractual procedures by implementing organisations through the introduction of standard contracts, including the introduction of audit reports according to which auditors are required to check the respect of applicable rules by the beneficiaries. The Commission is currently revising the template of the audit reports and developing improved terms of reference for the auditors.
Analysis of Annual Activity Reports and the Statements of the Authorising Officers by delegation

7.33. The Court reviewed the Annual Activity Reports and the statements by the Director-General of EuropeAid and the Director-General of DG ECHO. The review concentrated on the parts of the reports which dealt with the Commission's follow-up of recommendations given by the Court of Auditors, the Commission's internal auditors and of the actions formulated in the Commission's action plan (attached to its Synthesis of Annual Activity Reports on 2003 (5)) as well as on the internal control standards. The Court examined whether and to what extent the statements regarding the control procedures set up to ensure the legality and regularity of underlying transactions made by the Directors General were justified and based on sufficient evidence.

7.34. The Court found that the information presented in the reports was accurate and that, it reflected fairly the activities carried out on the follow-up to action plans and on the implementation of the internal control standards. Both DG ECHO and EuropeAid have taken appropriate actions to remedy shortcomings identified in 2003 and to complete and improve the compliance with the internal control standards.

7.35. Since January 2004, Delegations have had to report to headquarters on the external audits carried out, matters affecting legality and regularity and the relevant actions taken. Nevertheless, in the sample checked by the Court, this was not always being done consistently (see paragraph 7.19).

7.36. EuropeAid's Annual Activity Report gives a description of internal control systems, mainly focusing on transactions between the Commission and the implementing organisations, which generally function satisfactorily. A methodology for audits of implementing organisations was set up in 2004. However, its practical application needs time, in particular, the use and follow-up of the results of the audits are not yet adequate for the purpose of deriving assurance concerning the legality and regularity of transactions managed by those organisations.

7.35. The Commission refers to its reply to paragraph 7.19.

7.36. EuropeAid improved its audit function in 2004. It set up a comprehensive audit strategy to be applied by both EuropeAid and delegations, defined risk criteria for the identification of audits to be undertaken, issued standard terms of reference for the auditors, and put in place CRIS audit, a computerised system for supporting and monitoring audits.

The follow-up of audit results is part of budget heading management functions in delegations and headquarters. Audits are integrated into the whole project management cycle.

In addition, the findings of previous audits are taken into account when deciding whether or not to include the project in the annual audit plan, established on the basis of a risk assessment.

Nevertheless, the Commission continues to develop and implement the audit methodology referred to by the Court.

THE COURT’S OBSERVATIONS

7.37. The Director-General of EuropeAid declares that he had obtained reasonable assurance that the control procedures put in place give the necessary guarantees concerning the legality and regularity of the underlying transactions, based on his own judgement and on information available to him. The Court’s audit confirms this statement for the systems which ensure the legality and regularity of payments made by headquarters and Delegations to the implementing organisations. However, the Court found that the systems which supervise the legality and regularity of expenditure underlying the financial reports presented by implementing organisations are still inadequate and should be strengthened (see paragraph 7.27).

7.37. All the necessary supervisory and control systems were in place in 2004 to enable the Director-General to give reasonable assurance as to the legality and regularity of transactions carried out by EuropeAid in 2004.

As regards the use of audit results, external audits are not the only source of assurance available on the legality and regularity of underlying transactions. Other sources are also available, such as optional ex ante controls, ex post transactional control, missions on the ground and monitoring reports.

These controls were considered adequate for the purpose of deriving overall assurance in the context of the Director-General’s Declaration.

7.38. The statement given by the Director-General of DG ECHO includes a reservation on the non-respect of the contractual procedures by a humanitarian organisation. The statement provides sufficient information on the underlying problem and specifies what the potential financial impact could be.

7.39. During 2004, the Commission continued to improve its supervisory and control systems in line with some of the Court’s recommendations in the 2003 Annual Report as shown in Table 7.1. The effects of this improvement have not yet been completely felt at the implementing organisation level. The Court’s audit revealed few errors affecting transactions at the level of the Delegations (see paragraph 7.29). However, as in previous years, weaknesses in the internal controls (see paragraph 7.31), and a relatively high number of errors in terms of frequency and financial impact, were detected at the level of the project implementing organisations (see paragraph 7.32). The most common error was the failure to ensure that contracting procedures, including tenders, were in line with the Commission’s requirements. It underlines the necessity to have a comprehensive approach to the supervision, control and audit of these organisations.

7.40. The Annual Activity Reports of DG ECHO and of EuropeAid gave descriptions of the internal control systems in place. DG ECHO reduced the risk of illegal or irregular transactions by having an operational system of project audits although clearer instructions should be given to external auditors (see paragraphs 7.11 to 7.14). In the case of EuropeAid, the Court cannot derive assurance from the report and the statement (see paragraph 7.36) since essential components of the supervisory and control systems for the legality and regularity of underlying transactions at the level of implementing organisations need to be further improved to be fully operational.

7.39. The Commission notes that the Court considers that the Commission is continuing to improve its control system and observes that the audit carried out by the Court in the delegations confirms the Commission’s data.

The Commission, over the last years, has taken action to address deficiencies in the application of contractual procedures by implementing organisations.

As regards DG ECHO, the Commission acknowledges the conclusion of the Court that the system of operational audits reduces the risk of illegal or irregular transactions. The Commission reviews and clarifies, on an ongoing basis, the matters that should be reported on by the external auditors.

As regards EuropeAid, the Commission agrees that all the system components of internal control can and should be improved. However, all the necessary supervisory and control systems were in place in 2004 to enable the Director-General to give reasonable assurance as to the legality and regularity of transactions carried out by EuropeAid in 2004.
The steady progress made by EuropeAid in this area is acknowledged by the Court. Audits are a supplementary assurance, in addition to the conformity and 'reality checks' carried out entirely by the services of the Commission, before the payment. Such extra assurance also includes the Annual Audit Plan, ex post transactional controls, missions on the ground, and monitoring reports.

Recommendations

7.41. Based on the above, the Court recommends that:

(a) the Commission clarifies with the UN agencies the Court’s right of access to projects managed by them (see paragraph 7.8);

(b) EuropeAid’s risk assessment should cover the implementing organisation level (see paragraph 7.17);

(c) the information provided by Delegations, including the results of project audits, should be more systematically verified and followed up through headquarters’ audits (see paragraphs 7.19 and 7.20);

(d) information relating to all audits, even those contracted by implementing organisations, should be recorded in CRIS and linked to the corresponding project management information (see paragraph 7.21);

(e) the terms of reference for the audits of projects should be more specific in their requirements and cover checks on the compliance with the Commission’s requirements regarding contracting procedures, including tenders, and the eligibility of expenditure (see paragraphs 7.11 to 7.12 and 7.32). This would facilitate the quality control checks on external audits that the Commission should carry out.

(a) The UN has been reminded that as part of its audits of the Commission, the Court of Auditors may verify UN-implemented actions, and is entitled to do so by the verification clause.

(b) At project level, the toolbox of planning and monitoring instruments in use in the Commission allows due account to be given to risks and action to be taken to manage or mitigate these risks where they arise.

Please refer also to the reply to paragraph 7.17.

(c) EuropeAid intends to build on the experience acquired and extend the use of best practices.

(d) It is now possible to link CRIS audit information to the corresponding project information (see paragraph 7.21).

(e) As a result of its audit checks and risk analysis of the implementing partners systems, the Commission (DG ECHO) has focused its audit activities by emphasising the control of the tendering procedures operated by the implementing partners. The Commission will examine how it can further improve the already extensive quality control checks on its projects and will give further instructions to the external auditors concerning the checks to be carried out.

EuropeAid is issuing a revised version of the Practical Guide to EC External Aid contract procedures. The revised standard grant contract will contain terms of reference (ToR) for the use of beneficiaries. These ToR will specifically address compliance with the contract terms including those relating to procurement and eligibility.
THE COURT’S OBSERVATIONS

FOLLOW-UP OF PREVIOUS OBSERVATIONS

Special Report No 3/2001 concerning the Commission’s management of the international fisheries agreements

7.42. The Court published Special Report No 3/2001 concerning the Commission’s management of international fisheries agreements in July 2001. The main observations and recommendations, which were taken up by the Council in the discharge procedure (\textit{a}), focused on:

(a) the purpose of the agreements: the Court pointed out that the intertwining of the commercial role and the development aid aspects of some agreements made them difficult to evaluate; it also found a lack of consistency and poor coordination between the international agreements and the structural aspect of the common fisheries policy;

(b) cost-benefit ratio: the Court recommended setting up a system of ongoing monitoring and a detailed analysis of the costs/benefits of the agreements; it also regretted the fact that fishing opportunities are not always fully exploited.

Purpose of the agreements

Intertwining of commercial role and development aid aspects

7.43. The Commission’s views on fisheries agreements have changed since the publication of the Special Report \textit{(b)}. The Commission, as expressed in its communication, considers that the coherence between the objectives of the common fisheries policy \textit{(g)} and the European development policy \textit{(i)} should be reinforced. The Commission has drawn up a draft standard agreement in line with its new approach but there has not yet been a chance to incorporate this into an agreement with a non-member country.

7.43. The Commission has already concluded the negotiations for fisheries protocols which are in line with the new policy on Fisheries Partnership Agreements (e.g. with Seychelles) and for new framework agreements with a fisheries protocol (e.g. Micronesia, Solomon and Comores). These agreements are in the legislative process with the Council and the European Parliament.

\textit{a} Council Recommendation of 5 March 2002 on the discharge to be given to the Commission in respect of the implementation of the general budget of the European Communities for the financial year 2000 (SN 1651/02).


\textit{g} To maintain the European presence in distant fisheries and to protect European fisheries sector interests.

\textit{i} To foster developing countries’ capacities to exploit their marine resources, to increase local value added and to obtain the fairest price for access rights to their economic exclusion zones by foreign fleets.
7.44. However, the Parliament (10) and the Council (11) have put forward two concepts that do not appear explicitly in the communication: supplying the Community market and contributing to employment in the EU. Thus the risk of inconsistency as expressed in the Special Report remains.

Coordination with the structural aspect

7.45. Amendments to the structural assistance regulations (12) have eliminated potential sources of inconsistency by eliminating all forms of aid for modernisation of ships and creation of joint enterprises.

Cost/benefit ratio

Introduction of an evaluation system

7.46. The Commission has had a study (13) carried out to assist it in introducing an evaluation system for fisheries agreements. The Commission has set up an operational evaluation system which, however, is not yet finalised. Moreover it has not drawn up the action plan for improving the evaluation of stocks outside Community waters which it promised to present before the end of 2002 (14); or put in hand a new overall evaluation of the fisheries agreements, as announced in its report to the Council (15).

Effective use of fishing opportunities

7.47. The observation made in the Special Report about underutilisation, mainly concerned the agreements with Greenland and Senegal.

(a) The Commission proposed to the Council that the Greenland Agreement should include a mechanism to allow it to

(10) European Parliament resolution of 9 October 2003 adopted the Committee on Fisheries’ report on the Commission communication.


(13) Study identifying criteria and indicators for the evaluation of bilateral fisheries agreement (Oceanic Development, December 2003).


THE COURT'S OBSERVATIONS

transfer unused quotas from one Member State to another (16). The Council has not adopted this proposal (17).

(b) For the same Agreement the Special Report pointed out that many of the fishing possibilities theoretically available did not exist anymore. Following negotiations in 2003, the inflated figures for Greenland fish stocks have now been removed from the Agreement. But the Union is still paying the same amount for the right to fish.

(c) The Senegal Agreement now contains extra flexibility in the management of licences which should help to improve the utilisation rate.

THE COMMISSION'S REPLIES

(b) The revision of the fourth Protocol focused on the removal of the theoretical fishing possibilities. Some quotas were taken out and others were added or increased.

The Council conclusions of 24 February 2003 stated that the financial contribution should remain unchanged and that it should be based on real fishing possibilities for Community fishing vessels and the need to assist Greenland in the restructuring of its sectoral fisheries policy through a mechanism of budget support.

PRINCIPAL OBSERVATIONS IN SPECIAL REPORTS

Special Report No 10/2004 concerning the devolution of EC external aid management to the Commission Delegations

7.48. In May 2000, the Commission decided to devolve aid management tasks and responsibilities to its 78 Delegations over a period of three years to improve its delivery speed and quality. Since mid-2004, almost every Delegation is responsible for project preparation, contracting, and financial and technical implementation, and they have received substantial extra human and technical resources. The central services are moving away from direct management of projects, towards monitoring and supporting Delegations.


7.49. The Commission’s management of the devolution process can be considered reasonably successful, at least as far as the Delegations are concerned. The planning process, however, did not incorporate a number of elements which could have facilitated the control over that process and some problem areas need further attention.

7.49. The toolbox of planning and monitoring instruments that has been applied allowed due account to be given to particular situations (e.g. regional delegations, size/complexity of portfolio, easiness/difficulty of recruiting staff, etc.) and proved to be effective and appropriate for the management of the devolution process.

7.50. Regarding the results of devolution, it remains necessary to speed up, harmonise and simplify the financial procedures. Not having prepared, at an early stage, a complete set of performance indicators to monitor the devolution process, makes it difficult to measure progress against the main objectives.

7.50. Devolution was just one element of the overall reform package. The results of the reform are closely monitored, and Council and Parliament are kept regularly informed. It is not possible to dissociate the results of devolution from the results of the rest of the package. Nevertheless, not only was devolution largely completed within the timescale envisaged, but it did not result in the losses of quality, or reduction in speed, which many observers feared. For instance, prior to the reform, the number of years needed to design, implement and complete a project was increasing since 2000, this trend has been reversed, and projects are now completed faster.

7.51. The main recommendations made by the Court are the following:

(a) appropriate indicators should be introduced, relating to both delivery speed and quality of aid;

(b) the costs of devolution should be monitored against the estimated costs;

(c) recruitment procedures, salaries and other conditions of employment should attract staff with the appropriate expertise;

(d) Commission’s headquarters monitoring and support role should be further developed, notably by improving the financial information systems and addressing outstanding training needs.

7.51.

(a) A set of indicators based primarily on financial data was put in place from the beginning of the reform. Work on the development of complementary indicators, to measure improvement in speed and quality of aid delivery is ongoing.

(b) The Commission believes that at the end of 2005, after the completion of the devolution process, the monitoring of costs will allow for a comparison with initial estimates.

(c) In recent years, major efforts have been made to improve staff management within the External Service. Other measures planned under the administrative reform of 2002 are now gradually being implemented. Efforts are underway to find more effective ways of filling posts in reputedly difficult countries. None the less, the Commission acknowledges that improvements are still needed and is studying ways of achieving them.

(d) The objective of the reorganisation of EuropeAid in early 2005 is to improve the monitoring and support role of headquarters. Moreover, enhancing the role of CRIS (Common Relex Information System) as a planning and management tool will further strengthen EuropeAid’s capacity in these fields. Significant efforts are being made to ensure proper training of delegation staff. More training sessions are now being organised overseas, and e-learning modules are being developed.
7.52. EU economic cooperation expenditure in Asia is governed by Council Regulation (EEC) No 443/92. It is implemented in two different ways: bilateral projects, between the Commission and individual beneficiary countries, and regional programmes covering sub-regions, or those covering the whole of Asia (Asia-wide programmes).

7.53. The policy and the operational strategies are very broad, resulting in a wide variety of projects covering many different areas. Impact and output indicators concentrate on some aspects of the process rather than on the result of the expenditure. As a result, overall impact is difficult to measure and there is only a limited basis to assess the effectiveness of the expenditure.

7.53. With the reform of external assistance in 2000 and the introduction of country and regional strategy papers in conjunction with the strategic communications on Asia, the Commission aims to achieve better focus of development expenditure, including that on economic cooperation.

The Commission agrees with the Court that the definition and monitoring of indicators could be improved and this has been addressed by the Commission in the preparation of its Country and Regional Strategy Papers and related indicative programmes for 2005 and 2006.

7.54. The bilateral projects have faced long delays between the identification phase and the starting of the projects and during their implementation. Their monitoring was not always satisfactory. The Asia-wide projects, although subject to a heavy and complex application procedure, had produced positive results and were generally well monitored. For many of the bilateral as well as for the Asia-wide projects sustainability is in doubt.

7.54. The delays between the identification phase and the start of the projects, as well as those delays that were identified in projects under implementation, concern bilateral projects designed before the reform of EC external assistance. As a result of this reform, including the establishment of EuropeAid (January 2001) and the devolution of aid management to the Commission Delegations, together with the New Financial Regulation (January 2003), project delays will be limited and contained.

In the current design of projects, a monitoring, audit and evaluation plan is obligatory. In parallel, since 2000, monitoring has also been systematically carried out by independent experts. Within this monitoring exercise economic cooperation projects in Asia have scored well in terms of potential for sustainability.

7.55. The Court recommends the Commission to set a clear strategy which recognises the specific nature of the economic cooperation and of its objectives and contains indicators allowing for proper monitoring and progress assessment; to improve the procedures for the approving, implementation, monitoring and evaluation of the bilateral projects; to reconsider the application procedures for the Asia-wide programmes and to extend the successful system of monitoring the Asia-wide projects to other projects.

7.55. The Commission is of the firm view that economic cooperation must remain an integral part of its development actions in a single development strategy. As such, the Commission considers economic cooperation as one of the intertwined components of its development assistance. The Commission, however, recognises that economic cooperation indicators could be further developed.
Monitoring and evaluation of projects has been enhanced by obligatory use of the logical framework tool. The requirement to conduct an evaluation is now systematically included in the Financing Agreement of all projects. The results orientated monitoring (ROM) system, introduced since 2002, provides standardized monitoring information on projects and programmes.

The ongoing revision of AIDCO Practical guide to contractual procedures will simplify the application process for grants to the extent allowed by the Financial Regulation, as well as clarify the role of the delegations in the evaluation.
CHAPTER 8

Pre-accession strategy

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THE COURT’S OBSERVATIONS

INTRODUCTION

8.1. Heading 7 of the Financial Perspective contains the appropriations for the pre-accession instruments (Phare, ISPA and Sapard) for 10 Central and Eastern European countries (1) and the pre-accession assistance programme for Turkey. For the eight Central and Eastern European countries that became Member States on 1 May 2004 no new expenditure was committed after accession (except for Sapard, where commitments were made until end 2004). Payments however will continue until at least 2006.

8.2. The Phare programme (2) and the pre-accession assistance programme to Turkey (3), implemented by the Directorate-General for Enlargement, provide support for institution-building and investment. The programmes are mainly (4) implemented by decentralised management, either with ex ante control of procurement and award decisions (DIS (5)) or only ex post control (EDIS (6)). Payments to contractors and beneficiaries are, under decentralised management, made by national authorities, with ex post control by the Commission.

8.3. Sapard (7) has a similar objective in the field of agriculture and rural development. The audit of this instrument is reported upon in Chapter 4, the Common Agricultural Policy (see paragraphs 4.69 to 4.76). The conclusions are integrated into the general conclusions on pre-accession strategy in paragraph 8.37.

8.4. ISPA (8) was set up to facilitate accession in the fields of environment and transport. The audit of this instrument is

(1) Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia, Slovakia, Bulgaria and Romania.


(4) Of total Phare/Turkey payments made in 2004, approximately 80 % concerned programmes with decentralised implementation, 8 % centralised implementation, 7 % were implemented by joint management (mainly decommissioning of Nuclear Power Plants via the EBRD) and the remaining 5 % is managed by the EC Delegation in Turkey (devolved management) for the completion of former cooperation programmes with Turkey (mainly MEDA).

(5) Decentralised Implementation System.

(6) Extended Decentralised Implementation System where the Commission’s ex ante control of tendering and contracting is waived.


8.5 Expenditure in 2004 on pre-accession strategy totalled 3 053 million euro. Graphs 8.1 and 8.2 show a breakdown of the funds committed 1 718 million euro and spent in 2004 (see paragraphs 2.4 to 2.29 for observations on the budgetary management).

**Graph 8.1 — Breakdown of commitments by budgetary area in 2004**

![Graph 8.1](image)

Source: 2004 revenue and expenditure accounts.

**Graph 8.2 — Breakdown of payments by budgetary area in 2004**

![Graph 8.2](image)

Source: 2004 revenue and expenditure accounts.
THE COURT’S OBSERVATIONS

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Scope of the audit of the Phare and Turkey programmes

8.6. The Court:

(a) evaluated the supervisory and control systems, with a specific focus on the operation of systems for the control of national co-financing agreements (see paragraphs 8.7 to 8.29);

(b) carried out substantive tests on selected transactions in Bulgaria, the Czech Republic, Poland, Romania and Turkey (see paragraph 8.30);

(c) examined the annual activity report and declaration by the Director-General for Enlargement (see paragraphs 8.31 and 8.32).

Evaluation of supervisory and control systems

Directorate-General for Enlargement

8.7. The Directorate-General for Enlargement is inter alia responsible for programming and commitment of expenditure, payments to National Funds (9), monitoring of the full project cycle including national co-financing, evaluations and closure audits. The Directorate-General is also responsible for ex ante controls on procurement under decentralised management. The Court’s audit has led to observations concerning programming and budgetary commitments (see paragraphs 8.8 and 8.9), co-financing (see paragraphs 8.20 to 8.26) and closure audits (see paragraphs 8.10 to 8.13).

Need for improved project design

8.8. The projects from the programming years 2000 and 2001, to which most of the payments made in 2004 relate, suffer in some cases from weak design, complex objectives and unclear and unenforceable conditions, thereby increasing the risk of errors in implementation. Consequently, the Commission had to frequently modify the project fiches (10).

(9) National Funds have been set up in all candidate countries to channel the flow of all three pre-accession instruments, both receipts from the Commission and distribution of funds to implementing agencies.

(10) In 10 out of 16 Phare projects audited the Project Fiches had been amended.
Budgetary commitments for Bulgaria and Romania

8.9. Budgetary commitments for the national Phare programmes in Bulgaria and Romania were increased from 360 million euro in 2003 to 578 million euro in 2004 (+ 60%), in line with their accession roadmaps (\(^1\)). When authorising commitments for approved programmes under decentralised implementation, the Commission has to ensure that the countries concerned have an effective internal control system in place (\(^2\)). The Directorate-General for Enlargement is aware of several weaknesses in the management capacity of the national authorities and in the 2004 Annual Activity Report (see paragraphs 8.31 and 8.32) a reservation is made in respect of ‘Gaps in Romania’s and Bulgaria’s capacity to manage and implement increasing amounts of aid’. It is, however, inconsistent to authorise substantially increased budgetary commitments in a year when it was considered necessary to express a reservation regarding the management capacity (\(^3\)).

System of closure audits

8.10. In 2001 the Directorate-General for Enlargement adopted a closure audit strategy. The system of closure audits is one of the important tools for ensuring the legality and regularity of the Phare transactions.

8.11. The follow-up of the audits has been improved, although there are still some delays. The closure audits do not cover in sufficient depth expenditure declared as parallel national co-financing (\(^4\)). This is unsatisfactory given the risk and problems in this area, as identified by the Court’s audit (see paragraphs 8.20 to 8.28).

8.12. The number of audit reports followed up increased from 18 in 2003 to 57 in 2004, but progress with carrying out closure audits was slower in 2004 than 2003 (\(^5\)). The result from the closure audits was, however, the same in 2004 as in previous years, with no major irregularities being found in the underlying transactions.

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\(^{2}\) Article 164 of the Financial Regulation.

\(^{3}\) The Director-General for Enlargement has announced corrective actions, amongst others a reassessment of the allocation of funds for the period 2004 to 2006 based on a management system assessment to be carried out in 2005.

\(^{4}\) Joint co-financing implies that each project element is simultaneously co-financed and payments are made simultaneously by the partners. The other form is parallel co-financing, which implies that the partners finance different project elements, possibly at different times, and related payments are made separately.

\(^{5}\) 12 draft audit reports submitted in 2004, compared with 49 in 2003. The number of new audits launched was 32 in 2004, compared with 34 in 2003.
THE COURT’S OBSERVATIONS

8.13. The Commission’s instructions to the contracted auditors on reporting criteria were not clear enough. This reduced the relevance of the audit work. Moreover, this led to delays in the follow-up procedures in cases where the reported findings were not sufficiently clear to allow the Authorising Officer to take a decision concerning possible recoveries.

Observations on the operation of supervisory and control systems at EC Delegation level

8.14. The EC Delegations give their ex ante approval for tendering and contracting for the DIS managed programmes. For many years this function has been the key control to ensure the legality and regularity of the underlying transactions. The EC Delegations’ ex ante approval generally works well. However, when contracting is rushed, which is not unusual in Bulgaria and Romania, the quality of the ex ante approval is at risk.

8.15. The amount of work needed for the Commission’s ex ante approval reflects the quality of the management capacity of the candidate country. In Bulgaria and Romania a heavy burden is put on the EC Delegations to compensate for the countries’ weaknesses in project preparation and tender dossiers.

The operation of the management and control systems in new Member States and candidate countries

8.16. During 2004 the Directorate-General for Enlargement carried out verification audits as the final step of the EDIS process before the Commission decision on waiving the ex ante control on tendering and contracting. The verification audits, which were satisfactorily carried out in accordance with the regulatory framework, initially found some weaknesses. These weaknesses were remedied before the Commission decision on EDIS.

8.17. EDIS was granted to nine of the 10 new Member States in 2004 (16). The process of implementing EDIS has been a major step towards improving management capacity and control systems in the new Member States.

8.18. Bulgaria and Romania have drawn up action plans with the aim of having EDIS in place by January 2006.

THE COMMISSION’S REPLIES

8.13. The Commission’s instructions on reporting are set out in the terms of reference (TOR) of the contract concerned. More specific details are provided for each individual assignment when they are launched, where necessary identifying specific risks which the auditors are expected to address. Moreover, the contracted auditors are convened once a month to discuss progress on each audit.

In order to allow the Authorising Officer to take a decision concerning possible recoveries, guidelines on the treatment of audit findings have been issued in 2004.

8.14. The concerns of the Court on Bulgaria and Romania are reflected in the reservation in the Annual Declaration of the Director General. Concerning the issue of the quality of ex ante approval, this is a process, not an event, spread over the whole procurement process, sometimes several months, the signature of the contract being the final stage. Consequently, as indicated in paragraph 8.29, the Commission’s controls continue to be effective.

8.15. Indeed, a heavy burden rests on the Delegations in Bulgaria and Romania, but it has to be stressed that the Commission has drawn the attention of the national authority to take urgent corrective measures in relation to the present Decentralised Implementation System with ex ante control of procurement and award decision.

(16) For Poland EDIS was granted in March 2005.
8.19. For the first time systems put in place for DIS management were accredited for Turkey in October 2003. The Commission has had more than five years of experience in implementing pre-accession strategy in candidate countries. However, the outcome of the accreditation process in Turkey, as reflected in the current situation, indicates that lessons had not been learned despite the transfer of experience gained from DIS implementation in Phare countries. The start of the first DIS managed programme has been delayed mainly because of staffing problems in the Contracting and Finance Unit (CFCU) and other bodies, which could have been eased if the authorities had learned from experience.

8.20. The Court examined the operation of the management systems put in place for the control of national co-financing agreements on the basis of a selection of 10 projects in five countries (17) from the 2000 Phare programme.

8.21. The Directorate-General for Enlargement has improved the reporting requirements for national co-financing. The national authorities now have to certify amounts contracted and disbursed via National Funds, compare them with the forecast amounts agreed in Financing Memoranda and, where necessary, explain the differences between the amounts. The final declarations should now include the total amount of national co-financing, split into joint and parallel co-financing.

8.22. However, the national authorities are late with submitting the final declarations and the Directorate-General for Enlargement does not take sufficient action to remind them of this obligation.

8.22. The National Authorities submitted to the Commission final declarations that could have been sent within a reasonable timeframe. Improved reporting standards required by the Commission may have a delaying influence on submissions.

(17) Czech Republic (2), Poland (3), Slovenia (2), Bulgaria (1), and Romania (2).
Need for better overview

8.23. The Directorate-General for Enlargement does not systematically file amendments to Project Fiches. It is not possible to verify co-financing effectively without the final version of the Project Fiche. The interim reporting on parallel co-financing is incomplete and the Directorate-General for Enlargement is not able to quantify the total amounts of agreed parallel co-financing.

Prior to 2003 programming and in particular in 2000 and 2001 when minimum co-financing was still being introduced, parallel versus joint co-financing was not necessarily stipulated in order to facilitate the stretched public finances of the pre-accession countries. Therefore, countries were able to legally choose between the two forms or indeed to combine them during the course of implementation, provided all other legal requirements were fully respected (such as the 25 % minimum rule for investment projects). As parallel co-financing can be delivered at the end of a project there may be nothing to report in the interim context. Since 2003, parallel co-financing, has been virtually phased out in favor of joint co-financing which is self-verifying with each joint payment. Parallel co-financing compliance is nevertheless monitored with each payment and lastly there is an overall check before the final payment is made. Following risk assessment a further check may be made at the closure of accounts procedure stage.

Eligibility rules for parallel co-financing

8.24. Unlike for Structural Funds, the Commission has not laid down a clear set of rules to define eligible expenditure for national contributions. The Financing Memoranda, however, stipulate that ‘taxes, customs and import duties cannot be financed from Phare’ (18) and therefore, as a corollary, this expenditure is not eligible as national co-financing either. This rule is followed in the case of joint co-financing, in which the national contribution is managed along the same lines as the Phare money.

Parallel co-financing is managed by beneficiary ministries/authorities and is not part of the normal Phare reporting system. In June 2004 the Directorate-General for Enlargement issued a note to the National Authorising Officers stating that VAT was accepted as eligible for parallel co-financing provided that it was specified and duly explained in the final declarations. In the same note, expenditure provided as parallel co-financing was accepted up to one year after the expiry date of the Financing Memoranda.

8.25. In order to mitigate the more restrictive rules than those applying to Member States, in September 2002 the Commission’s guidelines on the ‘Principles for co-financing’ also included the Structural Funds’ ‘Rules of Eligibility’ (which do allow VAT under certain conditions) as a guidance document. Subsequently, after accession the Commission considered that it had no legal means to enforce the ineligibility of VAT paid out of parallel national co-financing. The guidelines were further streamlined in June 2004 and to this end a letter was sent to National Authorising Officers where amongst others, the eligibility of VAT, other taxes and duties was clarified. In fact it was aligned with those followed in the Structural Funds as most of the recipients had become Member States.

8.24. The rules and practices regarding co-financing for Phare have been evolving over a decade. For example, parallel co-financing allows ‘in-kind’ contributions and this by definition is excluded under joint co-financing arrangements. Furthermore, Phare countries would challenge any legally contentious and retroactive imposition of the most recent co-financing rules.

18 Article 13, paragraph 1, of the General conditions to the Financing Memoranda.
### The Court’s Observations

8.26. The Directorate-General for Enlargement’s acceptance of VAT as eligible expenditure under parallel co-financing does not have a legal basis. The Phare regulation excludes VAT from community funding, and the purpose of that exclusion would be circumvented if VAT were eligible for co-financing.

### Insufficient Verification of Parallel Co-Financing at National Level

8.27. The National Funds collect data on parallel co-financing when preparing Requests for Funds. The data are not verified, however, which may allow shortfalls in co-financing and ineligible expenditure to go undetected over a long period.

8.28. The Court’s audit of expenditure reported as parallel national co-financing revealed several cases where VAT was included, some cases where expenditure was made outside the eligible time period of the Financing Memoranda and one case of an ineligible in-kind contribution. The impact on the EU budget was marginal. However, in Bulgaria and Romania the interim reporting of expenditure as parallel co-financing could not be audited due to an insufficient audit trail and inadequate supporting documentation. In Turkey the same problem was found in a MEDA ([19]) programme with an agreed in-kind contribution.

### Conclusions on Supervisory and Control Systems

8.29. Over the years the supervisory and control systems have improved. For the new Member States the overall satisfactory level of supervisory and control systems is evidenced by the granting of EDIS after a thorough assessment and verification process. In Bulgaria, Romania and Turkey the supervisory and control systems at national level are rather weak. The key element in the Commission’s supervisory and control systems thus continues to be the effective performance of ex ante approval by the EC Delegations. Overall, the supervisory and control systems provide a reasonable level of assurance as to the legality and regularity of the underlying transactions, apart from the parallel co-financing requirements.

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THE COURT’S OBSERVATIONS

Substantive tests on transactions — Payments made at the implementing level

8.30. A total of 13 projects, with Commission payments in 2004, were selected in the Czech Republic, Poland, Bulgaria, Romania and Turkey for substantive testing of payments (20). Overall payments were legal and regular, with only a few formal errors such as late payments and minor non-compliance with tendering rules found. These results corroborate the Court’s assessment of the supervisory and control systems (see paragraph 8.29).

Annual activity report and declaration of the Director-General for Enlargement

8.31. The reservations made in previous years have not been maintained. Instead, the Director-General for Enlargement has made a new reservation about weaknesses in the administrative systems and gaps in Bulgaria’s and Romania’s capacity to manage and implement increasing amounts of aid.

8.32. The Court agrees with the Commission’s assessment. However, it is of the opinion that, in as far as risks for future management are referred to, these should not be expressed as a reservation against the Declaration on activities in 2004, but rather in the context of risk assessment in the annual activity report.

8.32. As explained in the text of the reservation, the reason for making this reservation in 2004 is that the risks refer to the future sound financial management of budgetary commitments which were made in 2004 and were therefore subject to the Director-General’s declaration in 2004. While the Court considers that the reservation has been set forward concerning the future, it is considered by the Director-General that the 2004 risk applies to that year’s commitments, although any materialisation of the risk (in terms of possible de-commitments) is likely to occur in later years.

Conclusions and recommendations

Conclusions of the Court’s audit relating to the Phare and Turkey programmes

8.33. The Court concluded that for Phare and Turkey programmes the Commission has continued to improve its internal control environment. The implementation of EDIS has been a major step towards improving the management capacity and control systems in the new Member States. The Directorate-General for Enlargement is aware that the control systems in Bulgaria and Romania are still weak, however.

(20) In total 60 payments were audited: Czech Republic (7), Poland (6), Bulgaria (23), Romania (17) and Turkey (7).
8.34. The audit did not reveal any material errors in the transactions tested, which is in line with the result from the previous year’s audit. However, the following remaining weaknesses in the supervisory and control systems have been identified:

(a) the Commission’s instructions to the contracted auditors on reporting criteria were not clear enough and expenditure declared as national parallel co-financing is not included in sufficient depth in the scope of the audit;

(b) despite the transfer of experience form DIS implementation in Phare countries, lessons learned by Turkish authorities have not been sufficient;

(c) there are delays in the submission of Final Declarations, incorrect application of eligibility rules, incomplete interim reporting and an insufficient audit trail for expenditure declared as parallel co-financing.

Recommendations: need for further improvements

8.35. The Commission should improve the project design, ensure that lessons learned from previous candidate countries are applied in new candidate countries and strengthen the control of parallel co-financing, amongst others by including it in the scope of the closure audits and bringing the eligibility rules in line with the legal framework. The Commission should intensify its efforts to improve the management and control systems in Bulgaria and Romania through the EDIS process.

8.35. As explained more in detail in the above paragraphs, the Commission has taken account of the observations. The Commission has e.g. issued the necessary guidelines, enforced the reporting, spread best practices and provided information and training e.g. through the seminar on ‘Lessons learned’ held in 2005.

GENERAL CONCLUSION ON PRE-ACCESSION STRATEGY

8.36. The Court’s assessment on pre-accession instruments is dealt with in the present chapter for Phare and Turkey (see paragraphs 8.33 and 8.34), in Chapter 4 for Sapard (see paragraph 4.76) and in Chapter 5 for Ispa (see paragraphs 5.55 and 5.56).

8.37. The result of the Court’s work shows that for all pre-accession instruments (Phare, Turkey, Sapard and Ispa) supervisory and control systems at the level of the Commission’s central services and delegations and certifying authorities were basically sound, and worked in practice. However, risks of varying degrees still exist at the level of implementing organisations in the candidate countries for all programmes (see paragraphs 8.29, 4.76 to 4.77 and 5.56). The Court’s audit has not identified material errors in the underlying transactions.
CHAPTER 9

 Administrative expenditure

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THE COURT’S OBSERVATIONS

ADMINISTRATIVE EXPENDITURE OF THE INSTITUTIONS AND COMMUNITY BODIES

Introduction

9.1. Heading 5 of the financial perspective, ‘Administrative expenditure’, contains the institutions’ and other bodies’ administrative appropriations. These appropriations are managed directly by each institution or body and are used to pay the salaries, allowances and pensions of persons working for the Community institutions, as well as rent, purchases and miscellaneous administrative expenditure. Expenditure in 2004 was 5 856 million euro, as further specified in Table 9.1. This chapter includes the specific assessment in the context of the Statement of Assurance and specific observations on the institutions, the satellite bodies and the European Schools.

Table 9.1 — Payments by institution

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<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
</tr>
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<tbody>
<tr>
<td>European Parliament</td>
<td>986</td>
<td>1 166</td>
</tr>
<tr>
<td>Council</td>
<td>410</td>
<td>507</td>
</tr>
<tr>
<td>Commission</td>
<td>3 546</td>
<td>3 721</td>
</tr>
<tr>
<td>Court of Justice</td>
<td>148</td>
<td>216</td>
</tr>
<tr>
<td>Court of Auditors</td>
<td>84</td>
<td>84</td>
</tr>
<tr>
<td>European Economic and Social Committee</td>
<td>91</td>
<td>92</td>
</tr>
<tr>
<td>Committee of the Regions</td>
<td>46</td>
<td>63</td>
</tr>
<tr>
<td>European Ombudsman</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>European Data Protection Supervisor</td>
<td>—</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>5 305</td>
<td>5 856</td>
</tr>
</tbody>
</table>

Specific assessment in the context of the Statement of Assurance

Introduction

9.2. The objective of the 2004 DAS audit concerning administrative expenditure was to enable the Court to assess the reliability of the consolidated accounts for the year ending 31 December 2004 (dealt with in Chapter 1) and the legality and regularity of the transactions which underlie them. A follow-up to observations from past Annual Reports is presented in Table 9.2.

9.3. Past audits by the Court show that the errors found were mostly of a formal nature and not due to serious weaknesses in the control systems. However, in 2004 the adoption of new staff regulations and of a new system for calculating staff remunerations, as well as the implementation of new systems in the framework of the new Financial Regulation, have introduced specific risks (see paragraphs 9.5 and 9.6).

9.2. REPLY OF THE COMMISSION

The Commission publishes a yearly report presenting the follow-up it considers proper to the Court’s Recommendations. The report covering the Court’s 2003 Annual Report is to be published in the autumn 2005.

9.3. REPLY OF THE COMMISSION

The phased introduction of a new salary payment system in 2003 and early 2004 created a new risk, like any new application (see reply to paragraph 9.5). The Commission departments addressed this situation by making a large number of manual controls on the results of the various provisional calculations of monthly salary payments and immediately corrected errors detected by the IT teams before the final monthly calculation and authorisation of salaries. The number of errors found ex post was very small.
Table 9.2 — Follow-up to observations from past annual reports

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<th>Further action needed?</th>
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<td><strong>Standing orders</strong></td>
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<tr>
<td>Annual Report concerning 2003, paragraph 9.14:</td>
<td></td>
<td></td>
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<tr>
<td>The Parliament’s internal rules for implementing its section of the budget allows for the possibility of making payments using a standing order. After the payment has been made, the authorising officer issues a ‘regularisation order with a view to charging the amount against the budget’ (Article 11, paragraph 4, of the internal rules). To conform with the Financial Regulation expenditure must be validated and authorised before payment.</td>
<td>No action taken: in 2004 the internal rule allowing the possibility of making payments using a standing order was still in force.</td>
<td>Yes, all payments should be made in accordance with the provisions of the Financial Regulation.</td>
<td>Following a revision carried out on 27 April 2005, Article 10 of the Internal Rules governing the implementation of Parliament’s budget now stipulates that ‘payment by direct debit is permissible only where it is stipulated in the contract with the creditor as being the sole method of payment’.</td>
</tr>
</tbody>
</table>

| **Additional pension scheme for Members of the European Parliament** | | | |
| Annual Report concerning 2002, paragraphs 9.17 and 9.20: | | | |
| If the additional pension scheme for Members of the European Parliament is to continue, a sufficient legal basis has to be created as soon as possible. | The additional pension scheme continues and no sufficient legal basis has been created. | Yes, a legal basis should be created. | The Statute for Members which will enter into force in 2009 provides for a single pension scheme for MEPs and will thus ultimately lead to the discontinuation of the additional pension scheme. |
| | No such rules have been established. | Yes, appropriate rules should be established. | An actuarial study of the scheme in question was carried out in spring 2005. It should enable Parliament to identify the measures needed to keep the fund on an even keel. The results of the study might also prompt a review of the respective powers and responsibilities of Parliament and the non-profit-making association set up under Luxembourg law to manage the pension fund during the period leading to the entry into force of the Statute. |

**Supervisory and control systems**

9.4. In 2004 all the institutions continued improving their supervisory and control systems in order to comply with the requirements of the new Financial Regulation. However, none of the institutions had fully implemented Internal Control Standards (ICS) (1).

9.4. **REPLY BY THE COUNCIL**

The Internal Control Standards (ICS) for the Council were been adopted on 20 July 2005.

(1) The Council did not set up any ICS, the Court of Justice did not implement several ICS, in the other institutions full compliance with all the ICS adopted has not yet been achieved.
9.4. REPLY OF THE COMMISSION

The Commission adopted its internal control standards in 2000 and does a yearly follow-up of the implementation of the related baseline requirements; the mentioned implementation is regularly followed up both from a compliance as well as from an effectiveness point of view. As the Court mentions in paragraph 1.87, 93\% of the baseline requirements were complied with, which could be considered as being practically fully implemented in an ever changing environment.

9.4. REPLY OF THE COURT OF JUSTICE

The Court of Justice’s administration acknowledges that it proved impossible to implement in full certain internal control standards in 2004. Reinforcement of qualified staff will allow swift improvement of the situation.

9.4. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

The implementation of the main measures resulting from the adoption of the internal control standards is now scheduled over a two-year period (2004 and 2005). They concern staff management (establishment of a written description of all posts; updating the description of recruitment procedures), the use of performance indicators (for which an interinstitutional consultation was asked) and systematic use of a quarterly spending plan. All of these were included in a consolidated action plan, adopted on 8 November 2004 by the Secretary-General.

9.5. In 2004, the NAP (‘Nouvelle Application Paie’), a new computer application for calculating staff remuneration created and managed by the Commission Paymaster Office (PMO), was used by all the institutions. The NAP presented in 2004 various technical weaknesses, which created a new risk and, in many cases, resulted in the erroneous calculation of various elements of staff remuneration. The most evident errors were corrected manually before payment. Concerning one of those elements, in March 2005 NAP programmes were amended, the amounts paid in 2004 recalculated and, where necessary, corrected. These corrections led to recoveries amounting, for all the institutions, to a total of around 1.9 million euro. Manual data transferred into the NAP from the computer systems recording the situations qualifying the staff for specific entitlements constituted a further specific risk of errors. However, controls were not reinforced accordingly.

9.5. THE REPLY OF THE EUROPEAN PARLIAMENT

While the near simultaneous introduction of the new Financial Regulation, the new Staff Regulations and the NAP payroll system did indeed give rise to major problems, the real nature of the latter needs to be properly understood. The Staff Regulations, in particular, gave rise to numerous problems of interpretation. Only when these difficulties had been resolved (normally at the level of Heads of Administration) could the NAP system be definitively adapted. The time lag involved in this procedure accounts for the greater part of the recoveries referred to. Purely technical teething problems with the NAP, while tedious and time-consuming for the services concerned, were speedily identified and corrected. While the manual entry of payroll data does also constitute a risk, the latter is not new and thus required no specific control measures beyond those already in place, although the NAP is a factor in leading Parliament to reinforce ex post controls on the payroll.

9.5. REPLY BY THE COUNCIL

For its part, the General Secretariat of the Council (GSC) would like to underline that it did actually reinforce controls when the old salary application was replaced by the NAP. The GSC regrets that the conclusion on control might distract the attention of the reader from the fact that a deficient computer application was implemented at the moment that the Staff Regulations were fundamentally modified.
THE COURT’S OBSERVATIONS

9.5. REPLY OF THE COMMISSION

The phased introduction of the NAP in 2003 and early 2004 created a new risk; such a risk is inherent in the launching of a new computer application.

The Commission departments addressed this situation by making a large number of manual controls on the results of the various provisional calculations of the monthly salary payments and immediately corrected errors detected by the IT teams before the final monthly calculation and authorisation of salaries. The number of errors found ex post was very small.

The changes to the Staff Regulations were only made by the Council on 22 March 2004, thereby leaving very little time for laying down detailed management rules and adjusting the NAP. Nevertheless, the Commission was able to introduce, in the May 2004 salary payments, most of the amendments made by the reform. Certain aspects could not be put in place definitively on the day of entry into force of the Reform, as the general implementing provisions or management rules had not been fully laid down. Provisional modules were therefore brought in to limit the impact on the beneficiaries. The amendments to the NAP in March 2005, which produced the corrections of 1.9 million euro referred to, were the outcome, for example, of work which could not be carried out earlier as the decision on the arrangements was not taken until November 2004.

The introduction of the NAP meant that controls of the quality of the data fed into the pay system had to be transferred to the entitlements management systems which now transmit the data automatically via an interface to the NAP. In 2003, the existing controls were evaluated and reorganised with a view to ensuring compliance from 1 January 2004 with the principle of initiation and ex ante verification as set out in the Financial Regulation.

9.5. REPLY OF THE COURT OF JUSTICE

The problems noted were caused by the implementation of the NAP application. That took place at the same time as the reform of the Staff Regulations of officials in far from perfect conditions that contributed to a significant increase in the workload of the ‘Remunerations’ section. Other institutions have, like the Court of Justice, encountered difficulties in the operation of that application. Those difficulties have on several occasions been brought to the attention of the Commission staff managing the NAP and have been discussed at regular meetings with those services. Many of them have now been overcome for the most part.

With regard to the transfer of data in the NAP, it is to be noted that in the Court of Justice that task is performed by the staff of the ‘Remunerations’ section directly, on the basis of the various administrative decisions creating rights and that it is subject to systematic checks within the section. Encoding is not therefore carried out in respect of the data already encoded within the personnel management system Centurio.
THE COURT’S OBSERVATIONS

9.5.  REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

At the EESC, no data are entered manually into NAP. Staff data are encoded in the personnel management computer system by one person and validated by a second person. Validated data are transferred directly from this system into NAP through an automated procedure. Also, individual payments coming from NAP are electronically inserted into the accounting information system, without any manual intervention. Furthermore, like any other payment, these payments are electronically sent to the bank, after double electronic signature, without any re-encoding.

9.6.  THE REPLY OF THE EUROPEAN PARLIAMENT

The dispersion of Parliament’s activities, over three places of work, gives rise to particular problems with regard to missions, one consequence of which was that it was in no position to introduce new rules by 1 May deadline. While the new rules introduced in 2005 do provide for flat-rate payments, Parliament’s view is that the new system strikes an appropriate balance between regulatory and practical requirements and is in conformity with the legal advice tendered to it.

9.6.  REPLY BY THE COUNCIL

The GSC will examine, together with the other institutions, the possibility of changing its internal rules on reimbursing accommodation costs without supporting documents.

9.6.  REPLY OF THE COMMISSION

Payment of a flat-rate amount instead of a variable payment on the basis of supporting documents was considered to be an implementing measure for a provision of the Staff Regulations which, within each administration’s freedom of judgment, takes into account its cost-effectiveness. However, the Commission is going to examine whether such a rule is well-founded.

9.6.  REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

The EESC’s Mission Guide is, to a large extent, based on the Commission’s Guide. Point 4.2 is exactly the same in both Guides. In order to keep a coherent set of rules between institutions, the EESC intends to continue to apply Article 13(1) of Annex VII in the same way as the Commission does.

9.7.  Weaknesses were noted in the control systems concerning the transfer of part of the staff emoluments with the application of a weighting coefficient. In various cases, transfers were granted, which were not supported by adequate evidence of the officials’ right to the transfers requested (3). The number of cases found was significant in some institutions (4).

9.7 and 9.8.  REPLY OF THE COMMISSION

The errors mentioned were found in other institutions and not in the Commission.

(3) Court of Justice, European Economic and Social Committee, Committee of the Regions and Council.
(4) European Economic and Social Committee and Committee of the Regions.
THE COURT'S OBSERVATIONS

9.7. REPLY OF THE COURT OF JUSTICE

This paragraph deals with cases in which the consequences of a change in an official's rights in respect of his family situation have not immediately been reflected in changes to the right to the transfer part of remuneration. Nevertheless, it is to be noted that Court of Justice's administration carries out periodic checks and, if need be, makes corrections by recovering the sums paid though not due.

9.7. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

The analysis of the supporting documents of transfers of part of the remuneration with a weighting coefficient is part of the systematic ex post checks which are currently ongoing. Any correction needed is being applied according to the new Staff Regulations.

9.8. A lack of control procedures concerning pension payments were noted in some institutions. Pension paid to retired officials residing in certain Member States are increased by a weighting coefficient. However no check had been performed in recent years to verify the actual place of residence of former officials (5).

9.8. REPLY BY THE COUNCIL

On the basis of a risk assessment, the GSC carried out, in March 2005, a survey concerning pension payments to United Kingdom residents leading to corrections by the administration which, in turn, resulted in two court cases.

9.8. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

After 2002 it was decided that the control of residence of the pensioners would be made every two years. This control was programmed for the end of 2004 but it was delayed because of the workload resulting from the 'Reform' (new calculations, new transfers etc.). During this period the EESC kept a close contact with its pensioners by mailing to them news/information letters and monitoring their delivery, as well as with individual correspondence whenever necessary. The full official control will be carried out between July and October 2005. On 31 August 2005, more than 80 % of the pensioners had been controlled.

9.9. Except for the European Ombudsman and the European Data Protection Supervisor, occasional weaknesses were observed in the supervisory and control systems concerning procurement.

9.9. THE REPLY OF THE EUROPEAN PARLIAMENT

Parliament notes the Court's observation and will continue its efforts to improve its procedures.

9.9. REPLY BY THE COUNCIL

The GSC considers that there is no argument which supports the statement of the Court that it found occasional weaknesses in its supervisory and control system concerning procurement. The GSC set up an internal organisation centred around DG A IV/procurement coordination unit which ensures that competitive tendering procedures are conducted in strict compliance with the rules and aiming at the most cost-effective solution.

In the context of its annual audit, the Court made one comment on a procurement-file which was related to the interpretation of the financial regulation but which has no bearing on the quality of the internal control system.

(5) Council and European Economic and Social Committee.
THE COURT'S OBSERVATIONS

9.9. REPLY OF THE COMMISSION

For the Commission, all services concerned have taken remedial measures:

— the annual instructions to delegations will be reviewed in order that all delegations provide sufficient ex ante information to headquarters,

— two additional controls, one ex ante and one ex post, were put in place in order to supplement the control system in the informatics procurement process,

— measures were taken in 2005 in what concerns office procurement to ensure compliance with Article 126 of the Implementing Rules of the Financial Regulation, the planning of calls for tenders over 2005 to 2006 was made and ex post controls were implemented throughout the year.

9.9. REPLY OF THE COURT OF JUSTICE

The Court of Justice’s administration will endeavour to strengthen yet further its supervision of procurement contracts and to develop the training of managers in that area.

9.9. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

One underlying reason for the weaknesses concerning the planning of the procurement activity and the operational management of the contracts was too much decentralisation of responsibility for procurement and contractual management to the different operating services, which do not have sufficient specialist skills in this area. In early 2004, it was proposed to establish a new unit responsible for coordinating financial and contractual activity throughout the Joint Services of the European Economic and Social Committee and the Committee of the Regions, which manage the vast majority of public procurement activities within the EESC. The unit was formally established on 1 November 2004 and, following a phase of recruitment, became fully operational in February 2005. The unit includes two completely new posts specifically involved in procurement and contractual management in the Joint Services. It should also be noted that the considerable impact during 2004 on the various operating services of the activity relating to the enlargement and the change of premises of the two Committees contributed to the weaknesses that have been identified.

Observations concerning transactions

9.10. The Court’s audit covered staff remunerations, transfers of a part of the salary, increased by a weighting coefficient, to bank accounts in Member States other than the Member State where the staff is employed, recruitments, allowances for Members of institutions and expenditure for procurement contracts.
THE COURT’S OBSERVATIONS

9.11. Several cases producing a long-lasting financial impact were found concerning remuneration of staff where the expenditure was not justified:

(a) grading of staff which did not comply with the provisions of the Staff Regulations or the Conditions of employment of other servants (CEOS) (6), awarding of the specific salary increase for heads of unit to persons who had no staff management tasks (7);

(b) transfer of part of the salary with weighting coefficients granted without the necessary justification for all or a part of the amount transferred (7).

9.11 and 9.12. REPLY OF THE COMMISSION

See reply to paragraph 9.7 and paragraph 9.8.

9.11.

(a) REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

With regard to the grading of staff, the Court’s observation refers to an omission in the regrading of a temporary agent under the transitional provisions of the new Staff Regulations. This error has been corrected. Moreover, an ex post check has shown this to be an isolated case.

With respect to the nomination of heads of Unit, the Staff Regulations do not stipulate any minimum number of staff to be managed by a head of unit. At the EESC, which is a small institution, the management options are the following: in order to increase individual motivation and collective efficiency, heads of unit have full responsibility and are accountable for the organisation and development of the activities in their sector as well as for the management of their human resources. The EESC Decision No 442/04 A states that, in order to be appointed head of unit at the EESC, a staff member must either:

— have major responsibilities in the definition, development and implementation of the EESC’s policies, or have major responsibilities in sensitive areas, or

— have major responsibilities in the field of staff or financial management, or perform the duties of authorising officer within the meaning of the Financial Regulation in important areas or for large amounts, or

— manage an administrative unit made up of at least nine officials.

Hence, in full compliance with the aforementioned decision, the head of Internal Audit and the head of the Legal unit were nominated head of unit, given the scope and nature of their responsibilities.

(b) REPLY BY THE COUNCIL

The Court of Auditors makes the same observation as presented in paragraph 9.7. Moreover, since the GSC requests, every year systematically, new supporting documents, it is not correct to conclude that the few cases found by the Court would have a long-lasting financial impact concerning remuneration of staff.

REPLY OF THE COURT OF JUSTICE

Reference is made to the answer to paragraph 9.7.

REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

Please refer to the EESC’s comments on paragraph 9.7.

(6) Council, European Economic and Social Committee and Committee of the Regions.
(7) European Economic and Social Committee, Committee of the Regions, Court of Justice and Council.
THE COURT’S OBSERVATIONS

9.12. The nature and type of errors found confirmed the weaknesses in the functioning of the supervisory and control systems mentioned above and provided indications on improvements required.

Annual activity reports and declarations of the authorising officers by delegation

9.13. Improvements were made in 2004 in the presentation of the annual activity reports and declarations of the authorising officers by delegation. Some of them included qualifications and most of them reported some weaknesses in the supervisory and control systems. For some institutions, the Court could not take the annual activity reports into consideration as they had not been produced before the Court’s audit was concluded (8).

9.13. REPLY OF THE COMMISSION

The Commission takes note of the evaluation made by the Court regarding the improvements made in the presentation of its services’ annual activity reports for 2004, which have all been produced in due time.

There were few reservations and observations entered in the Commission services’ annual activity reports related to the overall administrative expenditure. The Commission considers that the weaknesses reported at the level of supervisory systems and controls do not materially affect the legality and the regularity of the underlying transactions.

9.13. REPLY OF THE COURT OF JUSTICE

So far as the annual activity report is concerned, it must be borne in mind that the time limit of 15 June, laid down in Article 60(7) of the Financial Regulation for sending to the budgetary authority a summary of the annual activity reports, is applicable to the Commission alone. The annual activity report drawn up by the Court of Justice’s authorising officer by delegation was forwarded to the institution on 21 June 2005. In future, if the Court of Auditors expresses a wish to have the annual report available on a given date, the Court of Justice will make every effort to ensure a favourable response to that wish.

Specific observations

9.14. The following section concerns specific observations relating to each of the institutions.

Parliament

9.15. Paragraphs 9.6 and 9.9 apply to the Parliament. Validation of procurement expenditure in several cases did not operate as intended. In one of the cases the amount paid was overstated by 0.7 million euro.

9.15. THE REPLY OF THE EUROPEAN PARLIAMENT

As regards paragraphs 9.6 and 9.9 cited by the Court, see the relevant replies above. As regards the amount quoted, it is the result of a reduction in the VAT assessment base for the long lease conferring right in rem for the D4-D5 building, a reduction granted by the competent Belgian authorities following lengthy negotiations concluded at a very late stage. A political agreement on the assessment base was secured shortly before the lease was signed. It was only once notification had been given by the competent tax authority, a few days after the payment due when the lease was signed had been made, that the firm was able to issue a credit note and a new invoice. As a result, the sum of 701 537.76 euro was treated as an advance payment, in accordance with the terms of the lease agreed with the firm.

(8) Court of Justice and Committee of the Regions.
THE COURT’S OBSERVATIONS

9.16. Weaknesses were also observed, as in the past (see paragraphs 9.21 and 9.22 of the 2002 Annual Report), in the supervisory and control systems related to the payment of allowances to Members of the Parliament (MEPs). The procedures applied did not ensure that income obtained by former MEPs from certain activities (paid office in an international institution; membership in a national or regional government; etc) was deducted from the temporary end-of-service allowance.

9.16. THE REPLY OF THE EUROPEAN PARLIAMENT

As regards the secretarial assistance allowance, fresh changes to the PEAM Rules were approved in 2004 with the aim of strengthening checks on the use of the allowance, in particular in connection with contracts for the provision of services. In July 2005, the Quaestors approved practical arrangements for implementing these changes, which will enable the managing service to bring them into force. As regards the temporary end-of-service allowance, Parliament is aware that there is still some risk of misuse. Some measures have been taken, and further measures are planned, to minimise that risk even further.

Council

9.17. Paragraphs 9.4, 9.6, 9.7, 9.8, 9.9 and 9.11 apply to the Council. The Council did not set up minimum Internal Control Standards (Article 60(4) of the Financial Regulation) nor drafted charters describing the tasks, rights and obligations of the accounting officer and of the imprest administrator (Article 44 of the implementing rules).

9.17. REPLY BY THE COUNCIL

The GSC’s reactions to paragraphs 9.4, 9.6, 9.8, 9.9 and 9.11 can be found above. In addition it should be noted that the Council recently established a charter describing the tasks, rights and obligations of the accounting officer as well as a manual for imprest accounts.

9.18. Additional annual leave granted before 31 December 1997 as a compensation for overtime is paid on retirement if the official has not taken the additional leave. As staff of the A and B categories are not entitled to compensation for overtime, such payments are not in accordance with Article 56 of the Staff Regulation. At the end of 2004 the total annual leave granted before 31 December 1997 as a compensation for overtime and still not taken amounted to around 11 800 days. In September 2004 a total amount of approximately 95 000 euro was paid for additional annual leave not taken by A and B officials retiring in that month.

9.18. REPLY BY THE COUNCIL

The GSC envisages to gradually eliminate the stocks of compensatory leave for staff of the A and B categories granted before 31 December 1997; the most recent step in this process is presented in staff note 80/05 of 17 May 2005. Since the beginning of 2005, these stocks have been reduced by 2 500 days resulting in a stock of 9 317.5 on 7 September 2005.

Commission (*)

9.19. Paragraph 9.9 applies to the Commission. The Court also identified some weaknesses in the functioning of some supervisory and control systems at the Publications Office, where differences were observed between quantities of paper recorded in stocklists and actually existing in the warehouse, non-delivered copies of a publication were paid and price revisions, foreseen in the contracts in case of a decrease in the market prices of paper or raw materials, were not asked for.

9.19. REPLY OF THE COMMISSION

The Publications Office accepts the Court’s comment on the apparent differences between the levels registered in its stock management system and the actual physical stock held on two different sites. These differences are the result of an erroneous entry in the stock management system. New software is currently being developed to manage the stock, most of which has now been brought back to the Office’s main premises.

(*) The Commission departments responsible for most of the administrative expenditure are the following: Directorate-General ‘Personnel and Administration’, Directorate-General for Translation, Directorate-General for Interpretation, Directorate-General ‘Press and Communication’, Directorate-General for External Relations, Office for Infrastructures and Logistics — Luxembourg, Office for Infrastructures and Logistics — Brussels, Office for the Administration and Settlement of Individual Entitlements, European Personnel Selection Office, Publications Office.
THE COURT’S OBSERVATIONS

The Publications Office accepts the Court’s comments regarding the discrepancy of 1.4% found in the quantities delivered for one publication and will take steps to ensure that information circuits are improved so as to avoid repetition of this type of error.

The Publications Office accepts the Court’s comments as regards price revisions; it will pay attention to this in the future.

Court of Justice

9.20. Paragraphs 9.4, 9.7, 9.9, 9.11 and 9.13 apply to the Court of Justice. The Court of Justice adopted the Internal Control Standards in March 2004. However five of them were not implemented. In one case concerning indexation of rents, lack of supporting documents attached to rent payment orders and insufficient follow-up of the lease contract resulted in the obligation for the Court of Justice to pay the lessor in September 2004 716 000 euro for rent arrears, due to the non-indexation of the rent since 1999.

9.20. REPLY OF THE COURT OF JUSTICE

As regards internal control standards, reference is made to the answer given to paragraph 9.4.

The observations on the indexation of rent call for the following replies. Until 1999, except for the years 1983, 1984 and 1994 when a rent freeze was in force, the Court adjusted the amount of the payments due as rent for its main building, in the light of a letter sent by the owner, the Luxembourg State (1). Before that letter, when the preliminary draft budget was drawn up each year, an estimate was made of the rent payable for the year in question, on the basis of the estimated change in the index used for rent review.

After the main building was evacuated in 1999, it was agreed to add a second additional clause to the lease of the main building in order to take account of the occupation of a replacement building (the T building) on the same conditions as the main building.

From 2001 onwards, letters were sent to the Luxembourg authorities requesting them, in the light of the new situation, to adopt a view on the application of Article III of the lease which provides for adjustment of the rent in line with variations in the reference index. It was only by letter of 28 September 2004 that the Receveur des Domaines (collector of revenue from State/Crown property) replied, demanding the payment of rent due following its adjustment to the changes in that index for the period 1999 to 2004.

9.21. The Internal Auditor exercises the function of head of the ‘verification unit’ which performs ex ante controls on the authorising officer’s operations. Such an involvement in the carrying out of financial operations is not compatible with the tasks of an independent internal auditor. Since his appointment in 2003, the Internal Auditor did not complete any of the audits included in his work programme.

9.21. REPLY OF THE COURT OF JUSTICE

Ex ante verification activities and internal audit activities are performed by different people. It is pointed out that, having regard to the size of the Court, the decision was taken to place the verification agents under the administrative authority of a single official, also appointed as internal auditor. This administrative authority in no way affects the independence of the internal auditor in the conduct of his audit duties.

It is true that in 2004 the internal audit division suffered from a lack of qualified staff which made it impossible to complete the planned audit tasks. Unflagging efforts to remedy that situation led to the appointment in December 2004 of an auditor as a member of the auxiliary staff and, in June 2005, of an auditor as a member of the temporary staff. Last, a Category A* official recruited on a reserve list arrived to reinforce that team in September 2005. The division is now in a position to carry out its activities to the full.

(1) There is nothing extraordinary about this procedure when one considers, for example, that the fourth subparagraph of paragraph 5.1 of the lease for the GEOS building states: ‘The sums payable as a result of the application of indexation shall be paid to the lessor 45 days after the date of receipt of the request for indexation by the lessee’.
THE COURT’S OBSERVATIONS

Court of Auditors

9.22. The Court of Auditors is audited by an independent external audit firm which has issued a ‘certificate concerning the regularity and fairness of the financial statements at 31 December 2004’, accompanied by a ‘report on the administrative and accounting procedures, the soundness of the financial management and the internal control system’. The report states that, in the auditor’s opinion, ‘the current internal control rules ensure that the operational objectives are achieved satisfactorily, the financial statements are reliably drawn up and the legal framework is complied with’. Certificate and report will be published in the Official Journal.

Economic and Social Committee

9.23. Paragraphs 9.6, 9.7, 9.8, 9.9 and 9.11 apply to the Economic and Social Committee. The Internal Control Standards were approved in July 2004. Not all the measures needed to achieve full compliance with them have been taken yet.

9.23. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

Please refer to the EESC’ comments on these points and on paragraph 9.4.

Committee of the Regions

9.24. Paragraphs 9.6, 9.7, 9.9, 9.11 and 9.13 apply to the Committee of the Regions. Internal Control Standards were approved only in November 2004, but not all the measures needed to achieve full compliance with them were taken. The internal audit function was carried out by a member of temporary staff, employed on the basis of renewable contracts of short duration. In May 2005 an official was nominated internal auditor.


The Committee of the Regions undertook all possible efforts throughout 2004 to recruit a new Internal Auditor as well as the rest of the staff of the Audit Service. However, as very few eligible officials applied for the vacant posts, it was impossible to fill them on a permanent basis at that time.

European Ombudsman and European Data Protection Supervisor

9.25. The audit did not give rise to observations.

Overall conclusions and recommendations

9.26. Improvements have been made by all the institutions in order to adapt their supervisory and control systems to the requirements of the new Financial Regulation. However, the risks identified in 2003 linked to the implementation of the Financial Regulation (10), together with the risks resulting from the introduction of new Staff Regulations and computerised systems for calculating salaries and pensions (see paragraph 9.6) had not been adequately addressed by the supervisory and control systems in 2004.


Full compliance with the requirements of the new Financial Regulation will take some time. The introduction of the NAP payroll system and the new Staff Regulations increased the risks in 2004 but difficulties arose mainly from technical teething problems with the payroll system or in interpreting the provisions of the Staff Regulations and they were known by the services. While the latter did indeed give rise to a significant number of recoveries, the number of real errors left appeared to be low, due in particular to the degree of scrutiny to which appointing authority decisions are subject. However, supervisory and control systems and especially ex post controls on the payroll should still be reinforced.

(10) Annual Report concerning the financial year 2003, paragraph 9.68.
THE COURT’S OBSERVATIONS

9.26. REPLY OF THE COMMISSION

The phased introduction of the NAP in 2003 and early 2004 created a new risk; such a risk is inherent in the launching of a new computer application. The Commission departments addressed this situation by making a large number of manual controls on the results of the various provisional calculations of the monthly salary payments and immediately corrected errors detected by the IT teams before the final monthly calculation and authorisation of salaries. The number of errors found ex post was very small.

The introduction of a new payment system meant that controls of the quality of the data fed into the pay system had to be transferred to the entitlements management systems which now transmit the data automatically via an interface to the NAP. In 2003, the existing controls were evaluated and reorganised with a view to ensuring compliance from 1 January 2004 with the new principle of initiation and ex ante verification as set out in the Financial Regulation.

9.27. REPLY OF THE COMMISSION

The Commission notes that the formal errors identified did not materially affect administrative expenditure. Nevertheless, the Commission will continue to take the measures needed to prevent them from reoccurring.

9.28. The Court considers, as a result of its audit, and in order to address the risks identified, that improvements should be made in the supervisory and control systems relating to the following areas:

(a) documentation of procedures;

Following previous observations by the Court, the Commission has launched a specific action in order to document its human resource management administrative procedures. The results will be fully visible in the new ‘Personnel and Administration’ website, due to appear gradually online as from the end of 2005.

(a) and (b) REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

As already mentioned in the EESC’s comments on the Court’s annual report on the 2003 budget (paragraph 9.40(b)), many procedures do exist and are indeed documented. In the EESC’s risk-analysis guide, the establishment of written procedures has been identified as a standard measure to reduce risks. Hence, it has a permanent nature. In the consolidated action plan adopted at the end of 2004, descriptions of several procedures are scheduled for 2005.
THE COURT’S OBSERVATIONS

(b) definition of the nature of the supporting documents which should make it possible to check that the expenditure is in accordance with the terms of the contracts or of the regulations and rules;

(b) REPLY OF THE COMMISSION

This recommendation has already been taken into account for the drafting of new specific agreements, for instance that relating to the framework contract for the installation of further cables and fittings in the Jean Monnet building. The costs of services are specified more precisely in order to avoid the risk referred to by the Court.

(c) grading of staff under the new staff regulations;

c) and (d) REPLY OF THE COMMISSION

See reply to paragraph 9.7 and paragraph 9.8. Nevertheless, the Commission sees that the new provisions are implemented properly.

(d) remuneration, in particular payment of allowances and transfers of part of the staff emoluments with the application of a weighting coefficient.

(d) REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

Please refer to the EESC’s comments on paragraph 9.7.

9.28. THE REPLY OF THE COMMITTEE OF THE REGIONS

The Committee of the Regions will fully implement the Court’s recommendations contained in paragraph 9.28 of the draft final audit and shall continue its efforts with a view to improving the existing documentation on procedures while giving particular attention to the question of the ex post verifications concerning the regularity of expenditure.

Principal observations in Special Reports

Special Report No 1/2005 concerning the management of the European Anti-Fraud Office OLAF

9.29. The Court’s Special Report, together with the replies of the Commission, were published in OJ C 202 on 18 August 2005.

Special Report No 5/2005 concerning interpretation expenditure incurred by the Parliament, the Commission and the Council

9.30. The purpose of the Court’s audit was to assess the soundness of the financial management of interpretation services at the Parliament, the Commission and the Council.

9.30. THE REPLY OF THE EUROPEAN PARLIAMENT

Full multilingualism, Parliament’s preferred system, entails substantial costs stemming, in particular, from political decisions concerning the organisation of business (calendars and places of work) and the need to respond quickly to sometimes unforeseen political developments. However, with a view to improving the arrangements for the use of interpretation, Parliament has laid down framework provisions in a Code of Conduct adopted in 1999 and revised in 2004.
THE COURT’S OBSERVATIONS

Moreover, Parliament’s services are endeavouring to improve checks on the costs linked to the hiring of auxiliary conference interpreters and, in particular, their travel expenses and, the establishment of a single inter-institutional service, responsible for all payments to such interpreters, represents a major step forward. Parliament’s services which use interpretation will also study the best practices observed in the other institutions with a view to improving the scheduling of business, in keeping with the political imperatives referred to above.

9.30. REPLY BY THE COUNCIL

The GSC would like to point out that it is not only by more forethought on the part of meeting organisers, that further savings in interpretation could be made. According to the special report of the Court, savings can also be made in other ways, like lower freelance interpreter (ACI) costs or better interinstitutional cooperation.

9.31. REPLY OF THE COMMISSION

The Commission will continue its cost control policy through its ‘real needs’ approach, and will reinforce its endeavours to reduce provision of interpretation where it was requested but not used. The Commission action will also aim at improving the use of Human Resources in cooperation with the interpretation services of the other institutions, and, pending agreement of these to renegotiate the current agreements, will seek to reduce the costs of auxiliary conference interpreters, especially those linked to travelling.

AGENCIES AND OTHER DECENTRALISED BODIES

9.32. The audit of the European Union’s agencies and other decentralised bodies (ADBs) is the subject of specific annual reports (11). The ADBs’ budget totalled 872.3 million euro in 2004, as against 778 million euro in 2003. Their combined authorised posts increased from 2 009 in 2003 to 2 233 in 2004. The principal data on the ADBs are set out in Table 9.3 (12).

(11) In the process of being published in the Official Journal.
(12) During 2004, the budget of the European Railway Agency and the European Network and Information Security Agency were managed directly by the Commission. For this reason no specific annual report will be published.
### Table 9.3 — EU agencies and other decentralised bodies — Principal data

<table>
<thead>
<tr>
<th>Agencies and other decentralised bodies of the European Union</th>
<th>Headquarters</th>
<th>Year of establishment</th>
<th>Budget (million euro)</th>
<th>Authorised posts</th>
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<td></td>
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<td>2004</td>
<td>2003</td>
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<td>European Centre for the Development of Vocational Training</td>
<td>Thessaloniki</td>
<td>1975</td>
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<td>14.7</td>
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<td>18.1</td>
<td>16.8</td>
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<td>Copenhagen</td>
<td>1990</td>
<td>33.6</td>
<td>27.5</td>
</tr>
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<td>European Training Foundation</td>
<td>Turin</td>
<td>1990</td>
<td>18.4</td>
<td>17.2</td>
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<td>European Monitoring Centre for Drugs and Drug Addiction (1)</td>
<td>Lisbon</td>
<td>1993</td>
<td>12.2</td>
<td>10.5</td>
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<td>Angers</td>
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<td>11.3</td>
<td>11.1</td>
</tr>
<tr>
<td>Office for Harmonisation in the Internal Market</td>
<td>Alicante</td>
<td>1994</td>
<td>190</td>
<td>157.4</td>
</tr>
<tr>
<td>European Agency for Health and Safety at Work</td>
<td>Bilbao</td>
<td>1995</td>
<td>10.7</td>
<td>14.6</td>
</tr>
<tr>
<td>European Monitoring Centre on Racism and Xenophobia</td>
<td>Vienna</td>
<td>1997</td>
<td>7.9</td>
<td>6.6</td>
</tr>
<tr>
<td>European Agency for Reconstruction (2)</td>
<td>Thessaloniki</td>
<td>2000</td>
<td>374.6</td>
<td>358.6</td>
</tr>
<tr>
<td>Eurojust</td>
<td>The Hague</td>
<td>2002</td>
<td>9.3</td>
<td>8.1</td>
</tr>
<tr>
<td>European Aviation Safety Agency</td>
<td>Cologne (3)</td>
<td>2002</td>
<td>11.3</td>
<td>4.7</td>
</tr>
<tr>
<td>European Maritime Safety Agency</td>
<td>Lisbon (3)</td>
<td>2002</td>
<td>13.3</td>
<td>4.5</td>
</tr>
<tr>
<td>European Food Safety Authority</td>
<td>Parma (3)</td>
<td>2002</td>
<td>29.1</td>
<td>12.6</td>
</tr>
<tr>
<td>European Network and Information Security Agency (4)</td>
<td>Heraklion (3)</td>
<td>2003</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>European Railway Agency (4)</td>
<td>Valenciennes</td>
<td>2003</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>885.3</strong></td>
<td><strong>778.1</strong></td>
<td><strong>2 233</strong></td>
</tr>
</tbody>
</table>

(1) Includes PHARE programmes.
(2) Total posts including posts made available for local staff amount to 309 in 2004 (321 in 2003).
(3) In 2004, this body had its provisional headquarter in Brussels for all or part of the year.
(4) In 2004, the Commission was responsible for the management of this body's budget. There was no specific report on the implementation of this budget.

#### 9.33
Cases of non-respect of the principle of budgetary annuity were identified, in particular carry-over of appropriations not sufficiently justified. The Court also noted a few cases of non-respect of the principle of specification (irregular or insufficiently justified transfers of appropriations), the principle of universality (appropriations entered in the budget were set-off against negative expenditure), and the principle of budgetary accuracy (amounts entered in the budget which did not correspond to the requirements of the financial year).

#### 9.33 and 9.34. REPLY OF THE COMMISSION

The Agencies and ‘other decentralised bodies’ are independent and have a separate discharge procedure for their administrative expenses. Thus, the Court’s observations are a matter for the agencies themselves. Where they require it, the Commission can provide the necessary assistance to help them to understand and interpret the rules as well as to introduce internal control arrangements.

#### 9.34
The Court noted that in certain cases the systems of internal control developed in the ADBs needed improvement, in particular because of the absence of a satisfactory risk analysis.
THE COURT’S OBSERVATIONS

9.35. With regard to staff recruitment and public procurement procedures, the Court noted a series of weaknesses: procedures used for the selection of the candidates or contractors were incorrect or not duly justified; decisions concerning acceptance or rejection of candidatures and tenderer’s offers were inadequately substantiated. In addition, the Court’s examination of the files of individual members of staff showed that the documents justifying allowances and financial entitlements were not updated on a systematic basis.

REPLY OF THE COMMISSION

The agencies are required to comply with the provisions of the general financial rule relating to public procurement.

The year 2004 being the second year of the applicability of the new FR and IR, several agencies, especially those recently established, had to manage a period of transition. The Commission supported fully the agencies and authorities during this period. A number of agencies, though not all, have taken advantage of the services offered.

9.36. Almost one in three ADBs presented its financial statements on an accruals accounting basis. The others are generally on the right track to prepare accounts using this method of accounting in 2005 as foreseen by the new Financial Regulation. In the case of the ADBs preparing accruals based accounts, problems were noted in the identification of carry-overs to be regarded as charges for the financial year.

REPLY OF THE COMMISSION

The EC accounting rules adopted by the Commission’s Accounting Officer in December 2004 are applicable to all bodies falling under Article 185 of the Financial Regulation.

In order to ensure that the ADBs (agencies and other decentralised bodies) will be prepared for the accruals-based accounting and the consolidation requirements, the Commission continues to give them regular guidance. The Commission has provided the ADBs with specific documentation to assist them in identifying the adaptations to be carried out, in particular an IPSAS accounting questionnaire, the future reporting package for consolidation and a guidance document and form concerning the opening balance sheet as at 1 January 2005. The communication process will be further intensified during the second semester of 2005 in order to ensure a successful first consolidation of the ADBs.

9.37. The quality of monitoring of fixed assets is inconsistent between the ADBs. For some, a suitable monitoring system has not yet been established while for others, the requirements of the introduced system are insufficiently respected. This has resulted in discrepancies between the accounts and the physical inventory.

REPLY OF THE COMMISSION

The Commission underlines that the responsibility for the preparation of the annual accounts is ultimately the responsibility of the accounting officer of each ADB.

THE EUROPEAN SCHOOLS

9.38. The Court’s audit of the European Schools is the subject of a specific report (not published in the Official Journal), which is addressed to the Board of Governors and the head teachers of the European Schools. The Schools’ budget of 222,1 million euro was financed principally by Commission grants (118,4 million euro) and by contributions from the Member States (47,3 million euro). The principal data on the European Schools are set out in Table 9.4.
### Table 9.4 — European Schools — Principal data

<table>
<thead>
<tr>
<th>European School</th>
<th>Country</th>
<th>Year of establishment</th>
<th>2004 Budget (1) (2) (million euro)</th>
<th>2003 Budget (1) (2) (million euro)</th>
<th>Grant received from the Commission (2) (million euro)</th>
<th>School population (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office</td>
<td>Belgium</td>
<td>1957</td>
<td>7,9</td>
<td>7,2</td>
<td>5,7</td>
<td>6,1</td>
</tr>
<tr>
<td>Luxembourg I</td>
<td>Luxembourg</td>
<td>1953</td>
<td>34,6</td>
<td>31,9</td>
<td>20,3</td>
<td>19,1</td>
</tr>
<tr>
<td>Luxembourg II</td>
<td>Luxembourg</td>
<td>2004</td>
<td>2,7</td>
<td>—</td>
<td>1,2</td>
<td>—</td>
</tr>
<tr>
<td>Brussels I Uccle</td>
<td>Belgium</td>
<td>1958</td>
<td>26,0</td>
<td>24,3</td>
<td>17,0</td>
<td>15,8</td>
</tr>
<tr>
<td>Brussels II (Woluwé)</td>
<td>Belgium</td>
<td>1974</td>
<td>27,1</td>
<td>25,0</td>
<td>17,7</td>
<td>15,9</td>
</tr>
<tr>
<td>Brussels III (Ixelles)</td>
<td>Belgium</td>
<td>1999</td>
<td>24,2</td>
<td>22,7</td>
<td>15,7</td>
<td>15,0</td>
</tr>
<tr>
<td>Mol</td>
<td>Belgium</td>
<td>1960</td>
<td>10,9</td>
<td>10,7</td>
<td>6,4</td>
<td>6,5</td>
</tr>
<tr>
<td>Varese</td>
<td>Italy</td>
<td>1960</td>
<td>15,8</td>
<td>15,3</td>
<td>7,8</td>
<td>7,5</td>
</tr>
<tr>
<td>Karlsruhe</td>
<td>Germany</td>
<td>1962</td>
<td>11,8</td>
<td>11,5</td>
<td>3,9</td>
<td>4,1</td>
</tr>
<tr>
<td>Munich</td>
<td>Germany</td>
<td>1977</td>
<td>18,6</td>
<td>16,4</td>
<td>1</td>
<td>1,0</td>
</tr>
<tr>
<td>Frankfurt</td>
<td>Germany</td>
<td>2002</td>
<td>8,8</td>
<td>6,1</td>
<td>4,2</td>
<td>2,9</td>
</tr>
<tr>
<td>Alicante</td>
<td>Spain</td>
<td>2002</td>
<td>9,9</td>
<td>6,2</td>
<td>5,7</td>
<td>3,4</td>
</tr>
<tr>
<td>Bergen</td>
<td>Netherlands</td>
<td>1963</td>
<td>11,5</td>
<td>11,9</td>
<td>6,3</td>
<td>6,4</td>
</tr>
<tr>
<td>Cultain</td>
<td>United Kingdom</td>
<td>1978</td>
<td>12,3</td>
<td>12,3</td>
<td>5,5</td>
<td>6,1</td>
</tr>
</tbody>
</table>

| Total           |             |                       | 222,1                               | 201,5                               | 118,4                                               | 109,8                 | 19 862                 | 18 983                 |

(1) Total revenue and expenditure as foreseen in the budget of each European School and the Office including all modifications made to the budgets initially adopted.
(2) Source: European Schools.
(3) Source: 2005 Annual report of the Secretary-General to the Board of Governors of the European Schools.

NB: Variations in totals are due to the effects of rounding.

9.39. For the financial year 2004 the audit of the Court did not reveal any material issues to be reported in its annual report.


The Commission takes note of the Court’s observation.
CHAPTER 10

Financial instruments and banking activities

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<td>10.4-10.12</td>
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<td>Overview of assets held by financial institutions on behalf of the Commission</td>
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<td>The Guarantee Fund for external actions</td>
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<td>10.19-10.23</td>
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<td>The European Coal and Steel Community in liquidation</td>
</tr>
<tr>
<td>10.24-10.28</td>
</tr>
</tbody>
</table>
INTRODUCTION

10.1. The Community financial instruments relating to banking activities are as follows:

— loans granted from budget resources or from borrowed funds,

— interest subsidies from budgetary funds,

— guarantees on borrowings subscribed and on loans granted by third parties,

— shareholdings in common interest bodies (¹), and

— participation in special operations, such as the provision of venture capital.

10.2. These financial instruments operate both in the Member States and, to a greater extent, outside the Union, in the framework of external policies. Their main aims are to boost economic development, improve infrastructure and create jobs, notably in small- and medium-sized enterprises (SMEs), through measures to enhance their access to finance. The European Coal and Steel Community in Liquidation is involved in similar transactions.

(¹) For example, the European Bank for Reconstruction and Development (EBRD).
10.3. The Court’s audit covered:

— the Commission’s monitoring of its financial shareholdings,

— the overview of assets held by financial institutions on behalf of the Commission,

— the operation of the Guarantee Fund for External Actions (see Table 10.1), and

— the activities of the European Coal and Steel Community in Liquidation (ECSCi.L.) (see Table 10.2).

Table 10.1 — Guarantee Fund situation (1)

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Total Guarantee outstanding at 31 December (2)</th>
<th>Total Fund Resources at 31 December (3)</th>
<th>Coverage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>6 017</td>
<td>294,2</td>
<td>4,9</td>
</tr>
<tr>
<td>1995</td>
<td>5 882</td>
<td>300,9</td>
<td>5,1</td>
</tr>
<tr>
<td>1996</td>
<td>6 715</td>
<td>557,4</td>
<td>8,3</td>
</tr>
<tr>
<td>1997</td>
<td>7 960</td>
<td>861,8</td>
<td>10,8</td>
</tr>
<tr>
<td>1998</td>
<td>9 834</td>
<td>1 280,7</td>
<td>13,0</td>
</tr>
<tr>
<td>1999</td>
<td>12 052</td>
<td>1 313,1</td>
<td>10,9</td>
</tr>
<tr>
<td>2000</td>
<td>14 069</td>
<td>1 431,6</td>
<td>10,2</td>
</tr>
<tr>
<td>2001</td>
<td>15 577</td>
<td>1 774,4</td>
<td>11,4</td>
</tr>
<tr>
<td>2002</td>
<td>15 358</td>
<td>1 645,5</td>
<td>10,7</td>
</tr>
<tr>
<td>2003</td>
<td>15 211</td>
<td>1 592,1</td>
<td>10,5</td>
</tr>
<tr>
<td>2004</td>
<td>12 068</td>
<td>1 273,3 (4)</td>
<td>10,6</td>
</tr>
</tbody>
</table>

(1) Council Regulation (EC) No 2728/94 provides that the Guarantee Fund must reach an appropriate level (target amount) for potential payments, set from 1999 onwards at 9% of the amount guaranteed. The Fund is financed by payments from the budget at the beginning of a financial year on a provisional basis. At the end of a financial year, the Fund’s assets may exceed the target amount. In this case repayments apply.

(2) Including default interest incurred but not paid at 31 December.

(3) After deduction of EIB fees not paid at 31 December.

(4) Following the enlargement, the Council regulation (EC) 2273/2004 of 22 December 2004 reduced the target amount of the Fund by 338,8 million euro which were transferred to the Community budget with value date 10 January 2005.

Source: Commission.
### Table 10.2 — ECSCi.L. Balance sheet (evolution since the expiry of the ECSC’s Treaty) and outstanding commitments of the ECSC operating budget at 31 December 2004

#### ECSCi.L. Balance sheet at 31 December 2004

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>million euro</td>
<td>%</td>
<td>million euro</td>
<td>%</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans and advances to banks</td>
<td>103.38</td>
<td>4.82</td>
<td>133.43</td>
<td>6.49</td>
</tr>
<tr>
<td>Loans and advances to customers</td>
<td>315.35</td>
<td>14.71</td>
<td>361.66</td>
<td>17.59</td>
</tr>
<tr>
<td>Bonds and other fixed-income securities</td>
<td>1 488.96</td>
<td>69.46</td>
<td>1 485.91</td>
<td>72.25</td>
</tr>
<tr>
<td>Shares and other variable-income securities</td>
<td>7.09</td>
<td>0.33</td>
<td>15.75</td>
<td>0.77</td>
</tr>
<tr>
<td>Other assets</td>
<td>171.68</td>
<td>8.01</td>
<td>3.28</td>
<td>0.16</td>
</tr>
<tr>
<td>Prepayments and accrued income</td>
<td>57.07</td>
<td>2.66</td>
<td>56.46</td>
<td>2.75</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>2 143.53</td>
<td>100.00</td>
<td>2 056.49</td>
<td>100.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities vis-à-vis third parties</td>
<td>456.34</td>
<td>21.29</td>
<td>468.33</td>
<td>22.77</td>
</tr>
<tr>
<td>ECSC operating budget</td>
<td>109.24</td>
<td>5.10</td>
<td>222.46</td>
<td>10.82</td>
</tr>
<tr>
<td>Provisions for liabilities and charges</td>
<td>213.22</td>
<td>9.95</td>
<td>247.15</td>
<td>12.02</td>
</tr>
<tr>
<td>Budget for financing coal and steel research</td>
<td>296.30</td>
<td>13.82</td>
<td>293.00</td>
<td>14.25</td>
</tr>
<tr>
<td>Reserves and surplus</td>
<td>1 068.43</td>
<td>49.84</td>
<td>825.55</td>
<td>40.14</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>2 143.53</td>
<td>100.00</td>
<td>2 056.49</td>
<td>100.00</td>
</tr>
</tbody>
</table>

#### Outstanding commitments of the ECSC operating budget at 31 December 2004

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Readaptation</td>
<td>132.61</td>
<td>121.24</td>
<td>75.76</td>
<td>22.24</td>
<td>9.78</td>
<td>43.74</td>
</tr>
<tr>
<td>Research</td>
<td>180.83</td>
<td>158.71</td>
<td>99.11</td>
<td>44.25</td>
<td>6.22</td>
<td>48.64</td>
</tr>
<tr>
<td>Interest subsidies (Article 56)</td>
<td>16.84</td>
<td>16.05</td>
<td>11.21</td>
<td>0.25</td>
<td>9.99</td>
<td>0.97</td>
</tr>
<tr>
<td>Social measures coal (RECHAR)</td>
<td>70.64</td>
<td>46.56</td>
<td>36.39</td>
<td>17.54</td>
<td>2.96</td>
<td>15.89</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>400.92</td>
<td>342.56</td>
<td>222.47</td>
<td>84.28</td>
<td>28.95</td>
<td>109.24</td>
</tr>
</tbody>
</table>

THE COMMISSION’S MONITORING OF ITS FINANCIAL SHAREHOLDINGS

10.4. The EU holds shares in two financial institutions being the European Investment Fund (EIF) (1) and the European Bank for Reconstruction and Development (EBRD) (2). These two capital participations in related organisations totalled 277.5 million euro at 31 December 2004 (3).

10.5. The Court audited the Commission’s monitoring (4) of its two shareholdings in financial institutions by assessing:

(a) whether the monitoring measures taken by the Commission (in financial terms but also in respect of future risks) are adequate to ensure an efficient, effective and economic follow-up of its capital participations;

(b) whether the monitoring and management information provides the Commission with reasonable assurance that the activities of its participations in related organisations are in compliance with EU policies and do not conflict with applicable EU legislation.

(1) 20 % was called up (120 million euro valued at 176 million euro per 31 December 2004 in the Communities consolidated balance sheet) out of the participation of 600 million euro (30 % of the authorised capital totalling 2 000 million euro).

(2) 26.25 % was called up (157.5 million euro: 138.9 million euro were paid and the remaining 18.6 million euro are payable during 2005 to 2009) out of the participation of 600 million euro (3 % of the authorised capital totalling 20 000 million euro).

(3) In addition to these participations, there is a Community participation in the ‘Galileo Joint Undertaking’ of 282 million euro (called-up amount per 31 December 2004 valued at 192.7 million euro per 31 December 2004 in the Communities consolidated balance sheet) out of the participation of 520 million euro (90 % of the capital totalling 575 million euro). Furthermore, the Communities consolidated balance sheet includes other financial fixed assets totalling 1 810.9 million euro which were not included in the monitoring audit.

(4) In respect of EU participation in the European Investment Fund, a Tripartite Agreement between the Court, the Commission and the EIF applies. The agreement was renewed for a two-year period ending 25 September 2005. It can be renewed for another two-year period by tacit agreement.
10.6. The Commission nominates two members (\(\text{\footnotesize \#} \)) (and two alternates) for the EIF’s Board of Directors who are elected by the EIF’s General Meeting and an additional person (no alternate) as a member of the EIF’s Audit Board. The rules of conduct of the EIF do not normally allow them to divulge information outside the EIF other than to persons assisting them in the discharge of their duties as Board Members. There is no evidence proving that other Commission services are informed and, consulted as necessary, to check compliance with Community policies or rules.

10.7. In respect of the participation in the EIF, full reliance is put on the reports (\(^7\)) made available to the shareholders at the general meeting of the EIF. No evidence was provided to the Court of any subsequent monitoring of material issues arising.

10.8. There is close cooperation between the EIF with the relevant organs of EIB. The EIF operations are coordinated with the EIB corporate plan. There is no evidence of similar coordination and cooperation with the Commission. In order to ensure accountability, the Commission should be able to demonstrate that it obtains the same information for the management of the financial institution (EIF) as its major shareholder, the EIB, does.

10.6. European Investment Fund’s (EIF) activities are primarily in support of small- and medium-sized enterprises (SMEs). The Commission nominees to the EIF Board are senior officials in the three Directorates-General with the greatest interest and knowledge of this sector (Enterprise and Industry, Economic and Financial Affairs and Regional Policy). These services closely coordinate their position in advance of each board meeting. Other services are informally consulted on an ad hoc basis, from time to time, on specific issues (e.g. State aid) but the Commission does not consider it necessary to systematically consult those services.

However, as far as compliance with Community objectives is concerned, the Commission believes that the creation, in mid-2005, of the Compliance Function in the EIF (at the request of the Board of Directors and strongly supported by the Commission nominees) is a further important step in providing assurance of compliance with Community policies.

10.7. With regard to financial reports in relation to the EIF, the Commission has full confidence in the work performed by the independent internal and external auditors and the EIF Audit Board. No material issues have been raised by the auditors on the EIF financial statements. The shareholders ordinary annual meeting deals with the approval of the annual report and related financial statements and nominations matters. All extraordinary decisions are subject to decision by the Commission preceded by a formal interservice consultation. All decisions by the Shareholders are monitored by the Board of Directors as well as any recommendations arising from the Annual Report of the Audit Board.

10.8. The EIB, as majority shareholder, with around 60 % of the shares, faces particular group requirements which the Commission with 30 % does not. This applies to the corporate plan as well as to the consolidation process.

The EIF Corporate Plan is first reviewed and approved by the EIF Board of Directors before inclusion in the EIB Group Plan. The draft plan is subject to particularly close scrutiny by the staff supporting the Commission-designated Directors before a position is taken on the Board.

For the consolidation process, some financial data are made available by the accounting services of the EIF to the EIB within the context of the very specific consolidation need of the EIB Group accounts. The Commission is not aware of other differences in the treatment of shareholders.

\(^{\text{\footnotesize \#}}\) During 2004, the chairman of the EIF Board of Directors was nominated by the Commission. He had no function in the hierarchy of the Commission because he had retired.

\(^7\) For instance, the annual report and the report of the Audit Board.
10.9. In respect of the participation in the EBRD (8), the Commission has one member (9) and one alternate member on the EBRD’s Board of Directors who report regularly on the situation and developments to the responsible Commissioner and the Director-General of DG ECFIN.

10.10. According to the Commission, one of the aims of this EU participation in the EBRD is to ensure compliance with EU policies, for instance in respect of environmental standards that are not legally binding in non-EU Member States. There is regular follow-up at the level of DG ECFIN. The monitoring process within the Commission is operational and also ensures that compliance with Community policies and rules is assessed and taken into consideration in the work of the Commission’s member on the Board of Directors.

10.11. Although the monitoring is managed by the same Directorate-General, the level of information available in respect of the EBRD monitoring is more detailed than for EIF and includes the results of the consultations with other services.

10.12. The audit revealed that the monitoring and management information concerning the EBRD provides the Commission with reasonable assurance that their activities are in compliance with EU policies and do not conflict with applicable EU legislation. In order to provide the Commission with the same level of assurance concerning EIF participation the monitoring and management information for the EIF should be improved.

10.10. The EU has a main interest in the achievement of the objectives assigned to the European Bank for Reconstruction and Development (EBRD), namely to foster the transition towards market-oriented economies and to promote private sector development. Through participation, it also ensures compliance with EU legislation, for instance in respect of the environment, and EBRD promotion of international standards in non-EU countries, which are not bound by EU legislation.

10.11. The Commission considers that the monitoring of its participation in EBRD and EIF must be carried out taking into account the legal framework specific to each institution. As stated in paragraph 10.6, with respect to the EIF, the Commission does not consider it necessary to systematically consult services other than those with nominees on the Board.

10.12. As stated in paragraphs 10.6 and 10.11 the participation in the Board of Directors of senior officials from the three services, with the greatest policy interest in the EIF activities, explains largely the difference noted by the Court with respect to the EBRD. Participation of these senior officials in the Board is the best assurance of the protection of Community interest.

Furthermore, the Commission will examine the need to clarify, in the internal procedures of the relevant service, the ad hoc consultation process referred to in paragraph 10.6.

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(8) Agreement establishing the EBRD, signed in Paris on 29 May 1990 (basic documents of the EBRD April 1991).
(9) The member of the EBRD Board nominated by the Commission is based in London.
10.13. Apart from the Commission’s shareholdings, assets put under the management of financial institutions also require close monitoring. These assets are provided for measures that are carried out by financial institutions on behalf of the Commission in order to implement certain EU policies (10).

10.14. The Court assessed whether the Commission has a complete and up-to-date overview of the assets held by financial institutions on behalf of the Commission.

10.15. In respect of financial institutions, agreements exist in particular with the EIB, the EBRD, the EIF, the Council of Europe Development Bank and the German Kreditanstalt für Wiederaufbau (KfW). According to the Commission the amounts (11), kept in the trust and special accounts under the supervision of DG ECFIN, totalled 360.9 million euro at the end of 2004.

10.16. The audit revealed:

(a) the Commission has information on all accounts held with the EBRD but has no complete overview of accounts held by the EIF and the EIB on behalf of all Directorates-General;

(b) a contribution to a banking operation that the Kreditanstalt für Wiederaufbau is carrying out in Bosnia and Herzegovina, for which 44.25 million euro were paid, was not registered as an asset by the Commission and therefore not recorded in the accounts;

(c) EU funding totalling 16 million euro has been provided to the European Agency for Reconstruction (EAR) for banking operations in Kosovo, Montenegro and Serbia, managed by KfW, for housing credits and finance to the rural community and SMEs. Neither the Commission nor the EAR had included these amounts in its provisional 2004 accounts.

Although these latter items have been corrected and do not therefore affect the reliability of the accounts, they are an illustration of the lack of a complete overview of these aforementioned accounts.

(10) Conventions are being concluded between the Commission and the financial institutions which lay down rules in respect of the details of the mandate (e.g. procedures, reporting obligations and the finance from the general budget).
(11) Current accounts, fixed-term deposits and cash investments.
10.17. The Commission does not have a complete overview of existing assets held by financial institutions on behalf of the Commission.

10.17. It is the responsibility of each authorising officer to ensure that the assets under his/her control are subject to regular and adequate monitoring. Thus the management and monitoring of such assets are done by each responsible Directorate-General, which also ensure that these are correctly and completely entered in the accounting system. Based on the information the Directorates-General have provided, the Directorate-General for Budget prepares the annual accounts. The accounts thus provide an overview of the various assets of the Commission, including those held by financial institutions. However, the Commission does not report by financial institution, but instead, and in accordance with the accounting rules, by asset category in the balance sheet.

10.18. Such an overview should ensure that the assets are subject to regular and adequate monitoring. It should benefit from the expertise that is available at DG ECFIN with the objective of harmonising the related conventions and ensuring more transparency for the budgetary authorities.

10.18. It is already the responsibility of each authorising officer to ensure that the assets under his/her control are subject to regular and adequate monitoring (See Article 60 of the Financial Regulation). Authorising officers are also already required to include this information in the accounting system so that it can be reported in the annual accounts.

With the introduction of the new accounting system in 2005, the authorising officers have better tools at their disposal to monitor the assets under their responsibility and equally the information is better centralised in the system, which gives a better overview of the total situation which should avoid the occurrence of the situation described by the Court.

THE GUARANTEE FUND FOR EXTERNAL ACTIONS

10.19. The Community budget is particularly exposed to credit risk as regards the guarantees for loans to third countries. The purpose of the Guarantee Fund for External Actions (12) is to reimburse the Community’s creditors (13) in the event of a beneficiary’s defaulting and to avoid direct calls on the Community budget.

10.20. DG ECFIN carries out the administrative management of the Fund and the EIB is responsible for the treasury management. The Court’s audit focused on the sound financial management of the Fund for the financial year 2004 (14).

10.19. The Community budget is particularly exposed to credit risk as regards the guarantees for loans to third countries. The purpose of the Guarantee Fund for External Actions (12) is to reimburse the Community’s creditors (13) in the event of a beneficiary’s defaulting and to avoid direct calls on the Community budget.

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(13) Principally the EIB, but also Euratom external lending and EU macro-financial assistance (MFA) loans to third countries.

(14) The audit work carried out by the Court is based on a specific tripartite agreement between the Court, the EIB and the Commission, signed in January 1996.
THE COURT’S OBSERVATIONS

10.21. **Table 10.1** shows the development of the Fund over the 10 years to the end of 2004. The corresponding target amount \(^{(15)}\) totalled 1 086 million euro at the end of 2004. The surplus to be refunded to the budget was thus 187 million euro.

10.22. The Court found that the Guarantee Fund was managed in a satisfactory manner during 2004.

10.23. DG ECFIN should formally define and document checks performed on the data received from the EIB, especially on the outstanding amounts of the loans granted to third parties under Community guarantees.

THE COMMISSION’S REPLIES

10.23. The Commission is in discussion with the EIB in order to obtain, in future, an audit certificate on the outstanding loans covered by the Guarantee Fund. The manual of procedures will then be updated to integrate document controls already carried out.

THE EUROPEAN COAL AND STEEL COMMUNITY IN LIQUIDATION

10.24. The Treaty establishing the European Coal and Steel Community expired on 23 July 2002. The assets and liabilities of the ECSC were transferred to the European Community \(^{(16)}\): their net worth, referred to as the European Coal and Steel Community in Liquidation (ECSCi.L.), is allocated to research in the sectors related to the coal and steel industry.

10.25. The objective of the Court’s audit was to obtain reasonable assurance as to the proper implementation of the legislation governing the ECSCi.L.

10.26. As in previous years, the ECSCi.L. accounts have been examined by an external auditor, who has expressed an unqualified audit opinion \(^{(17)}\).

10.27. **Table 10.2** sets out the evolution of the ECSCi.L.’s balance sheet and outstanding commitments from its operating budget. The winding-up of the financial operations of the ECSCi.L. is proceeding in compliance with the relevant legislation, including the Multiannual Financial Guidelines laid down by the Council which fix strict rules for managing the assets of the ECSCi.L.

\(^{(15)}\) The target amount is fixed at 9% of the outstanding amount of guaranteed loans.

\(^{(16)}\) Protocol annexed to the Treaty establishing the European Community.

\(^{(17)}\) In the Financial Report of the ECSC in liquidation as at 31 December 2004 (page 19), the external auditor concluded that: ‘(…) the financial statements (…) faithfully reflect (…) the assets and financial situation of the ECSCi.L as at 31 December 2004 and the outturn of the financial year ending on that date’.
10.28. The Court has obtained reasonable assurance as to the proper implementation of the provisions governing the ECSCiL. However, the Court notes that the Commission should fully comply with the Multiannual Financial Guidelines regarding maturity restrictions and rating limits for all securities.

10.28. The Commission already complies with all maturity restrictions and rating limits for the investments made since the entry into force of the Guidelines and has rigorous procedures to ensure compliance. Before the Guidelines came into force, the Commission entered into a special hedging transaction with an AAA counterparty to match two long-term borrowings. This was necessary to protect ECSC interests following the restructuring of a major infrastructure loan in 1998, in which all lenders were treated equally and which resulted in the conversion of three of ECSC’s loan tranches into a variety of instruments.