In accordance with the provisions of the Treaties (Article 248(4) of the EC Treaty and Article 160c(4) of the EAEC treaty) and Articles 143 and 181(2) of the Financial Regulation of 25 June 2002 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 European Development Funds, the Court of Auditors of the European Communities, at its meeting of 6 and 7 October 2004, adopted its

ANNUAL REPORT

concerning the financial year 2003

(2004/C 293/01)

The report, together with the institutions’ replies to the Court’s observations, was transmitted to the authorities responsible for giving discharge and to the other institutions.

Juan Manuel FABRA VALLÉS
(President)
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GENERAL INTRODUCTION

0.1. The Court’s 27th Annual Report covering the 2003 financial year follows the structure established for 2002: the Statement of Assurance is presented in Chapter 1; observations on budgetary management are given in Chapter 2; Chapters 3 to 9 report on own resources and activities financed from different parts of the budget; and Chapter 10 covers financial instruments and banking activities. The Court’s observations on the European Development Funds, including a Statement of Assurance, are presented separately in this document. The replies of the Commission (or other EU institutions where appropriate) are presented alongside the Court’s observations.

0.2. As for previous years, the chapters covering revenue and the major areas of expenditure, which reflect the headings of the financial perspective, have, as their main element, detailed analyses and results of the audit work carried out in the context of the Statement of Assurance. These ‘specific assessments’ form the basis for the Statement of Assurance set out in Chapter 1. The chapters present the results of reviews following up progress made on implementing recommendations arising from previous audits. They also include summaries of 10 Special Reports published by the Court since the last Annual Report. The Annexes to Chapters 3 to 9 set out the elements used for monitoring and evaluating financial management of the EU budget.

0.3. This report is being published in a period of considerable change for the European Union: enlargement of the Union to 25 Member States; negotiation of an EU Constitutional Treaty; an enlarged and renewed European Parliament; and a change of Commission amid ongoing administrative reform aimed at better delivery of EU policies and improved financial management. In addition, negotiations are under way on the future funding of the Union and spending for the 2007 to 2013 financial perspective period.

0.4. Despite progress made by the European institutions, further efforts are needed to ensure that the EU budget is implemented in a way which satisfies the legitimate expectations of the citizens of the Union. Once again, the Court has no reasonable assurance that the supervisory systems and controls of significant areas of the budget are effectively implemented so as to manage the risks concerning the legality and regularity of the underlying operations. The bulk of expenditure is managed in a shared or decentralised way, which requires, either through good practice or regulation, an adequate control over EU funds. The Court’s audit work has repeatedly shown that many irregularities occur in such expenditure.

0.5. In its Opinion No 2/2004 (1), the Court underlines the need for efficient and effective control over the EU budget at all levels of administration. It considers that there remains scope for further improving the design of control systems by establishing clear and consistent objectives and responsibilities, ensuring effective coordination, providing information on their costs and benefits and ensuring a consistent application of requirements. The Court proposes that a Community internal control framework be developed to facilitate effective control of the EU budget. The framework should contain common principles and standards to be used as a basis for developing new or existing control systems. The Commission should be responsible for promoting the improvement in internal control systems in partnership with Member States.

0.6. A particular challenge facing the Union, discussed in Chapter 2 of this Annual Report, is the increasing level of outstanding commitments, expenditure legally committed but yet to be made. At the end of 2003, these represented five years’ worth of payments at the current spending rate, a significantly worse situation than at the same moment of the previous financial perspective period. The situation is caused by overly ambitious budgeting and the inability of Member and beneficiary States to absorb EU funds, partly due to delays in setting up the necessary management and control requirements, and partly due to an insufficient number of projects eligible for Community financing.


The financial perspective is determined by agreement between the European Parliament, the Council and the Commission and sets limits on expenditure for each of seven categories (headings) of expenditure for commitment appropriations, and on total expenditure for payment appropriations. This report does not present a separate chapter on the Reserves heading as its resources are only used through transfer to the other headings.

Article 248(1) of the EC Treaty as amended by the Treaty of Nice.

0.7. A realistic expectation of spending ability, and of the timing of that spending, should be made when budgeting in the 2007 to 2013 financial perspective period. A significant proportion of the new period will be needed to liquidate commitments made in the current 2000 to 2006 period. Unless specific measures are taken, underspending in the new period will build upon the problem causing an even greater gap between budgeting and spending (and therefore policy delivery) in the future.

0.8. Over the coming year the Court will continue to build upon its role as the independent audit institution of the European Union. It has taken advantage of its expansion to 25 Members to streamline its decision-making procedures with the purpose of improving delivery of its reports and opinions. The Court is constantly seeking to improve its audit methodology and tools, as well as training its staff, in order to better fulfil its mission to contribute actively to improving financial management of the Union at all levels.
REPORT ON THE ACTIVITIES FINANCED FROM THE BUDGET
CHAPTER 1

The Statement of Assurance and supporting information

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I. Pursuant to the provisions of Article 248 of the Treaty, the Court has examined the consolidated annual accounts (1) of the European Communities for the financial year ended 31 December 2003. 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 own resources the scope of the Court’s audit work was limited (2).

Reliability of the accounts

II. In the Court’s opinion, the consolidated annual accounts of the European Communities and the notes to them 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 (3). 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 fact that, as in the past, the accounting system used to draw up the 2003 accounts was not designed to ensure that the assets are fully recorded. On 17 December 2002 the Commission approved an action plan for the modernisation of the European Communities’ accounting system which should be operational as from 1 January 2005. The Court notes, however, that the full implementation of all the new rules and accounting plans requires a considerable effort by the bodies whose accounts will be subject to consolidation.

Legality and regularity of the underlying transactions

V. In view of the results of its audits, the Court is of the opinion that the transactions underlying the consolidated annual accounts of the European Communities, taken as a whole, are legal and regular in respect of revenue, commitments and administrative expenditure.

VI. As regards other expenditure, the Court established that:

a) In the case of the EAGGF Guarantee Section the payments were, again, materially affected by errors. Arable crops are less subject to the risk of error than animal premiums, whereas the other categories of expenditure which are not subject to the integrated administration and control system present a higher risk whilst being subject to less effective controls. There is still room for progress as regards agricultural expenditure in its entirety in order to rectify the significant shortcomings observed in the supervisory systems and controls;

b) in the case of the structural measures, owing to persistent weaknesses at Member State level in the systems for supervising and controlling the implementation of the EU budget, payments were still subject to the same errors occurring with the same frequency as in previous years:

(2) Firstly, the Court’s audits focus on macroeconomic statistics for which the underlying data cannot be audited directly, and secondly, they cannot possibly cover the imports that have not been subject to customs supervision.
(3) See Annex 1, Volume 1 of the final accounts of the European Communities, financial year 2003.
c) in the case of internal policies, the improvements noted in the supervisory systems and controls are not yet sufficient to prevent significant errors of legality and regularity in terms of payments. In the case of the research framework programmes, these errors are likely to persist if the rules governing the programmes are not revised;

d) in the case of the external actions, a relatively large number of legality and regularity errors continue to affect not only the bodies responsible for implementing the projects but also the projects themselves. Although in principle 2003 was the last year of management decentralisation, it is essential that the tools needed to supervise and control systems and expenditure should become operational with a view to making the improvements which are still necessary;

e) in the case of pre-accession aid, shortcomings in the supervisory systems and controls which had already been identified in 2002 resulted in errors and greater risks affecting the legality and regularity of the transactions.

VII. The Court notes the progress made by the Commission as regards the reform of its internal control system and the positive impact of this reform on the legality and regularity of operations subject to direct management by the Commission. However, progress is still required in terms of actual implementation.

VIII. In the area of shared or decentralised management (see paragraphs VI(a) and (b) and VI(d) and (e) respectively) and of indirect centralised management (see paragraph VI(c)), where operations are materially affected by errors, a greater effort must be made to apply the supervisory systems and controls in an effective manner so as to improve the handling of the attendant risks.

IX. The Court notes that the Commission, as the institution responsible under Article 274 of the Treaty for implementing the budget, included, for the first time in its Synthesis of the 2003 annual activity reports of its Directorates-General and departments, an analysis of the assurance provided by the supervisory systems and controls as to the legality and regularity of the underlying transactions, which, in general, is corroborated by the Court’s audit work.
Introduction

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). Since the financial year 2002, in the wake of the Treaty of Nice, which extended the Court's mandate by authorising it to supplement this statement with specific assessments of each major area of Community activity, the Court has sought to consolidate the basis for its statement by relying more systematically on an examination of the way in which the supervisory systems and controls set up by the Commission in each of these major areas work.

1.2. The aim of the work on the reliability of the accounts of the European Communities is to obtain reasonable assurance that all the 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.

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 prove that the underlying transactions are in accordance with the applicable regulations or contractual provisions and that the total amount involved in these transactions has been correctly calculated.

1.4. With regard to the legality and regularity of the underlying transactions, the Court has based its statement on a number of separate sources:

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

b) an examination 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 necessary, an examination of the work of other auditors who are independent of Community management procedures.
1.5. Once again, the Court paid particular attention to the efforts made by the Commission as part of the reorganisation of its internal control system and to the follow-up given to the action plans annexed to the Syntheses of the annual reports and declarations of its Directors-General for the financial years 2001 and 2002 (see paragraphs 1.55 to 1.87).

1.6. Lastly, overall and for every major area subjected to specific assessment, the Court wished to provide certain key information to serve as a basis for monitoring and evaluating developments in these areas in the longer term. This key information is presented in table form in the annexes to this Chapter and to Chapters 3 to 9.

Reliability of the accounts

1.7. The Court’s observations concern the final consolidated annual accounts for the financial year 2003, as drawn up by the Commission in compliance with the provisions of the Financial Regulation of 25 June 2002 (4).

1.8. Pending the implementation of the action plan on the modernisation of the accounting system as of the financial year 2005 (see paragraphs 1.22 to 1.26) and 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. The evaluations used for this are not linked to the budgetary transactions from which they stem and the central accounting departments are not always able to guarantee their accuracy or their comprehensiveness. Furthermore, the present accounting system, which to a large extent follows cash-based accounting principles, does not make it possible to distinguish between administrative expenditure and capital expenditure, between final payments and prefinancing, or even to determine the amount of debts and receivables. The calculation of the economic out-turn is thus adversely affected. The reservations contained in the declaration of the Director-General for Budgets (flawed presentation of the assets and finances of the Communities and the EDF; and architecture of the accounting system based on two subsystems instead of one integrated system) are confirmed by the Court’s findings.

1.9. Table 1.1 contains a follow-up of the four reservations concerning the reliability of the accounts which were expressed in the 2002 DAS and other points raised by the Court in the Annual Report concerning the financial year 2002, which, according to the Commission, ought to be settled in the context of the modernisation of the Community accounting framework.

1.8. The European Communities use cash accounting, as do most other public sector organisations in the world. 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 as mentioned by the Court. The Commission aims to comply with International Public Sector Accounting Standards (IPSAS) by 2005, the deadline set in the Financial Regulation, and is addressing the issues mentioned by the Court.

### Table 1.1 — Follow-up to the reservations expressed in the 2002 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 2002 Annual Report

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<td>On account of a lack of sufficient budgetary appropriations, legal commitments of 820 million euro are included in off-balance-sheet commitments.</td>
<td>The system of annual instalments results in the Commission’s only making commitments for the relevant annual instalment which is accepted by the new Financial Regulation if stipulated by the basic text.</td>
<td>The new Financial Regulation makes express provision for the practice criticised as from January 2003.</td>
</tr>
<tr>
<td>The called-up part of the Commission’s commitment to the capital of the Galileo joint undertaking (120 million euro) does not appear as such on the assets side of the balance sheet.</td>
<td>Given that the present situation regarding the nature of Galileo and its accounts is unclear, reviews are planned for 2003.</td>
<td>Galileo is now recorded in the balance sheet according to the equity method.</td>
</tr>
<tr>
<td>The transitional accounts should be reclassified under other balance sheet headings or in the revenue and expenditure account, according to the nature of their constituent parts.</td>
<td>The Commission is awaiting the opinion of the Accounting Standards Committee in order to avoid successive changes. The reclassifications will be made on the changeover to accrual accounting.</td>
<td>The transitional accounts have been reclassified; the heading ‘transitional accounts’ no longer appears in the balance sheet.</td>
</tr>
<tr>
<td>In the absence of effective internal control procedures for miscellaneous revenue and advances paid, the Court cannot obtain assurance that the record of operations relating to the item ‘sundry debtors’ is complete and accurate.</td>
<td>The mechanism for the identification and recovery of debts is in the process of being improved: a review of all commitment balances which have remained open is under way, the modernisation project will assure accounting controls over prefinancing and the balance of forecasts of revenue and of recovery orders which are overdue is from now on reported to the authorising departments.</td>
<td>Of the measures undertaken, the Commission has pointed out that training courses were given to the authorising officers, that a mature balance of debts and recovery orders is sent quarterly to the authorising departments and that a rears interest on recovery orders to be collected will soon be calculated by the accounting system. Likewise, the Commission has made clear that an inventory of prefinancing operations has been started, that the accounting norms and manual will make it possible to improve the situation and that adequate accounting procedures will be applied as from 2005. Nevertheless, the actions undertaken to date do not enable the Court to consider the problems solved (see paragraphs 1.14 and 1.15).</td>
</tr>
<tr>
<td>Points potentially resolved within the framework of the modernisation of the Communities’ accounting system</td>
<td>The Commission has established an accounting standards committee which deals with these problems. The standards to be adopted by the Accounting Officer will fully reflect this committee’s opinions.</td>
<td>The accounting standards committee has already adopted all the ‘exposure drafts’ except the one relating to staff advantages (pensions). They will be submitted to the other institutions and agencies for consultation before adoption by the accounting officer. A new accounting manual is being drawn up with a view to the application of these accounting rules.</td>
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<tr>
<td>Amongst other things, on account of the procedures for shared management, the Commission only becomes aware at a very late stage of the events which in a classic accruals-based accounting system constitute the economic events that trigger entries in the accounts. The Commission should therefore exercise prudence and define the economic events that give rise to accounting entries in a way which allows it to maintain control over the process. Whatever methods the Commission adopts in the end, it is important that the recording base remains comparable from one year to the next and is defined without ambiguity.</td>
<td>Considerable efforts have been made to record financial intermediaries, which will be useful for the changeover to accrual accounting. The identification of prefinancing operations by the new computer systems makes it possible to limit the extra accounting records.</td>
<td>The Commission has made provision for additional resources in order to record prefinancing operations within open commitments. The accounting standards committee has, moreover, dealt with some of these questions.</td>
</tr>
<tr>
<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 contributions and loans against budgetary appropriations (ECIP and Media for example).</td>
<td>These various points are dealt with within the framework of the Accounting Standards Committee and the Commission is awaiting its final opinion in order to avoid successive changes.</td>
<td>The application of the accounting rules to be adopted by the accounting officer before the end of 2004 is supposed to settle a number of the points raised. 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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Source: Court of Auditors.
1.10. Despite the progress that has been noted, in particular as regards the presentation of the financial statements and the reduction in the number and scale of the reservations, the Court's audit highlighted the fact that the following problems, already pointed out in previous reports, still persist:

a) agricultural expenditure - modulation: accounting entries have been made against a budget heading which ultimately will not be the one to which the expenditure concerned will be charged (88.9 million euro in 2003), and expenditure which has not yet been implemented (237.9 million euro at 31 December 2003) has been presented in the accounts as already having been effected (see paragraphs 1.13 and 1.14 of the 2002 Annual Report);

b) ECIP (European Community Investment Partners): the Commission's basis for recording a 100% write-down in the value of loans, investments and advances (88.5 million euro at 31 December 2003) was a dubious one, as the constituent parts to which it applies are not even identified (see paragraph 1.18 of the 2002 Annual Report);

c) Eurotech Capital, Venture Consort and Joint Venture Programme: in the absence of accurate and detailed information on the amounts invested, the Commission wrote off its participations in full (12.7 million euro at 31 December 2003) even though repayments are still being made (see paragraphs 1.21 and 1.22 of the 2002 Annual Report);

d) EAGGF-Guarantee: reservations concerning the exhaustiveness and accuracy of the amounts due to the Commission (905.9 million euro net at 31 December 2003) have been expressed by several certifying bodies (see paragraph 1.25 of the 2002 Annual Report);

1.10. As regards the accounting entry of EUR 88,9 million in 2003, the procedure for the entry of amounts deducted under Articles 3 and 4 of Regulation No 1259/1999 has been drawn up in line with Article 1 of Commission Regulation No 1017/2001 (amending Article 2 of Regulation No 296/1996).

As regards expenditure which has not yet been implemented by the Member States (EUR 237.9 million in 2003), Article 5(2) of Council Regulation No 1259/1999 states that these amounts remain available to the Member State concerned for a maximum of three years to finance support measures under Regulation No 1257/1999.

The current system of modulation is being phased out and there are no plans to change entry in the budget accounts in its final years. Entry in the general accounts is being examined in connection with the transition to accrual accounting in 2005.

As far as the presentation of the invested amounts in the balance sheet of the Communities is concerned, the Commission considers that a write-down of invested amounts is fully justified on the basis of the principle of prudence. The very nature of investments in risk capital and other high risk business areas such as joint ventures in the central and eastern European Countries and the Newly Independent States carries an inherent potential risk of loss. The Commission notes that it has made good progress since the previous year in finalising and closing contracts which have reached the end of their term.

With regard to the correct evaluation of the debts, the doubtful debts provision is based on the best estimates of each paying agency involved — this is the same procedure that was used in 2002. This is based on the surmise 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 81 of the 85 agencies were able to provide assurance that debtors ledgers were not materially misstated.
The Court’s observations

e) recording of sundry debtors (3,610.4 million euro at 31 December 2003): the Court is not able to give an assurance as to the correctness and completeness of the sundry debtors (see paragraph 1.23 of the 2002 Annual Report and paragraphs 1.14 and 1.15 of this year's Report);

f) recording of amounts held by financial intermediaries (included under the sundry debtors — see paragraph (e)) totalling 1,008.6 million euro at 31 December 2003 (5): in the absence of a suitable accounting system, the Court is not able to give an assurance as to the correctness and completeness of the amounts entered as held by financial intermediaries (see paragraph 1.27 of the 2002 Annual Report);

g) Interest on advances paid to financial intermediaries: the Commission is still not able to demonstrate that the interest yielded by advances is recorded systematically and without delay as budget revenue, and this allows doubts as to the exhaustiveness of the records concerning the Community contribution to certain programmes (see paragraph 1.29 of the 2002 Annual Report);

h) provision for pensions: the current presentation in the balance sheet of the provision for pensions (22,800 million euro at 31 December 2003 according to an actuarial study) and of the corresponding amount receivable from the Member States has the effect of neutralising the impact on the economic out-turn (see paragraphs 1.31-1.32 of the 2002 Annual Report);

i) current liabilities: the presentation under this balance-sheet item of some of the payment appropriations carried over (176.5 million euro at 31 December 2003) is inappropriate (see paragraph 1.34 of the 2002 Annual Report).

The Commission’s replies

e) The Commission continues to improve its methods of dealing with this area using the systems currently at its disposal, as stated in response to the remark 1.23 in the annual report 2002 (for example, the regular reporting of overdue amounts since mid-2003.) However, as also stated in the response given last year, 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.

f) As was indicated in 2002, the Commission has already done significant work in this area. 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 based on reports supplied by the financial intermediaries.

g) As pointed out last year, while not all interest was recorded as budgetary revenue it was none the less included in the annual accounts. Since the introduction of the new Financial Regulation which requires all interest to be returned to the Commission, the Commission has continued to improve the procedures for recording such interest.

h) As has been discussed in the Accounting Standards Committee, there is currently no international public sector accounting guidance available in this area. Thus until this is available, the current practice will remain in force.

i) As replied in 2002, this issue is being analysed as part of the modernisation of the accounting system project, and changes will be made to the current accounting treatment in 2005.

Observations concerning the consolidated statements on the implementation of the budget

Provisional components of the implementation of the budget

1.11. Despite the Court’s observation in its Annual Report concerning the financial year 2002 (6), 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 (clearance of the EAGGF-Guarantee paying agencies’ accounts, adjustment of the provisional amounts in the case of the VAT and GNI own resources, closure procedure for projects and programmes relating to Internal policies, External actions and Structural Funds), nor any indication of the possible scale of such corrections. Furthermore, there are other uncertainties which may

(5) Including 46.5 million euro in interest.
(6) Annual Report of the Court of Auditors concerning the financial year 2002, paragraphs 1.10 and 1.11.
temporarily affect the accounts, for example the reservations, concerning around 11 300 million euro, issued by the bodies certifying the accounts of the agricultural paying agencies (see paragraph 4.54), and the Commission’s postponement of its financial clearance decision for the financial year 2003 of paying agency accounts representing 43 % of the expenditure declared for the financial year 2003, pending further information or the completion of certain audit work (see paragraph 4.69).

Budgetary commitments and contingent liabilities

1.12. According to the new Financial Regulation, applicable as of 1 January 2003, 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 (7). This practice, which has already been applied in the past for structural measures (8), in accordance with the sectoral regulations, is henceforth also expressly provided for in respect of other areas (for example, for international agreements in the fisheries sector and for other external actions). The amounts which, pursuant to the Financial Regulation, have not yet been recorded as budgetary commitments are presented as contingent liabilities. Nevertheless, these differences of definition for commitments from one area to another make it difficult to interpret the figures presented in the statements on the implementation of the budget.

Observations concerning the consolidated financial statements: balance sheet

Traditional own resources

1.13. The established entitlements recorded in the separate accounts, known as the ‘B accounts’, were written down by 1 043,9 million euro on 31 December 2003 resulting in a net amount of 729,3 million euro in the Commission’s financial statements. This correction was made in recognition of the fact that recovery of a large number of these claims is doubtful. This write-down was calculated on the basis of statistics and represents an estimated amount.

Recording of sundry debtors

1.14. The recording of sundry debtors continues to pose problems (9). 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.

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 effects of this analysis should be seen in the 2005 annual accounts.

Concerning the Commission’s postponement of the financial clearance decision see reply to point 4.79.

1.12. The Commission, aware of this issue, has improved the explanatory notes to the financial statements accordingly so as to include a clearer explanation of the treatment of commitments foreseen in the Financial Regulation, in particular making reference to the inclusion of a contingent liability concerning the budgetary commitments of differentiated appropriations not yet made for future years.

1.13. Regulatory amendments providing for an annual estimate by Member States of the amount of the debts in their separate account for which they consider recovery has become unlikely are expected to be formally adopted by the end of 2004.

See also reply to 1.10. e).

Controls over provisional payments and pre-financing will be improved as from 2005 as part of the modernisation of the accounting system.
THE COURT'S OBSERVATIONS

1.15. In spite of the movements noted, in particular following the implementation of the procedure to set off amounts receivable against payments due, the recovery of a large number of amounts receivable is still subject to considerable delay. In addition, interest on arrears is not calculated and charged systematically and there is no end-of-year procedure to calculate and record in the accounts the interest accrued. The Court considers that monitoring of the backlog of arrears should be coordinated more efficiently at central level and that a system should be set up which would enable the departments concerned to ensure that amounts receivable are recorded immediately.

1.16. Since the financial year 1999 the Court has made a number of observations concerning the Sincom 2 computerised system. Those relating to security (10) concerned, amongst other things, the payment system used by the Commission’s treasury management, which accepted these observations and undertook to solve the problems found (11). In 2002 and at the beginning of 2003, the Internal Audit Capability (IAC) of the Budget Directorate-General and the Internal Audit Service (IAS) carried out audits of the Commission’s treasury management and these audits confirmed that the problems highlighted by the Court still exist.

1.17. In the context of its work on the Statement of Assurance for 2003 the Court carried out a follow-up to its previous observations, which revealed that some points have still not been dealt with, in particular those relating to a number of security problems and the segregation of duties.

1.18. In order to cope with the existing risks, the security system in place should be improved in respect of the definition and management of user profiles and users’ rights of access to the system’s various functions. Some users have rights of access to transactions within treasury management which are mutually incompatible. The number of users with system administrator or equivalent rights, allowing them to carry out all transactions in the system, is too high. The profiles of some of these users are generic and not personalised and this makes monitoring their activities difficult. The Court also found that generic users are created ad hoc for specific periods and purposes but are given broad rights of access.

Treasury management

1.15. The Commission has introduced since the beginning of 2003 the central co-ordination of recoveries and monitors unpaid recovery orders, (‘ROs’), through a quarterly aged balance that shows the amount of the unpaid ROs outstanding per quarter and per authorising officer. The Commission also records in its database the follow-up actions made for each RO, and the indicators which accompany the aged balance.

Since 2004, the Accounting Officer has used an IT tool to monitor the recovery of interest on arrears, and the establishment of ROs by the responsible authorising officer for such interest. Interest is recorded in the accounts during the year when it is received, but no evaluation is made of interest accrued at the year-end, as the Court points out. This issue will be addressed as part of the modernisation of the accounting system project and the move to accrual accounting.

1.18. The Commission agrees that the number of users with extended access rights was too high. This number has now been significantly reduced. The Commission is developing and will put in place before the end of 2004 a reporting system to enable it to identify such cases in the future.

The Commission is currently reviewing all accesses to the central accounting system with the aid of a specialist consultant. This work is expected to be completed by the end of 2004 in time for the introduction of the new accounting system (ABAC).

(10) Mainly paragraphs 8.55 and 8.56 of the Annual Report concerning the financial year 1999 and paragraphs 9.41 to 9.43 of the Annual Report concerning the financial year 2000 and the continuous follow-up in the Sector Letters of the following years.

(11) See the replies to the paragraphs mentioned above.
1.19. When payments are launched in the central accounting system, files containing all the data on the payments are transferred to a system used for coordination with the banks. The Commission should continue its efforts to guarantee a complete control over the integrity of the data contained in the files which are transferred to the banks.

1.19. In November 2003 the Budget Directorate-General introduced a new mechanism for the protection of payment transactions between SINCOM2 and the SWIFT network. This new protection mechanism is not yet fully applicable as it does not cover transactions involving small amounts which are more difficult to alter in the base because of their specific format. The Budget Directorate-General plans to expand the new protection mechanism — which is more complicated to implement for this type of transaction — by the end of 2004.

1.20. In 2003, the Commission modified its technical infrastructure. It finalised a new contingency plan, which has not yet been tested. In the field of treasury management, a test (17 February 2004) to retrieve the bank coordination system using an alternative site, in the event of system failure, showed that improvements needed to be made in the start-up procedure.

1.20. The SINCOM2 contingency plan was tested in November 2002. A new contingency plan will be needed because of the operational changes and changes in technical infrastructure expected when the Commission’s new accounting and financial system (ABAC) comes into operation in January 2005. As regards treasury management, the Budget Directorate-General will improve the procedure for launching the SWIFT contingency plan before the end of 2004 along the lines identified during the test.

1.21. In addition to the problems identified in paragraph 1.16, other points have still not received an adequate response:

a) the rules governing the management of imprest accounts have still not been applied in the context of the implementation of the new Financial Regulation;

b) a solution still has to be found to the problem of preventing the recording of accounting entries in bank accounts which have been closed, without losing historic data;

c) a clear and formalised description of the tasks and responsibilities within treasury management must be drawn up in order to allow an appropriate segregation of duties, on the one hand, and, on the other, efficient management of the necessary sub-delegation of powers.

1.21. Although the imprest account section in the treasury has not been fully adapted, extra resources have been devoted to it in order, particularly, to verify the bank accounts of all imprest accounts;

b) An IT procedure exists since the beginning of 2004 which rejects any attempted posting to the general ledger accounts for closed bank accounts;

c) The formalisation of delegations from the Accounting Officer to treasury staff was completed in September 2004.
Action plan for the modernisation of the accounting system

1.22. On 17 December 2002 the Commission adopted the Action Plan for the modernisation of the European Communities' accounting system (12), which was a response to a number of previous observations by the Court and takes into account the provisions of the new Financial Regulation adopted in June 2002 (13). This action plan, which is intended to be fully operational as of 1 January 2005, consists of two strands, one concerning the adoption of the new accounting framework (14) and the other the development of the information systems required for its implementation (15). The two committees provided for under this action plan, a project oversight board and an advisory committee for accounting standards, were set up during the first quarter of 2003.

1.23. The Advisory Committee for Accounting Standards, which is chaired by the Commission's Accounting Officer, consists of representatives of certain institutions (the European Parliament, the Court of Justice and the Commission) and certain satellite bodies (agencies) (16), and also external experts. Its task is to examine international accounting standards (17) and to adapt them to the Community context, as required by the provisions of Article 133(2) of the Financial Regulation. This examination led, in April 2004, to the submission of 15 draft basic accounting rules covering the various subjects likely to be dealt with in the accounts with a view to the presentation of the year-end financial statements in accordance with the principle of accruals-based accounting (18).

1.24. These basic rules still have to be definitively adopted by the Commission's Accounting Officer, who, in addition, must ensure that they are transposed into charts of accounts applicable in the institutions and bodies whose accounts are to be consolidated (19). As regards the timetable described in the Commission's action plan, the progress made so far with the work would seem to indicate that the planned deadlines are likely to be kept to. The basic accounting rules and the charts of accounts of the bodies whose accounts are required to be consolidated should therefore be available in time for the drawing-up of the accounts for the financial year 2005.

1.24. All directorates-general were consulted on the draft accounting rules in June 2004, as well as the accounting officers of the Institutions and Agencies (in accordance with Article 133 of the Financial Regulation). Their comments and remarks have been taken into account in the finalisation of these rules. These rules have been used as a basis for preparing the accounting manual. The objective of the manual is to describe the application and operation of these rules and the new accounting system. The directorates-general were consulted on the draft manual in July 2004.

The chart of accounts was also finalised in July 2004, again based on the new accounting rules and following consultation with the Institutions and Agencies.

The accounting rules will be adopted by the Accounting Officer of the Commission in the last quarter of 2004.

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(17) 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).
(18) See Articles 123 to 125 of the Financial Regulation of 25 June 2002.
THE COURT’S OBSERVATIONS

1.25. As regards the informatics aspect, provision has been made to develop an integrated information system containing, in general, all the accounting data needed for the introduction of an accruals-based accounting system on 1 January 2005 in accordance with the Financial Regulation. The progress made concerning accounting standards has made it possible to lay down the architecture and the operating arrangements for this system. The local systems used by the authorising officers by delegation have to be linked to the central information system. Nevertheless, as the Court has already pointed out, the timetable for the necessary adaptations and validations is very ambitious and there is a risk that the Commission will be forced to make gradual adjustments to the current systems.

1.26. The operation of drawing up the opening balance sheet as at 1 January 2005 is crucial to the success of the transition from a cash-based accounting system to an accruals-based system. From this perspective, the accounting data must be processed in such a way that the comparative components required to draw up the financial statements for 2005 will be available. For this reason it is essential that the authorising departments be provided with adequate resources to carry out this large-scale operation properly and that provision be made for suitable support and monitoring by the central accounting departments. It is also very important for the accounting officer to ensure that the procedures for initiating and validating accounting operations in the authorising departments are organised in such a way as to guarantee correct booking as soon as they take place, even if, pursuant to the Financial Regulation, the reliability of the data comes under the responsibility of the authorising officer.

THE COMMISSION’S REPLIES

1.25. The project continues to be implemented largely in accordance with the timetable in the Commission’s Communication of 17 December 2002, and with the more detailed project plan proposed on 8 July 2003. Subject to the testing of the IT functionalities once their development is completed, the new central IT system, termed ‘ABAC’, is expected to be ready to undertake the transition to accrual accounting in 2005. The essential of the IT developments required of the services other than the Budget Directorate-General has been scheduled over the second half of 2004. According to the self-assessments received by end-June 2004, all expect to complete these developments by the end of 2004. However, given the limited time available, several expect to complete development at a date which leaves no margin for unforeseen circumstances.

The modernisation project has very largely met the objectives set and aims to continue to respect the time table set, so far as concerns meeting the formal requirements of the new Financial Regulation in 2005. The Commission still considers that this ambitious objective is feasible, though remaining subject to the risks faced by all large-scale IT developments.

1.26. The Commission is aware of the importance and scale of the opening balance sheet exercise, which is why it has allocated the appropriate resources to its services so as to accomplish this task. Extra human resources have been given to directorates-general to help identify the opening balances for pre-financings, invoices and guarantees, as well as for creating the new legal entity files. Meetings to provide further information and support have also been arranged with the directorates-general by the central services and there is constant dialogue between the two. Additionally, a frequently asked questions list is maintained on the Intranet.

The Accounting Officer will validate the Authorising Officer’s systems as required by the Financial Regulation. The Commission is providing training and guidance to support the authorising services in their responsibility for introducing procedures which ensure the reliability of the accounting data.

(20) Ex-budget borrowing and lending transactions managed by the Directorate-General for Economic and Financial Affairs will not be incorporated until July 2005. The accounting information system of the EDFs will be adapted to the requirements of accruals-based accounting in 2006.


(22) Article 61(2) of the Financial Regulation of 25 June 2002.
THE COURT’S OBSERVATIONS

Legality and regularity of the underlying transactions

Own resources

1.27. The scope of the Court’s work was subject to the limits explained in paragraphs 3.6 and 3.42.

1.28. Although the transactions examined by the Court were not on the whole affected by material errors, the Court’s audit found a number of features in the Members States’ supervisory systems and controls and in their traditional own resources accounts which require improvements in order to reduce the risks of incorrect and incomplete sums of Community own resources being made available (see paragraphs 3.59 to 3.62).

1.28. The Commission will follow up the Court’s specific findings with those Member States involved. In the meantime the Commission anticipates that an amendment to the traditional own resources accounting requirements will lead to Member States maintaining more accurate and reliable separate accounts.

1.29. With the exception of the reservations concerning the supervision of the implementation of preferential trade agreements, the Directors-General responsible declared that the control procedures introduced provide the requisite guarantees as regards the legality and regularity of the underlying transactions, which is corroborated by the Court’s audit findings (see paragraph 3.58).

1.30. The overall situation for the entire sector is stable compared with previous years. However, further progress is required to eliminate the risks with regard to the accuracy of the statistical data used to calculate resources (VAT and GNI) and to the legality and regularity of certain transactions.

1.30. The Commission takes note of the weaknesses identified by the Court in its conclusions in Chapter 3 and will examine the measures that could be introduced to address them.

The Common Agricultural Policy (CAP)

1.31. The Court’s audit of the way the supervisory systems and controls in the Member states work revealed that, in general, the IACS is a useful source of information for assessing the legality and regularity of approximately 58 % of the CAP. On the other hand, inconsistencies and control weaknesses were found concerning aid paid in relation to quantities produced (olive oil, cotton, tobacco and dried fodder), rural development aid, export refunds and intervention storage (see paragraphs 4.24 to 4.46).

1.31. The Commission considers that the supervision and control it exercises over the Common Agricultural Policy (CAP) form a sound basis for addressing the risk of irregularity in the underlying transactions. Errors and deficiencies found in the areas mentioned remain subject to recoveries from the Member States concerned under the clearance of accounts procedure.
1.32. As already noted by the Court in previous years, CAP expenditure as a whole was significantly affected by error. However, there are variations between the main categories of agricultural expenditure as regards the risk affecting their legality and regularity. Arable crops are less exposed than animal premiums, while the other categories of expenditure are exposed to a more critical level of risk and are subject to less effective checks (see paragraph 4.47).

The Commission points out that its budget is exposed to the risk of irregularity in the underlying transactions by the nature of the aid schemes financed by the Community. The Commission endeavours to limit this risk when designing the aid schemes, and through its supervisory systems and controls over the implementation of each scheme. Any control system is a trade-off between the cost of operating the defined intensity of checks on the one hand, and the benefit these procedures bring on the other. In the Community context the benefit involves reducing the risk that funds are wasted and containing the risk of error to a tolerable level, which varies between different budgetary areas, depending on both the cost of controls as well as the inherent risk of transactions containing errors or irregularities. This view is consistent with the Court’s opinion no 2/2004 on the ‘single audit’ model.

The Commission has sought to switch support to direct payments to farmers as, inter alia, such a change in policy limits the risk to the Fund and helps to protect EU tax-payers’ interests. The 2003 CAP Reform, followed by the second wave of the Reform in 2004 on Mediterranean products, will further enhance this positive evolution. In addition, the Member States had to ensure that many of the schemes referred to by the Court were linked to IACS from 1 January 2003. Regarding export refunds and some intervention measures, the Commission agrees that those schemes are exposed to greater risk. Nevertheless, the continuing reduction in the incidence of irregularities communicated by Member States seems to suggest that the effort made over the years to strengthen controls and sanctions for non-IACS aid (via ex-post checks under Regulation 4045/89, for example) has not been without effect.

1.33. The annual activity report and declaration by the Director-General of the Directorate-General for Agriculture would allow a better assessment to be made of the legality and regularity of the underlying transactions if they were based to a greater extent on the most pertinent existing sources of information, such as the IACS, rather than on information relating to financial years previous to 2003, the usefulness of which is still only limited in the context of the Court’s Statement of Assurance (see paragraphs 4.18 to 4.23).

The declaration of assurance of the Director-General of the Agriculture Directorate-General is, as far as EAGGF Guarantee is concerned, based on the following elements:

The existence of an effective clearance of accounts procedure as foreseen by article 53.5 of the Financial Regulation. Financial corrections imposed are based on the Commission audits carried out in Member States. The fact that clearance of accounts decisions are made 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.

The assurance which can be gained from the accreditation of paying agencies, the annual certification procedure and the IACS. These elements permit a great deal of reliance to be placed on the control over the expenditure declared.

A number of other elements contribute to the basis on which the assurance is obtained. These include results of audits made by the Commission’s Internal Audit Service and the Internal Audit Capability and possible information received from OLAF. The Directorate-General for Agriculture also takes account of information received from the Court of Auditors. The annual activity report aims to highlight the principle achievements of the year (see reply to point 4.22).
1.34. Although, with regard to the IACS, the risks affecting legality and regularity are generally better managed, taking agricultural expenditure as a whole there is still some progress to be made in order to rectify the substantial shortcomings found in the supervisory systems and controls. Furthermore, the content of the annual activity report and the drafting of the declaration of the Director-General could be improved with a view to providing a source of information for the Court's Statement of Assurance.

1.34. The Commission considers the current system of statistical reporting for IACS to be effective. It agrees that, in cases where controls have been poorly executed by Member States (for example certain post-payment checks), improvements should be sought. In any case, discrepancies are investigated and dealt with under the clearance of accounts procedure as appropriate.

The Agriculture Directorate-General will take account of the Court's recommendation for future annual activity reports.

Structural operations

1.35. The Court's audit confirmed that there are still weaknesses in the Member States' systems for the supervision and control of the implementation of the Community budget. With regard to the closure of the various forms of intervention in the 1994-1999 programming, there was found to have been little progress because the Member States had submitted incomplete and inadequate documentation in support of the final payment claims. This is compounded by the difficulties encountered by the Commission's departments when processing files (see paragraph 5.67). The Court's audit confirmed the repetition of weaknesses of the same type as in previous years in the management and control systems for the 2000-2006 period (see paragraph 5.68).

1.35. The Commission considers that the supervision and control it exercises over the structural measures form a sound basis for addressing the risk of irregularity in the underlying transactions.

Despite the late submission and variable quality of the closure documentation provided by Member States, the Commission made good progress in 2003 in examining the final claims for 1994-1999 programmes. The closure strategy adopted by the Commission aims to reduce the risk that final payments are made for irregular expenditure.

For the 2000-2006 period the Commission refers to its reply to point 1.38.

1.36. The results of the Court's audit of beneficiaries revealed the repetition of errors of the same type and with the same frequency as in previous years, which confirms the findings regarding system failures (see paragraph 5.56).

1.36. The Commission is continuing to devote a large proportion of its audit resources to checking Member States' systems. Where necessary it uses its powers to suspend payments to programmes whose systems show serious weaknesses which place Community funds at risk and applies financial corrections for resulting irregularities. The Commission follows up errors identified in the Court's and its own audits and take measures to correct them.

1.37. In their annual activity reports and declarations, the Directors-General provided an assurance as to the legality and regularity of the underlying transactions, but the Court found that for all of the structural measures the reservations made were not compatible with the assurance given. Furthermore, it was found that the risks associated with the closure of the 1994-1999 programme period were not the subject of a reservation in the declarations of the Directors-General responsible (see paragraphs 5.57 to 5.62).

1.37. The assurance given by the four Directorates-General responsible for the resources of the Structural Fund was justified by the progress made in examining and auditing the systems of the Member States. The absence of reservations on 1994-1999 programmes is justified given the rigorous procedures in place in the Directorates-General and the closure audits which are being carried out to verify the reliability of the closure statements.
THE COURT’S OBSERVATIONS

1.38. In general, the Court notes that the operation of the supervisory systems and controls for the 2000-2006 programme period has still not achieved a satisfactory level, which is reflected in the large number of material errors still detected in this area.

Internal policies

1.39. Shortcomings were identified in respect of the management and control systems of the sixth Framework Programme for Research and of the programme for the European Refugee Fund in the freedom, security and justice field. Furthermore, work must continue on the supervisory systems and controls at Commission level so as to complete the implementation of the internal control standards (see paragraphs 6.4 to 6.16 and 6.41).

1.40. Substantive testing of transactions in the Internal Policies sector revealed weaknesses in the Commission’s internal control systems and numerous errors at final beneficiary level, which confirms the Court’s previous observations on the legality and regularity of the underlying transactions and corroborates the weaknesses identified in the control procedures applied (see paragraphs 6.17 to 6.26 and 6.42). An analysis of the Commission’s ex post financial audits in the Internal Policies sector also showed that a large number of final beneficiaries overdeclared the costs relating to the operations co-financed by the European Union. In this regard, the Court believes that the corrective measures provided for in the case of the sixth R&D Framework Programme to reduce the risks affecting the legality and regularity of the underlying transactions are inadequate (see paragraphs 6.27 to 6.33 and 6.43).

1.41. The quality and reliability of the information contained in the activity reports for 2003 had improved, thus making a better assessment of the legality and regularity of the underlying transactions possible. Nevertheless, there are still weaknesses as regards the drafting of the reservations (see paragraphs 6.34 to 6.40 and 6.44).

1.42. In general, the Court notes that the improvements observed in 2003 in internal control are not yet sufficient to avoid numerous errors at the level of final beneficiaries and weaknesses in the operation of the Commission’s own systems (see paragraph 6.45).

THE COMMISSION’S REPLIES

1.38. For the 2000-2006 period the Commission is following a multi-annual strategy, which in addition to including a level of audit work on the current period commensurate with the risks, taking account of other priorities, also involves applying the ‘single audit’ approach in order to maximise the effect of its own and Member States’ audit work. In addition, the Commission disseminates guidance and good practices to Member States.

1.39. The Commission fully supports the objectives which the Court lists in the report and pursues them in its day-to-day management. The control systems have been strengthened under the administrative reform and will continue to be subject to strict monitoring.

As regards the second phase of the European Refugee Fund, the Commission organised monitoring visits to all the Member States in 2002 and 2003. These visits showed that improvements were possible and the shortcomings have been taken into account in the planning of ex-post controls.

1.40. In particular since the implementation of its administrative reform, the Commission is confident that it respects the requirements of the Financial Regulation regarding ex-ante and ex-post controls on directly managed expenditure. The Commission constantly seeks to improve its supervisory systems and controls, and welcomes the recommendations the Court makes to this effect. At the final beneficiaries’ level, the analysis of ex-post financial audits by the Commission shows that final beneficiaries make mistakes often due to the complex nature of the fifth Framework Programme model contract. These mistakes are made in two senses, some contractors overstate, and others understate their expenditure. The net impact of the errors on the Commission’s budget remains limited.

Measures have been introduced and the sixth Framework Programme has been considerably simplified, leading to substantial improvements in management at the level of participants.

1.41. Reservations are drafted after thorough examination of the activities of the DGs and the main factors are contained in their annual activity reports. (Each reservation is covered by an action plan which is systematically followed up)

1.42. The Commission is always trying to improve the systems introduced, particularly in the light of the Court’s recommendations (see paragraph 6.44).
1.43. Although 2003 was, in principle, the last year of the devolution process for the geographical programmes (23), the reliability and effectiveness of the controls (checks, reviews, inspections, internal audits and audits carried out by external firms) differ markedly between the Delegations and the Directorates in the Europe Aid Cooperation Office (see paragraphs 7.14 to 7.32).

The main budgetised geographical programmes were almost all devolved during the period 2001-2003 but devolution of the thematic budget lines has taken place during 2004. The gradual implementation of devolution explains to a large degree the difference between Delegations and between the different directorates of EuropeAid.

1.44. A small number of errors which had no significant financial impact were found at the level of the Commission’s central departments and Delegations (see paragraph 7.36). On the other hand, the Court’s audit revealed the existence of weaknesses in the internal control systems and a relatively large number of irregularities at the level of the bodies responsible for implementing the final beneficiaries’ projects and in the actual projects (see paragraphs 7.37 to 7.39).

The Commission agrees with the Court that the observance of tender and procurement procedures by project management units and NGOs remains an area of concern. With the devolution of projects stricter controls can be applied on the spot by the respective delegations. Moreover, since June 2003, in line with the revised grant contract provisions, the project accounts are subject to an audit before the final payment is made.

1.45. The Directors-General responsible declared that the control procedures introduced provide the requisite guarantees concerning the legality and regularity of the underlying transactions. The annual activity reports of the Humanitarian Aid Office and the EuropeAid Cooperation Office describe the internal control systems in place. However, in the case of the EuropeAid Cooperation Office the Court noted that the systems for supervising the legality and regularity of the expenditure underlying the financial statements presented by the bodies responsible for implementation are not yet able to guarantee the legality and regularity of the payments made by these bodies.

Essential supervisory systems and controls for EuropeAid were operational in 2003. These controls were considered as adequate for the purpose of deriving overall assurance in the context of the Director-General’s declaration. See also the replies to paragraphs 7.45 and 7.48.

1.46. With regard to the field as a whole, some elements required for the supervision and control of the systems and expenditure were already in place in 2003. Nevertheless, it is essential for these components to be made operational with a view to improving the legality and regularity of the underlying transactions, which is still necessary, at the level of the organisations responsible for implementing projects and at that of final beneficiaries.

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. Payments and the verification of supporting documents are made as required by the financial regulations. Contract provisions for ‘certification audits’ have also been improved (see replies to paragraphs 7.30 and 7.32). Moreover, the external audit strategy has been strengthened through the establishment of annual audit plans — on the basis of a risk assessment — of audits to be launched by headquarters and delegations.

(23) Devolution means that the Commission’s central departments transfer to delegations in the beneficiary countries tasks and responsibilities relating to the management of cooperation activities financed by the European Union.
Pre-accession aid

1.47. In spite of the improvements noted, the evaluation of the supervisory and control systems further identified a number of weaknesses in the audits carried out by the Commission of the management and control systems in the candidate countries. These weaknesses must be corrected in order to reduce the risk resulting from the removal of the Community Delegations’ ex ante controls (see paragraphs 8.40 to 8.43).

1.47. The Commission is following up the findings of the Court for pre-accession aid and will take every appropriate action. The Commission provided extensive support and guidance to the accession countries and carried out substantial audit work to help them improve their management in accordance with EU rules. It is continuing its work to ensure that the countries that have now joined the European Union have appropriate systems for managing the Structural and Cohesion Funds.

1.48. The Court’s checks on payments revealed errors. Furthermore, there is a risk that national obligations as regards parallel co-financing may not be met (see paragraphs 8.30 to 8.34).

1.48. The Commission considers that a number of errors identified by the Court do not have a financial impact and are formal in nature. Co-financing is monitored during implementation. However in a decentralised environment assurance of absolute compliance with any requirement, not only co-financing, can only be obtained when closure audits are carried out.

1.49. In their annual activity reports and declarations, the Directors-General provided an assurance as to the legality and regularity of the underlying transactions, whilst expressing significant reservations concerning Phare and ISPA (24). The Court believes that the risk of non-compliance with cofinancing obligations on the part of the applicant countries is sufficiently important to justify a reservation in the 2003 declaration accompanying the annual activity report of the enlargement Director-General (see paragraph 8.36).

1.49. The Commission considers that the Director-Generals’ Annual Activity Reports clearly set out risks attaching to pre-accession aid. Nevertheless, the Commission will further consider a reservation on co-financing as this issue matures and in the light of developments.

1.50. Notwithstanding the fact that, in 2003, the candidate countries made real progress in creating management structures and setting up internal control mechanisms, efforts still need to be made with a view to getting them to work efficiently so that there is positive progress in the situation regarding the legality and regularity of Community expenditure and due account is taken of the removal of the Delegations’ ex ante controls. The in-depth audit carried out by the Court in 2003 revealed that, in general, the situation regarding the Commission’s own supervisory systems and controls is unsatisfactory, which is reflected in the number of errors detected at transaction level. These errors confirm the risk already identified in 2002, which results from the weaknesses identified in these systems.

1.50. The Commission is aware of the need for further improvement in the management and control systems in the new Member States and the accession countries. It continues to support these improvements, inter alia through its own audit work. Concerning the errors in its internal systems found by the Court, the Commission refers to its reply to paragraph 1.48.

(24) No reservations were expressed with regard to Sapard in the Director-General’s declaration.
Administrative expenditure

1.51. In spite of the efforts made in 2003, the Court's audits revealed that the changes required to fully implement the new internal control framework laid down in the Financial Regulation had not yet been implemented in their entirety by the majority of the institutions (see paragraph 9.65).

1.52. The Court's audit did not reveal any significant problems affecting the legality and regularity of the transactions examined taken as a whole (see paragraphs 9.66 and 9.68).

1.53. The annual activity reports of the majority of the institutions' authorising officers by delegation and the declarations of the Directors-General provided reasonable assurance as to the legality and regularity of the administrative expenditure (see paragraphs 9.16 to 9.17, 9.24, 9.29, 9.34, 9.46, 9.53, 9.63 and 9.67). However, in his declaration the Commission's Director-General for external relations expressed two reservations concerning the implementation of the internal control standards in the Community Delegations (see paragraph 9.64).

1.54. Although examination of the transactions showed a stable situation compared with previous years, the institutions must still work towards reinforcing the supervisory systems and controls in order to minimise the risks entailed by the existing weaknesses for the legality and regularity of the underlying transactions.

1.51. The Commission has considered implementation of the reform as one of its first priorities. So, by the end of 2002 all services conducted a detailed Readiness assessment which indicated that services were ready for implementing the requirements of the new Financial Regulation.

The Office for Official Publications of the European Communities has already stated that it intends to increase its efforts in the area mentioned by the Court of Auditors, in particular in the 2003 annual activity report (page 100) and in the Readiness assessment.

1.53. The Commission notes that it is one of the institutions whose authorising officers by delegation provided reasonable assurance.

The Director-General for External Relations in his declaration for 2003 has formulated reserves on the implementation of control standards No 17 (Surveillance) and No 12 (Management information) in the Delegations and maintained the reserve on control standard No 16 (Segregation of duties) formulated in 2002. A specific action plan to address these reserves is under implementation since January 2004.

1.54. As far as the supervisory systems are concerned, the Commission considers that supervision is really executed in the services but, as stated in the overview of the state of the internal control systems (1), acknowledges that there is still room for improvement in order to evidence that supervision. The Commission plans to have specific workshops on this issue in the second half of 2004.

See also the comment concerning the Official Publications Office in the reply to paragraph 1.51.

Development of the Commission’s internal control system

1.55. In the context of its Statement of Assurance (DAS) for the financial year 2002, the Court examined the progress of the administrative reform of the Commission (25) by carrying out an initial evaluation of the Commission’s new internal control system, as well as of the guarantees it provided as regards the legality and regularity of the transactions underlying the budgetary payments (26).

1.56. In 2003 the Court continued its evaluation of the Commission’s internal control system. 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 in implementing key elements of the revision of its internal control system (White Paper actions, action plans annexed to the Synthesis of the 2002 and 2001 annual activity reports and declarations by Commission Directors-General and minimum internal control rules).

1.57. According to Article 274 of the EC Treaty, the Commission is responsible for implementing the budget. Nevertheless, not all the transactions are subject to the same management system and the impact of the reform of the Commission varies from sector to sector. With regard to expenditure, the Financial Regulation distinguishes between the following cases (Article 53):

a) the Commission implements the budget on a centralised basis (administrative expenditure and internal policies). In this case, implementation tasks are performed either directly by its departments (direct centralised management), or indirectly when the Commission resorts to agents (indirect centralised management). In the case of the first category, the reform affects all the procedures for implementing expenditure. In the second category, the reform has a particular impact on those aspects concerning the definition, supervision and implementation of the tasks concerned;

b) management of the transactions is assigned to the national authorities in the Member States (EAGGF-Guarantee and Structural Funds). This is shared management and the Commission must verify that the national authorities act in compliance with the applicable rules. In this case the reform of the Commission only affects activities concerning the monitoring of implementation;

b) The Commission has developed an audit strategy based on the single audit approach which aims to improve the management and control systems in the Member States.


THE COURT’S OBSERVATIONS

c) the Commission can entrust implementation of certain aspects of its operations to beneficiary countries after having carried out an ex ante check (pre-accession aid). Management is then termed decentralised and the reform affects most of the aspects of management, in the same way as in cases of delegation by the Commission to an agent in the context of centralised management.

The Commission’s replies

1.58. By means of its 2003 Synthesis of the annual activity reports \(^\text{27}\), the Commission is continuing its efforts at transparency as regards its obligation to render an account of its management \(^\text{28}\). The Court found that for the first time the Commission had presented an analysis of the degree of assurance provided by the supervisory systems and controls with regard to the legality and regularity of the underlying transactions. In this way, as an institution, it assumes 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.

1.59. The Commission states that is not yet in a position to provide assurance without qualification with respect to one important area of shared management (Structural Funds). Moreover, it notes that, in spite of a satisfactory level of assurance in the areas of direct and indirect centralised management, there is still a problem with regard to grants based on the partial reimbursement of costs declared by the beneficiaries. In fact, reservations concerning the frequency of errors have been issued by most Directorates-General managing these types of programme. All the above-mentioned statements are confirmed by the Court’s audit findings (see paragraphs 5.66 to 5.69 and 6.41 to 6.45).

1.58-1.60. As in previous financial years (see section 5.3.3 of the 2002 synthesis (COM(2003) 391) for shared management), when adopting the 2003 Synthesis of Annual Activity Reports the Commission gave an overview of the assurances given by the various authorising officers by delegation and introduced corrective measures at institution level in the case of recurrent weaknesses in certain sectors.

In particular, the Commission has expressed its position on a number of sectors which can be identified more clearly under the new structure of the 2003 synthesis and in which the weaknesses detected by the authorising officers require action at institution level. The synthesis proposes action by the institution only for those areas where important weaknesses have been identified at Commission level. For those areas not explicitly mentioned in the synthesis, the assurances are provided at Directorate-General/Service level through the declaration of each authorising officer by delegation.

1.59. See replies to paragraphs 1.35 to 1.38.

For the Structural Funds, each Directorate-General took account of the level of audit work completed on the systems for the 2000–2006 and its own audit strategy in determining the scope of its reservations, which were generally more limited than in 2002.


\(^\text{28}\) See the Annual Report concerning the financial year 2002, paragraph 1.108 and that concerning the financial year 2001, paragraph 9.98.
1.60. However, the Commission has not stated its position on the situation regarding the Common Agricultural Policy, which is the most important area in which management is shared. The same applies to centralised management (Own resources and Pre-accession aid) and joint management (External aid).

Annual activity reports and declarations of the Directors-General for the financial year 2003

Annual activity reports

1.61. The new circular (29) on the 2003 Annual activity reports, which for general matters refers to the guidelines for drawing up the 2002 annual activity reports and to some aspects of shared management (30), introduces changes and some new elements:

a) the timetable has been brought forward as required by the new Financial Regulation (31):

b) the Directorates-General are asked to present a number of management indicators (32) and to formalise the reservations by presenting standardised summary information in a standard table (33):

c) a declaration by the Director of Resources is attached to the annual activity report to certify the reliability of the information on the drafting process, the financial data and the implementation of internal control standards (34).

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(31) Article 60(7) of the Financial Regulation.
(32) The performance indicators concern human resources, the implementation of the budget and auditing.
(33) The standard table requires a minimum of information about the cause, the materiality criterion employed, quantification (where the weakness is quantifiable), the impact as regards reasonable assurance and the corrective measures envisaged.
THE COURT’S OBSERVATIONS

1.62. These elements, plus peer review, helped to improve the quality of the annual activity reports. Thus, in general, the corresponding annual activity reports noted the follow-up to the action plans adopted in the context of the annual activity reports and the Commission’s 2002 Synthesis (15) and the monitoring of the measures taken as a result of the internal and external audit recommendations. The introduction of a specific circular on these action plans (16), which are incorporated into the Commission’s annual management plans, enabled progress to be monitored more effectively. However, the Court feels that this whole exercise requires further consolidation if it is to be implemented effectively.

Reservations contained in the declarations of the Directors-General

1.63. In their declarations attached to the annual activity reports, the Directors-General state that the internal controls carried out in their departments offer reasonable assurance that the underlying transactions are legal and regular. In the event of internal control weaknesses or irregularities, they make reservations and draw up action plans which include deadlines for implementation.

1.64. 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 (17). The Court feels that this notion of materiality is not in itself adequate to identify systemic weaknesses (18).

THE COMMISSION’S REPLIES

1.62. The Commission considers that the annual activity reports are a useful management tool for supplying information on the weaknesses detected and providing an effective remedy. It feels that substantial improvements have been made to these reports and to the declarations accompanying them in 2003 and will continue its efforts along these lines.

1.64. In order to highlight only the most serious management weaknesses (management by exception), the term ‘reservation’ has been restricted to those shortcomings which have a real and verifiable impact — i.e. not those with only a potential risk — on the assurance to be given that the control procedures introduced provide the requisite guarantees as to the legality and regularity of the transactions carried out during the reference year. Now that the term ‘reservation’ has been defined in this way, progress still has to be made on the precise determination by the authorising officer by delegation of the impact which the reservations expressed have on the assurance given.

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(16) Circular on the follow-up to the action plans resulting from the 2002 annual activity reports and from the synthesis (SEC(2003) 1078 of 10 October 2003) drawn up to implement Action No 24 ‘Follow-up by services’ (ref. 5.4.6.) of the 2002 summary.
(18) The fact is that weaknesses may constitute a risk for management without necessarily leading to actual errors in terms of the legality and regularity of the underlying transactions. In order to assess the significance of a systemic weakness, account must be taken not only of its nature (i.e. the seriousness of the shortcoming) but also of its extent (i.e. the potential financial impact).
1.65. The Directors-General may depart from this criterion 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 criterion must be justified in the annual activity report. Where appropriate, this choice should take account of the risks intrinsic to each of the areas considered. In this connection, the Commission should define a more suitable, specific policy for establishing materiality thresholds based on the nature of the transactions concerned and on the risks that are acceptable for the area in question and for determining the resources to be allocated to checks (39).

The Commission is willing to consider the possibility of introducing a certain degree of flexibility when determining the materiality thresholds for the various areas of management.

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. 21 of the 39 declarations contain reservations limiting the assurance given by the Directors-General. Thus, as in the previous year (40), the Director-General for Budgets upheld the reservations concerning imperfections in the Commission’s accounting systems (41) (see paragraph 1.8).

See Commission’s reply to paragraph 1.8.

The main reservations are shown in Table 1.2. Of the 49 reservations expressed in 2003 (42), the majority concern weaknesses already brought to light in 2002 (43). The other reservations had generally already been mentioned in various connections in the annual activity reports of the Directorates-General for the previous year (see paragraphs 3.58, 4.18, 5.57 to 5.62, 6.36, 7.47, 8.35, 8.37 and 9.64). This shows that the weaknesses identified can be eliminated only in the medium term (see paragraphs 1.73, 1.76 and 1.79).

Although it does not agree with the Court’s criticisms in Table 1.2 on the impact and the scope of reservations, the Commission takes note of the Court’s observations and will continue to enhance the information so that the Court can use it more effectively in support of its declaration of assurance.

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(40) Paragraph 1.92 of the Annual Report concerning the financial year 2002.

(41) The Joint Research Centre also issued a reservation about the reliability of the accounts.

### Table 1.2 — Follow-up by the Court to the reservations expressed in 2003 by the Directors-General

<table>
<thead>
<tr>
<th>Sector</th>
<th>Main reservations</th>
<th>Impact of the reservations on the Director-General’s assurance in the Court’s view (1)</th>
<th>Scope of reservations (2)</th>
<th>Other weaknesses revealed by the Court’s audit</th>
<th>Account taken of all this information in the Court’s conclusions (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own Resources</td>
<td>Monitoring the application of preferential schemes</td>
<td>B</td>
<td>A</td>
<td>—</td>
<td>A</td>
</tr>
<tr>
<td></td>
<td>— Import of Basmati rice</td>
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<td></td>
<td>— ‘Hilton’ beef</td>
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<tr>
<td>Common Agricultural Policy</td>
<td>International Olive Oil Council</td>
<td>B</td>
<td>C</td>
<td>Insufficient account taken of the supervisory and control systems for 2003 transactions</td>
<td>C</td>
</tr>
<tr>
<td></td>
<td>— IACS in Greece</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Structural measures</td>
<td>EAGGF-Guidance, ESF, IFOP: management and control systems in the Member States (2000/2006)</td>
<td>C</td>
<td>C</td>
<td>Risks connected with the closure of the 1994-1999 programming period and/or significant weaknesses in the implementation of Regulation (EC) No 2064/97</td>
<td>C</td>
</tr>
<tr>
<td></td>
<td>ERDF: management and control systems in Greece and Spain (2000/2006)</td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>URBAN and Interreg management and control systems (2000/2006)</td>
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<tr>
<td></td>
<td>Cohesion Funds: management and control systems in Greece, Spain and Portugal (2000/2006)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Internal policies, including research</td>
<td>Preliminary testing within the framework of indirect centralised management (Article 35 MERF)</td>
<td>B</td>
<td>B</td>
<td>Risks related to the systematic exceeding of the payment period in the area of research</td>
<td>B</td>
</tr>
<tr>
<td></td>
<td>— On-the-spot audits</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>— Error frequency (eligibility) in the cost declarations for research contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>External actions</td>
<td>Partnership with a non-governmental organisation</td>
<td>B</td>
<td>C</td>
<td>Monitoring and control systems are not yet fully operational</td>
<td>C</td>
</tr>
<tr>
<td>Pre-accession aid</td>
<td>ISPA: management and control systems</td>
<td>C</td>
<td>C</td>
<td>Risk that some candidate countries cannot fulfil their obligations regarding co-financing</td>
<td>C</td>
</tr>
<tr>
<td></td>
<td>Phare: risks inherent in the decentralised systems, omissions in the audit of systems and transactions, uncertainties regarding financial intermediaries' complaints</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Administrative expenditure</td>
<td>Implementation of internal control standards in the EUs delegations.</td>
<td>A</td>
<td>B</td>
<td>—</td>
<td>B</td>
</tr>
</tbody>
</table>

Key:

(1) Impact of the reservations on the Director-General’s assurance in the Court’s view:
A: reasonable assurance that the internal control systems ensure the legality and regularity of the underlying transactions
B: reasonable qualified assurance that the internal control systems ensure the legality and regularity of the underlying transactions
C: reasonable assurance insufficient or insufficiently supported

(2) Scope of reservations:
A: clear and unambiguous
B: with insignificant 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) Account taken of all this information in the Court’s conclusions:
A: useful source
B: useful source after corrections
C: non-useful source (e.g. material inaccuracies, missing or unusable information)

Source: Court of Auditors.
THE COURT’S OBSERVATIONS

1.68. The guidelines for the annual activity reports and the Charter for Authorising Officers by Delegation (44) specify that the reservations must not make the declaration meaningless and that, in extreme cases (45), the Director-General may not be able to provide the required assurance.

1.69. For 2003, the extent of the reservations expressed by some departments (46) is not compatible or sufficiently justified in view of the assurance provided in the declarations (see Table 1.2 and paragraphs 5.57 to 5.62, 7.48, 8.36 and 8.38). The impact of the reservations on the assurance given in the declarations was nevertheless defined more clearly than in the financial year 2002.

Determination of the impact of reservations on the assurance is improving as the practice becomes routine. The Commission considers that, at present and increasingly so in the future, determining the consequences of the reservation for the area in question already makes it possible to establish — and will make it even clearer in future — that the assurance to be given by the authorising officer by delegation is totally justified.

1.70. The Court’s work shows that the supervisory systems and controls in several areas of the financial perspectives have not yet reached a satisfactory level and that further efforts are required in order to strengthen them. Thus, 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 4.22, 5.62, 6.37, 7.48 and 8.36). In addition, the Declaration by the Director-General of DG Agriculture is not based on an examination of the transactions belonging to the financial year 2003 (see paragraphs 4.19 and 4.20).

See answers to paragraphs 1.33, 1.37 and 1.67 and to the specific paragraphs mentioned by the Court.

1.71. In spite of some improvement, the Court believes that the annual activity reports and declarations of the Directors-General cannot yet systematically serve as a useful basis (see paragraph 1.4) for its audit conclusions in the various areas of the financial perspectives (see Table 1.2).

Through its work to improve the content of declarations and its monitoring of compliance with the standards on which the declarations are based, the Commission is endeavouring to make the annual declarations into a reliable indicator of its performance and its strategy for dealing with the risks identified, in order that the Court can use them as a basis for its assurance.

THE COMMISSION’S REPLIES

1.69. Determination of the impact of reservations on the assurance is improving as the practice becomes routine. The Commission considers that, at present and increasingly so in the future, determining the consequences of the reservation for the area in question already makes it possible to establish — and will make it even clearer in future — that the assurance to be given by the authorising officer by delegation is totally justified.

1.70. See answers to paragraphs 1.33, 1.37 and 1.67 and to the specific paragraphs mentioned by the Court.

1.71. Through its work to improve the content of declarations and its monitoring of compliance with the standards on which the declarations are based, the Commission is endeavouring to make the annual declarations into a reliable indicator of its performance and its strategy for dealing with the risks identified, in order that the Court can use them as a basis for its assurance.


(45) E.g. when the reservations have a significant impact on the Directorate-General’s budget.

(46) E.g. the Directorates-General for Agriculture, Education and Culture, Enlargement, Employment and Social Affairs, Fisheries, Press and Communication, Regional Policy and Eurostat.
THE COURT’S OBSERVATIONS

Progress in the area of administrative reform

2003 Synthesis

1.72. In general, the Commission states in its Synthesis that 2003 saw substantial progress in the area of administrative reform, that practically all of the actions of the White Paper had been completed and that most of the action plans envisaged by the 2001 and 2002 Syntheses had been completed or had made significant progress. However, the Court’s audits show that this assessment is very optimistic. Furthermore, the Commission itself acknowledges in the various sections of its Synthesis that some areas will still require monitoring in the years to come, thereby corroborating the Court’s audit findings in the following areas:

a) the implementation of the actions of the White Paper (see paragraphs 1.74 to 1.76) and of the 2001 and 2002 Syntheses (see paragraphs 1.77 to 1.79);

b) the implementation of internal control standards (47) (see paragraphs 1.80 to 1.84);

c) the production of adequate indicators for activity-based management, and strategic planning and programming (see paragraphs 1.85 to 1.87);

d) financial management and reporting (48) (see paragraphs 1.27 to 1.54 and 1.22 to 1.26);

e) the quality and extent of the reservations contained in the declarations of the Directors-General (see paragraphs 1.63 to 1.71).

1.73. The Court shares the Commission’s view that the aforementioned points are already covered by the actions envisaged in the syntheses for previous years. It stresses the importance for the Commission of successfully consolidating all the horizontal action plans and notes the Commission’s willingness to consider the recommendations contained in its opinion on the single audit model (49).

THE COMMISSION’S REPLIES

1.72. The significant progress made in 2003 does not rule out the need to implement the corrective measures in the various sectors identified in the 2003 synthesis report. In some cases, the problems underlying these operations will only be resolved effectively and satisfactorily in the medium term. Thus, every year the synthesis of annual activity reports takes stock of the progress achieved and sets out and updates all the actions to be conducted at Commission level.

Each of the actions under the White Paper and previous syntheses calls for the application of an instrument (e.g. a communication, the introduction of a measure, etc.). Once this instrument has been achieved, the action as such is no longer taken into consideration and, if the underlying problem has not been resolved, a new action is undertaken, usually through the annual synthesis report. This makes it possible to update the measures to be taken and also to perform an annual consolidation of ongoing actions which is not obstructed by the widerange of actions carried out in the past. It is thus the consolidation in the most recent synthesis which must be taken into account to obtain a table of ongoing horizontal actions.

(47) In particular, internal control standards. The internal control system concerns not only the departments in Brussels but also the Commission’s local offices (delegations, representations and executive agencies).

(48) In particular, shared, central, direct and indirect management, ex-ante and ex-post checks and the implementation of the Financial Regulation.

(49) Court Opinion No 2/2004.
1.74. As part of its monitoring of progress in the area of administrative reform, the Commission announced that, of the 36 actions listed in Chapter V of the White Paper (50) on ‘Audit, management and financial control’, 32 had been completed in 2003. A progress report on the White Paper was thus drawn up (51) to include a full account of the objectives still to be attained and of the measures still to be implemented.

1.75. The Court notes the progress made by the Commission as regards the design of the new regulatory control framework but believes that the results as far as implementation and actual procedure are concerned are not yet satisfactory. Thus, of the 18 out of 36 actions under Chapter V of the White Paper that had still not been completed at the end of the financial year 2002 (52), eight actions were still being implemented (53) as at 31 December 2003. For eight of the 10 other areas where actions have theoretically been completed, the objective has not yet been fully achieved, implementation is not yet satisfactory or there is no guarantee that they are permanent (54).

1.76. Many of the unfinished actions are also covered in the synthesis of the annual activity reports and declarations (55) (see paragraphs 1.77 to 1.79) and require departments to change their habits or necessitate the introduction of new activities (56). Full completion of these actions, which will enable the attendant objectives to be achieved, is feasible only in the medium term (see Table 1.3).

1.74-1.76. Once the instruments aimed at by the various measures have been installed, the settlement of outstanding issues will be covered each year by the synthesis reports (see reply to paragraph 1.72). Within this framework, the Commission considers that most of the actions mentioned by the Court had been achieved at 31 December 2003.

1.75. The Commission would make two comments on Action 83:

— in communication COM(2004) 93, which is mentioned by the Court, Action 83 is incorporated into Action 62, which refers both to the reform and to the effect of policies on the resources required;

— the resources required are examined every year during the annual policy strategy exercise (APS): since 2003 the Commission has adopted the policy of restricting the new posts it requests to the level needed for an enlarged European Union (see also the communication COM(2002) 311 on this subject) and of satisfying its other requirements by redeployment and the allocation of posts freed by successive early retirement schemes.

1.76. Many of the unfinished actions are also covered in the synthesis of the annual activity reports and declarations (55) (see paragraphs 1.77 to 1.79) and require departments to change their habits or necessitate the introduction of new activities (56). Full completion of these actions, which will enable the attendant objectives to be achieved, is feasible only in the medium term (see Table 1.3).

(52) Paragraphs 1.65 to 1.67 of the Annual Report concerning the financial year 2002.
(53) Actions Nos 74 ‘Contracts database’, 83 ‘Adequate levels of staffing’, 87 ‘Examination of the progress made by Commission departments during the process of change’, 93 ‘The better coordination of interaction between OLAF and other services’, 94 ‘The imperviousness of legislation and contract management to fraud’, 95 ‘Optimisation of early warning system’, 96 ‘More effective management of recovery of unduly paid funds’ and 97 ‘Improved financial monitoring and control of Structural Funds’.
Table 1.3 — The Court’s analysis of the main non-closed actions in Chapter V ‘Audit, financial management and control’ of the White Paper and the action plan annexed to the Synthesis of the annual activity reports and declarations of its Directors-General for the years 2002 and 2001 (as at 31 December 2003)

<table>
<thead>
<tr>
<th>Chronological reference and/or synthesis</th>
<th>Action</th>
<th>Sector/Type of measure</th>
<th>Source of action plan</th>
<th>Diagnosis/measures still to be undertaken</th>
</tr>
</thead>
<tbody>
<tr>
<td>71</td>
<td>Audit Progress Committee</td>
<td>Chapter V ‘Audit, financial management and control’</td>
<td>White Paper</td>
<td>Action finished/improvements possible Some organisational changes have been made to improve the running of the Committee, in particular rules governing the chairing of meetings in the event of potential conflicts of interest, the moving of the Committee’s Secretariat from DG BUDG to the Secretariat-General and the appointment of a second external member (COM(2004) 93 of 10 February 2004, paragraph 10.3). Improvements are still required, however, to enable the Committee to monitor effectively the Commission’s audits. This action is linked to action 19 ‘Audit progress committee’ (ref. 3.3.3) of the 2002 Synthesis.</td>
</tr>
<tr>
<td>78</td>
<td>Minimum standards for internal control</td>
<td>Chapter V ‘Audit, financial management and control’</td>
<td>White Paper</td>
<td>Action finished/implementation under way — improvements possible The internal audit standards were adopted on 13 December 2000 (SEC(2000) 2203) and amended on 21 December 2001 (SEC(2001) 2037). They provide for a minimum level of internal control which each Commission DG should put in place (full implementation of internal control standards). The new guidelines established (SEC(2003) 1287 of 26 November 2003, Annex 5) confine the application of internal control standards to the baseline requirements alone. The extent of implementation of the baseline requirements as at 31 December 2003 reveals that the action is not yet finished (see Table 1.4). This action is linked to action 1 ‘Internal control standards’ (ref. 5.4.5) of the 2002 Synthesis.</td>
</tr>
<tr>
<td>81</td>
<td>Strengthening the role of the DGs’ control function (internal audit structures/audit capabilities)</td>
<td>Chapter V ‘Audit, financial management and control’</td>
<td>White Paper</td>
<td>Action finished/improvements possible As at 31 December 2003, each Commission department had its own internal audit capability (SEC(2004) 250 of 27 February 2004), except for some cases such as the IAS, GOPA, SCIC-DGT and the Offices of DG ADMIN (OIB, OIL, PMO and EPSO). The extent of implementation of the baseline requirements of standard 22 ‘internal audit capability’ as at 31 December 2003 reveals, however, that the action is not yet finished (see Table 1.4). This action is linked to action 12 ‘Coordination of the Commission’s audit community’ (ref. 3.3.2) of the 2002 Synthesis.</td>
</tr>
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<td>83</td>
<td>Adequate levels of staffing</td>
<td>Chapter V ‘Audit, financial management and control’</td>
<td>White Paper</td>
<td>Action in progress A report on the Commission’s requirements in terms of training and resources is in the process of being finalised. This action is linked to actions 21 ‘Risk assessment by management’ (ref. 3.3.2) and 22 ‘Human resources’ (ref. 5.3.1) of the 2002 Synthesis, 5 and 14 ‘Human resources’ of the 2001 Synthesis.</td>
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<td>87</td>
<td>Review of progress made by the Commission's services in the change process</td>
<td>Chapter V 'Audit, financial management and control'</td>
<td>White Paper</td>
<td><strong>Action in progress</strong>&lt;br&gt;The Commission's Internal Audit Service planned to complete the cycle of in-depth audits in all Directorates-General by the end of September 2004 (COM(2004) 93 of 10 February 2004, Annex 1).</td>
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<td>Better coordination of interaction between OLAF and other services</td>
<td>Chapter V 'Audit, financial management and control'</td>
<td>White Paper</td>
<td><strong>Action in progress</strong>&lt;br&gt;A provisional protocol agreement on a code of conduct to ensure that information is exchanged in good time between OLAF and the Commission about OLAF's internal inquiries at the Commission was approved in July 2003. The proposals to amend the regulation on OLAF which were presented by the Commission in February 2004 will have an impact on this protocol agreement (COM(2004) 93, Annex 1). Furthermore, work on improving exchanges of information and cooperation between OLAF and the Commission through protocol agreements is ongoing.&lt;br&gt;&lt;br&gt;This action is linked to action 15 'OLAF monitoring' (ref. 5.3.9) in the 2002 Synthesis.</td>
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<td>94</td>
<td>'Fraud-proofing' of legislation and contract management</td>
<td>Chapter V 'Audit, financial management and control'</td>
<td>White Paper</td>
<td><strong>Continuous action</strong>&lt;br&gt;The interservice group on 'fraud-proofing' chaired by OLAF will continue in 2004 the follow-up work to legislation-related aspects as concerns the Commission Communication on fraud-proofing (SEC(2001) 2029 of 7 November 2001 and COM(2004) 93, Annex 1).</td>
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<td>96</td>
<td>More effective management of recovery of unduly paid funds</td>
<td>Chapter V 'Audit, financial management and control'</td>
<td>White Paper</td>
<td><strong>Action in progress</strong>&lt;br&gt;The recommendations by the Internal Audit Department must be taken into consideration by the Directorates-General and the process of monitoring the arrears on recoveries should be coordinated more effectively at the central level by the Directorate-General for Budgets.&lt;br&gt;&lt;br&gt;This action is linked to action 9 'Recovery' (ref. 5.3.2) in the 2002 Synthesis.</td>
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<td>97</td>
<td>Improved monitoring of Structural Funds</td>
<td>Chapter V 'Audit, financial management and control'</td>
<td>White Paper</td>
<td><strong>Action in progress</strong>&lt;br&gt;The application of the new procedures for the management of the Structural Funds has required the adoption of a Commission Memorandum on the clarification of responsibilities within the framework of shared management (C(2003) 1830-2 of 17 June 2003). An interdepartmental group has been set up to analyse possible measures to improve the management of the Structural Funds. In September 2004 the Commission adopted a Communication on the legal responsibilities (COM(2004) 580 final) and in August 2004 it adopted a Communication on audit methodology (C(2004) 3113) (see paragraph 1.84)&lt;br&gt;&lt;br&gt;This action is linked to actions 7 'Shared management' and 17 'Audit in shared management' (ref. 5.3.3) in the 2002 Synthesis and 4 'Structural Funds' and 12 'Shared management' in the 2001 Synthesis.</td>
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<td>6 (5.3.7)</td>
<td>Accounting framework</td>
<td>Financial management</td>
<td>2002 Synthesis</td>
<td><strong>Action in progress</strong>&lt;br&gt;In general the accounting modernisation project is running according to the timetable set, as regards meeting the formal requirements of the new Financial Regulation in 2005 (COM(2004) 565 of 18 August 2004).&lt;br&gt;&lt;br&gt;This action is linked to actions 16 'Accounting framework' and 17 'Central systems of financial information' in the 2001 Synthesis.</td>
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| 8 (5.3.4) Co-financing                   | Financial management | 2002 Synthesis         | **Action in progress**  
The interservice group set up in 2003 under the presidency of the Secretariat-General to implement this measure is divided into 2 sub-groups (fixed-rate factors and auditing methods). It plans to continue its work in 2004.  
This action is linked to action 1 ‘Research programme’ in the 2001 Synthesis. |
| 12 (3.3.2) Coordination of the Commis- | Audit | 2002 Synthesis         | **Action in progress**  
The Commission clarified the responsibilities of the key actors in the domain of internal audit and internal control (SEC(2003) 59 of 21 January 2003). Several coordination activities (Auditnet network, development of methods, joint tools and techniques) have been implemented by the Internal Audit Service but require additional efforts in 2004. As at 31 December 2003 an adequate level of audit coordination has not yet been achieved.  
This action is linked to action 81 ‘Strengthening of the role of the DGs’ control function (audit capabilities)’ in the White Paper. |
| 23 (4.4) Methodology for the annual activity reports | Methodology for the annual activity reports | 2002 Synthesis         | **Action finished/improvements possible**  
The guidelines for drawing up the 2003 annual activity reports clarified the concepts of ‘reservations’, ‘assurance’, ‘materiality’ and ‘declaration’ (SEC(2003) 1469 of 19 December 2003 and SEC(2004) 147 of 19 February 2004). Improvements are still necessary as regards the concept of materiality and the impact of the reservations on the Director-General’s assurance. Moreover, more specific guidelines should be provided as regards the impact indicators (and result), in particular on the quality of the revenue and expenditure.  
This action is linked to action 82 ‘Declaration by the Director-General in her/his Annual Activity Report’ in the White Paper. |
| 2 External actions | Cross-sectoral political questions | 2001 Synthesis         | **Action partially unfinished and objective partially met**  
The organisation of the structures and resources of the departments concerned by External Relations has not been re-examined so as to identify potential synergies. |
| 7 Management-related information systems | Implementation of the reform | 2001 Synthesis         | **Action in progress**  
Following the IAS audit ‘Review of IT governance at the Commission’, a Commission Memorandum on the inter-operability of existing IT systems in the area of management is in the process of being drawn up. |

Source: Court of Auditors.
THE COURT’S OBSERVATIONS

Action plans annexed to the Synthesis of the annual activity reports of the Commission Directorates-General and departments for the financial years 2002 and 2001

1.77. The synthesis of the annual activity reports and declarations of the Directors-General (57) for the financial year 2002 takes stock of the reform of the Commission’s internal control system and launches a new action plan to rectify the weaknesses observed. This action plan comprises 25 corrective measures in addition to the action plans set out by the Directors-General in their annual activity reports and the follow-up of the action plan envisaged in the 2001 Synthesis (58). Of the actions which are likely to have an impact on the legality and regularity of the underlying transactions (59), the Court found that the horizontal actions (60) had not been completed (61) by 31 December 2003.

1.77–1.78. In line with what was set out in the reply to paragraph 1.72 — that the actions to be undertaken are updated each year and the actions established by previous syntheses disappear — the actions in the 2001 and 2002 syntheses which were not completed at 31 December 2003 have been taken over and updated in the 2003 synthesis.

Substantial progress has been made in the implementation of two actions concerning shared management. By September 2004 the Commission had adopted communications on the legal responsibilities under shared management (COM(2004) 580 final) and on the alignment of audit methodology in this area (C(2004) 3115); in December 2003 the Commission also published revised audit manuals for the Structural and Cohesion Funds. In the draft legislation for the Structural Funds in the 2007-2013 period the Commission has also taken up the idea of annual declarations by an independent audit body which was also mentioned in action 17.

(59) Actions Nos 1 ‘Internal Control Standards’ (ref. 5.4.5), 3 ‘Communication’ (ref. 3.3.2), 6 ‘Accounting framework’ (ref. 5.3.7), 7 ‘Shared management’ (ref. 5.3.3), 8 ‘Co-financing’ (ref. 5.3.4), 9 ‘Recovery’ (ref. 5.3.2), 12 ‘Co-ordination of the Commission’s audit community’ (ref. 3.3.2), 13 ‘Audit methodology’ (ref. 3.3.3), 14 ‘Follow up of audit reports’ (ref. 5.3.8), 15 ‘Follow up OLAF’ (ref. 5.3.9), 17 ‘Audit in shared management’ (ref. 5.3.3), 19 ‘Audit Progress Committee: organisation’ (ref. 3.3.3), 21 ‘Management risk assessment’ (ref. 3.3.2), 23 ‘AAR Methodology’ (ref. 4.4) and 24 ‘Follow up by services’ (ref. 5.4.6).
(60) Actions Nos 6, 7, 8, 9, 12, 15, 17, 19, 21 and 23.
(61) Actions Nos 6, 7, 8, 9, 12, 17 and 21: ‘ongoing’; actions Nos 15, 19 and 23: ‘completed, partially completed or follow-up action to be launched’.
1.78. Similarly, the follow-up of the action plan envisaged in the 2001 Synthesis reveals that most of the actions which had not been completed by the end of the financial year 2002 (62) were still being implemented (63) on 31 December 2003. In two of the areas covered by actions which had, in principle, been completed, the objective has not yet been achieved in full, implementation is not yet satisfactory or there is no guarantee that they are permanent (64). In two other areas, the actions are incomplete and the objective has been partially achieved (65).

1.78. With regard to the actions on shared management, the Commission refers to its reply to paragraph 1.77.

Two separate actions are planned for Action 5: consideration of the resources needed (see reply to paragraph 1.75) and establishment of a method for assessing the resources required for existing and new activities. As regards Action 14, the Personnel and Administration Directorate-General has defined, through a poll in departments, the recruitment profiles relating to their needs and has asked the European Personnel Selection Office (EPSO) to organise the corresponding competitions from 2003 on. In the meantime, it may be necessary to continue recruiting more temporary staff on permanent posts.

1.79. The Court encourages the Commission to implement the unfinished action plans so that the new internal control system can actually function, in particular in the areas of shared management, management risk assessment and debt recovery (see Table 1.3).

1.79. The Commission is investing considerable effort and interest in progressing on the three issues highlighted by the Court (i.e. shared management, risk management and recovery) as reflected in both the Synthesis of the 2003 and 2002 annual activity reports and the Overview of the state of internal control systems.

(63) Actions Nos 1 ‘Research programmes’, 4 ‘Structural Funds’ (shared management), 5 ‘Human resources’ (reform), 7 ‘Management Information Systems’, 12 ‘Shared management’, 14 ‘Human resources’ (recruitment), 16 ‘Accounting framework’ and 17 ‘Core financial Information systems’.
(64) Actions Nos 9 ‘Internal control procedures, in particular financial procedures’ and 15 ‘Training’ (financial management).
(65) Actions Nos 2 ‘External actions’ and 18 ‘Action plans’.
Internal control standards

1.80. The Court analysed the application of internal control standards (66) by 16 of the Commission’s Directorates-General (67). The aim was not only to measure the degree of implementation but also to evaluate the Commission’s application of the standards so as to assess the legality and regularity of the underlying transactions in the area concerned.

1.81. The Court found that, in general, the scope and substance of the systems and basic controls underlying the standards set out in 2003 (68) are not easy to compare with those defined in 2002.

1.81. The fact that baseline requirements defined in 2003 are not entirely comparable with those defined in 2002 is consistent with the philosophy of those requirements. In fact, the baseline requirements were initially introduced in 2000 to make the 24 Internal control standards more concrete in practice by defining the minimum requirements at that time. Each year the baselines are updated in order to consider any additional requirement from any relevant Commission’s decision/communication adopted in the meantime.

In terms of charting progress from one point in time to another, the clarifications/updating made to the baselines make it difficult to compare the position at the end of 2002 and the end of 2003. However, there have been significant actions taken to strengthen internal control, particularly regarding the flow of information from Directorates-General to their Commissioner on critical issues of audit and control and Directorates-General have already demonstrated a strong commitment to delivering this in practice.

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(67) The Directorates-General for Economic and Financial Affairs, Agriculture, Education and Culture, Employment and Social Affairs, Fisheries, Regional Policy, Research, the Information Society, Enlargement, Budget, Personnel and Administration, Justice and Home Affairs, the Humanitarian Aid Office, the EuropeAid Cooperation Office, Eurostat and the Internal Audit Department.

THE COURT'S OBSERVATIONS

1.82. The Commission declared that 91% of the baselines had been complied with by 31 December 2003 (69). Of these baselines, 26% seem to have been introduced since the end of September 2003 when the Directorates-General reported on their ability to meet the deadline of 31 December 2003 for complying with all of the baselines (70).

1.82-1.83. As indicated by the Court, Directorates-General assessed in December 2003 that overall 91% of the baselines were achieved against 65% reported by September 2003. It should be noted that in many cases those baselines not fully implemented by September 2003 were ongoing actions, where important progress had already been made and where there was only a little work required to finalise them.

As stated in the Overview, the Commission acknowledges that in future the focus on internal control will need to concentrate on how well the internal control arrangements are working in practice and delivering the assurances needed rather than focusing overly on compliance.

Furthermore, effective implementation of an appropriate internal control system which delivers the assurances needed takes time. In reality, important attempts have already been made in moving beyond compliance. To this end, the Commission has developed a tool, iCAT (internal control assessment tool), to help services to assess the effectiveness of their internal control systems and some Directorates-General started to use a first version of this tool in 2003.

1.83. In the Court’s view, it is hard to see how this rate of progress can have an immediate impact on the actual workings of the internal control system upon which the legality and regularity of the underlying transactions is based. As regards the introduction of procedural rules or control instruments, more time is needed to ensure that these standards are actually applied. Thus, in most cases the Court’s audit aimed to establish whether the practices of the Directorates-General complied with the internal control baselines (see paragraphs 4.23, 6.5, 7.40 and 7.41 and 9.55).

1.84. As regards the internal control standards examined at the Directorates-General selected, the Court found that the information presented was balanced insofar as it referred more to the existence and compliance of the internal control mechanisms than to their actual workings (see Table 1.4 and paragraphs 4.23, 5.10, 6.5, 7.43 and 9.55). Overall, this degree of implementation cannot yet be considered sufficient to enable the Commission’s internal control system to provide reasonable assurance as to the legality and regularity of the underlying transactions.

THE COMMISSION'S REPLIES

1.82-1.83. As indicated by the Court, Directorates-General assessed in December 2003 that overall 91% of the baselines were achieved against 65% reported by September 2003. It should be noted that in many cases those baselines not fully implemented by September 2003 were ongoing actions, where important progress had already been made and where there was only a little work required to finalise them.

1.84. The table 1.4 differs from the Commission’s services’ own assessment, which concludes that the internal control standards were 91% applied at 31 December 2003. The incomplete application largely concerned areas with little effect on the risk of irregularity.

Concerning the link between the level of compliance with those standards and the assurances needed on the legality and regularity of the underlying transactions, see Commission’s reply to paragraphs 1.82 and 1.83.

(69) Information note by Mrs Schreyer ‘concerning the readiness of Commission departments to comply with the minimum requirements of the internal control standards by 31 December 2003’ (SEC(2004) 250 of 27 February 2004).

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 2003

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Assessment:
A: implementation of the baseline requirements
B: inadequate implementation of the baseline requirements
Source: Court of Auditors.
THE COURT’S OBSERVATIONS

Indicators of the quality of revenue and expenditure

1.85. In general, the 2003 annual activity reports contain information on the results achieved (in terms of economy, efficiency and effectiveness) by the Directorates-General as regards political activities and the management of the resources allocated.

1.86. However, the Court’s analysis reveals that the design and use of this information by the Commission (71) is still not sufficient (72) to measure the quality of the internal control system and aspects of the legality and regularity of the underlying transactions (73).

The aspects linked to the legality and regularity of transactions are monitored by each Directorate-General. Ex ante and ex post control systems have been introduced or are now being introduced. Nevertheless, the Commission is ready to analyse the possibility of further developing the concepts of performance indicators already launched in the context of the Activity Based Management (ABM) process.

1.87. The Court believes that the production of information for monitoring the legality and regularity of the underlying transactions should be a priority for the Commission. In the context of the strategic planning and programming cycle, this information would be an essential management tool for guaranteeing the quality of the revenue and expenditure and for assessing the progress made (74) if it concerned the extent to which key aspects of the supervisory systems and controls had been implemented and the frequency, nature and impact on the budget of the errors which these systems and controls had not detected and rectified.

THE COMMISSION’S REPLIES

1.85. The aim of the annual activity reports is to take stock of the achievement of the objectives laid down in line with the Commission’s priorities and the resources required for this purpose. They represent an instrument for monitoring the results of activities in relation to the objectives laid down, the risks involved, utilisation of the resources allocated and operation of the internal control system.

1.86. The monitoring aspects are therefore highlighted in the annual activity reports. The overview mentioned above in paragraph 1.53 gives a more detailed account of internal control systems at the Commission.

The aspects linked to the legality and regularity of transactions are monitored by each Directorate-General. Ex ante and ex post control systems have been introduced or are now being introduced. Nevertheless, the Commission is ready to analyse the possibility of further developing the concepts of performance indicators already launched in the context of the Activity Based Management (ABM) process.

1.87. Continuous improvement of its performance and the assumption of responsibility by its managers to achieve the objectives laid down and implement an efficient internal control system are Commission priorities.

Although monitoring implementation of the control systems and determining the extent to which they guarantee the legality and regularity of transactions is not the sole purpose of the annual activity reports, the Commission is willing to explore the possibility of giving greater coverage to supervisory controls and risk management in the next annual activity report.

(72) Paragraphs 1.68 to 1.74 of the Annual Report concerning the financial year 2002
(73) E.g. the Directorates-General for Competition, Environment, Internal Market, Press and Communication, Interpretation, Trade, Energy and Transport, the Legal Service and the Group of Policy Advisers did not provide the performance indicators proposed by the guidelines.
(74) Paragraph 1.110 of the Annual Report concerning the financial year 2002.
CHAPTER 2

Budgetary management

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INTRODUCTION

2.1. This chapter discusses the implementation of the EU budget in 2003, the last full year before enlargement of the Union and halfway through the 2000-2006 financial perspective.

2.2. The annual budget of the European Union is approved by the budgetary authority (Parliament and Council) on the basis of proposals presented by the Commission. The Commission implements the budget in cooperation with Member States and other beneficiary states in the case of expenditure on agriculture, structural operations, external actions and pre-accession aid.

2.3. There are separate budgets for commitments and payments. 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 to 2006 for the Structural Funds current programming period), in which budgetary commitments — reflecting legal commitments to spend — are made in one year but paid off ('liquidated') over a number of years ('differentiated appropriations') (1).

2.4. Detailed information on budgetary implementation for 2003 can be obtained from the Commission document entitled 'Report on budgetary and financial management — Financial year 2003'. Article 29 of the Financial Regulation requires this report to be published in the Official Journal of the European Union. This was not done for the 2002 report but the document was made available on the Commission's website (2). The 2003 version is available at the same location. The Court notes the efforts made to improve the document as compared with 2002 but considers that the overall analysis could be made more useful by including information on the cumulative state of implementation of Community programmes and on the speed with which Member and beneficiary States make payments to final beneficiaries.

2.4. The Commission appreciates the Court’s statement regarding the improved 'Report on budgetary and financial management' and agrees with the observation of the Court that there is still room for further improvements. With regard to payments to final beneficiaries, the regulations (for example, Regulation (EC) 1260/1999 for the Structural Funds, Regulation (EC) 1663/95 for EAGGF Guarantee) require Member and beneficiary States to reimburse final beneficiaries promptly. In future the Commission could distinguish, in the information provided on the Structural Funds in its 'Report on budgetary and financial management', between advances, paid at the beginning of the period and serving to constitute a rolling fund with which to pre-finance expenditure, and reimbursements of expenditure declared by final beneficiaries. The amount of advances (for the Structural Funds, 7 %) can be taken to be equivalent to the maximum level of payments by the Commission not yet paid to final beneficiaries.

(1) See Annex I for further background information on the budget.
GENERAL OBSERVATIONS

Increase in budget

2.5. For 2003, total payment appropriations in the approved initial budget (1) increased by 1.9% compared with the final 2002 budget. Commitment appropriations increased by just 0.3%. According to the Commission the virtually static level of commitment appropriations ‘demonstrates the determination of [the] budgetary authority and [the] Commission alike to tackle the problems of outstanding commitments still awaiting payment’ (2).

2.6. Commitment and payment appropriations remained respectively 2.6 billion euro and 5.4 billion euro below their annual financial perspective ceilings (3). The margin in respect of commitments mostly relates to agriculture: the other expenditure areas are at, or near, their respective ceilings. For payments, the financial perspective ceiling applies to the budget as a whole and not by area.

92% spending rate for payments

2.7. Table 2.1 gives an overview of the budgetary outturn for the 2003 financial year for both commitments and payments. In 2003 the proportion of commitment appropriations used (the implementation rate for commitments) was 99%, similar to the 98% rate in 2002. The proportion of payment appropriations used (the spending rate for payments) was 92%, which represents an increase on the 86% achieved in 2002. This increase was primarily due to higher spending on structural operations — 90% of payment appropriations were spent, compared with 74% in 2002 (see paragraphs 2.27 to 2.30).

2.8. These overall spending rates do not tell the whole story about budget implementation for two main reasons. Firstly, only a small proportion of the commitments made in a particular year result in payments during the same year (see paragraphs 2.3 and 2.16 to 2.22). Secondly, ‘payments’ as defined in the Commission’s accounts include advances made to Member and beneficiary States administrations’ or other intermediaries to be used for payment to final beneficiaries. In some cases, such as Sapard (see paragraph 2.43), payment of the funds to final beneficiaries can take considerably longer.

2.8. In the case of Sapard, payments are made upon receipt of eligible claims, where the beneficiaries have to demonstrate that eligible project expenditure has been incurred. This process can be lengthy. The Sapard countries generally experienced technical and procedural difficulties during the initial period of implementation, resulting in delays in the processing of applications and payment claims. Although there are still certain problems in some countries, overall the situation has improved substantially.

(2) Source: General budget of the European Union for the financial year 2003 — The figures, paragraph 3.
(3) Subsequent amending budgets brought the commitment appropriations to 2.5 billion euro and payment appropriations to 10.4 billion euro below the ceilings.
### Table 2.1 — Implementation of the 2003 budget by financial perspective heading

(million euro and %)

<table>
<thead>
<tr>
<th>Financial perspective heading</th>
<th>Financial perspective ceiling</th>
<th>Budget</th>
<th>Implementation of the budget</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Initial appropriations (1)</td>
<td>Final appropriations (2)</td>
<td>Commitments and payments made</td>
</tr>
<tr>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
</tr>
</tbody>
</table>

**Commitment appropriations**

| Common agricultural policy  | 47 378           | 44 780           | 44 865           | 44 462           | 99%  | 41 | 0,1 | 361 | 0,8 |
| Structural operations       | 33 968           | 33 980           | 34 013           | 33 987           | 100% | 4  | 0,0 | 22  | 0,1 |
| Internal policies           | 6 796            | 6 796            | 7 744            | 7 173            | 93%  | 43 | 1,2 | 13  | 0,4 |
| External action             | 4 972            | 4 949            | 5 219            | 5 067            | 97%  | 94 | 1,8 | 59  | 1,1 |
| Pre-accession aid           | 3 386            | 3 386            | 3 449            | 3 393            | 98%  | 43 | 1,2 | 13  | 0,4 |
| Administrative expenditure  | 5 211            | 5 360            | 5 616            | 5 545            | 99%  | 39 | 0,7 | 31  | 0,6 |
| Reserves                    | 434              | 434              | 328              | 148              | 45%  | 0  | 0,0 | 180 | 54,9 |
| Rounding                    | 1                | –                | –                | –                | –    | –  | –   | –   | –   |
| **Total**                   | **102 145**      | **98 686**       | **101 233**      | **99 775**       | **99%** | **651** | **0,6** | **807** | **0,8** |

**Payment appropriations**

| Common agricultural policy  | 44 780           | 45 096           | 44 379           | 98%  | 331 | 0,7 | 385 | 0,9 |
| Structural operations       | 33 173           | 31 838           | 28 528           | 90%  | 177 | 0,6 | 3 134 | 9,8 |
| Internal policies           | 6 204            | 7 257            | 5 672            | 79%  | 920 | 12,7 | 665 | 9,2 |
| External actions            | 4 844            | 4 899            | 4 286            | 88%  | 113 | 2,3 | 500 | 10,2 |
| Pre-accession aid           | 2 707            | 2 799            | 2 240            | 80%  | 55  | 2,0 | 504 | 18,0 |
| Administrative expenditure  | 5 360            | 6 087            | 5 305            | 87%  | 650 | 10,7 | 132 | 2,2 |
| Reserves                    | 434              | 364              | 148              | 41%  | 0   | 0,0 | 216 | 59,3 |
| Rounding                    | 1                | –                | –                | –    | –   | –   | –   | –   |
| **Total**                   | **102 767**      | **97 318**       | **98 339**       | **90 558**       | **92%** | **2 246** | **2,3** | **5 535** | **5,6** |


(2) Budget appropriations amended after taking into account amending budgets and transfers, and including appropriations carried over from 2002, appropriations resulting from the contributions by third parties and other revenue corresponding to a defined purpose, and appropriations made available again.

Source: 2003 annual accounts.
Reduced and better managed surplus

2.9. For 2003 the surplus (6) of the budget totalled 5,5 billion euro — for analysis see Table 2.2. While still large in absolute terms, it represents a fall compared with 7,4 billion euro in 2002 and 15,0 billion euro in 2001.

Table 2.2 — Composition of surplus 2003 (and 2002)

<table>
<thead>
<tr>
<th>Revenue</th>
<th>2003</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budgeted</strong></td>
<td><strong>Amending budgets (7)</strong></td>
<td><strong>Collected</strong></td>
</tr>
<tr>
<td>Own resources</td>
<td>88 989</td>
<td>– 4 978</td>
</tr>
<tr>
<td>Other revenue</td>
<td>8 514</td>
<td>9 836</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>97 503</strong></td>
<td><strong>– 4 978</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenditure</th>
<th><strong>Underspending (8)</strong></th>
<th><strong>Amending budgets (7)</strong></th>
<th><strong>Less carryover to 2004 (9)</strong></th>
<th><strong>Underspending (8)</strong></th>
<th><strong>Less carryover to 2003 (9)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>717</td>
<td>– 331</td>
<td>386</td>
<td>1 419</td>
<td>– 315</td>
</tr>
<tr>
<td>Structural operations</td>
<td>8 310</td>
<td>– 5 000</td>
<td>– 177</td>
<td>3 133</td>
<td>8 104</td>
</tr>
<tr>
<td>Internal policies</td>
<td>1 585</td>
<td>– 920</td>
<td>665</td>
<td>1 390</td>
<td>– 750</td>
</tr>
<tr>
<td>External actions</td>
<td>613</td>
<td>– 113</td>
<td>500</td>
<td>546</td>
<td>– 68</td>
</tr>
<tr>
<td>Pre-accession aid</td>
<td>559</td>
<td>– 55</td>
<td>504</td>
<td>849</td>
<td>– 51</td>
</tr>
<tr>
<td>Administration</td>
<td>760</td>
<td>22</td>
<td>– 650</td>
<td>132</td>
<td>645</td>
</tr>
<tr>
<td>Reserves</td>
<td>216</td>
<td>0</td>
<td>216</td>
<td>481</td>
<td>– 9</td>
</tr>
<tr>
<td>Rounding</td>
<td>– 1</td>
<td>– 1</td>
<td>1</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>12 759</strong></td>
<td><strong>– 4 978</strong></td>
<td><strong>– 2 246</strong></td>
<td><strong>5 535</strong></td>
<td><strong>13 434</strong></td>
</tr>
</tbody>
</table>

| Exchange differences | – 109 | – 253 |
| Earmarked revenue (6) | – 740 | 0 |
| Other (7) | – 146 | – 147 |
| **Total surplus** | **5 484** | **7 422** |

(6) The surplus is not a reserve which can be used in future years. Unused payment appropriations are in most cases cancelled and 'lost'.

Source: 2003 annual accounts.

(8) Includes the cancellation of 2 074 million unused credits brought forward (309 million in 2002).
(9) Amount carried over includes, 1 044 million euro in respect of third party earmarked revenues for which the usual cancellation rules for carry-overs do not apply (684 million euro in 2002).
(9) Adjustment for earmarked revenue received but not budgeted for. No adjustment necessary in 2002 due to different budgeting procedures.
(9) Sundry elements mainly related to reused credits carried forward and EFTA contributions.
2.10. In respect of the 2002 financial year the Court criticised the Commission for failing to take action on substantial underspending, although the situation was foreseen before the year end (7). In 2003 specific measures were taken by the Commission to improve the forecasting of the use of the budget, taking into account information from Member and beneficiary States. The improved information received permitted the Commission to bring forward the amending budget referred to above whereby it reduced payment appropriations by 5 billion euro, with a commensurate reduction in revenue.

2.11. The Commission’s action during 2003 represented a significant improvement in budgetary management as compared with the previous year. However, despite the action taken, the large remaining surplus (5.5 billion euro) indicates that there was scope for a substantially greater reduction in appropriations.

2.12. Table 2.3 shows the level of gross underspending, and its consequences, for the past five years. Over this period underspending has caused 39.9 billion euro of payment appropriations to be cancelled. Over the same period the budget has increased by 16.3 %, representing a cumulative total of 53.6 billion euro of extra appropriations.

<table>
<thead>
<tr>
<th>Table 2.3 — Underspending 1999 to 2003 (million euro)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underspending (1)</td>
</tr>
<tr>
<td>Proportion of budget</td>
</tr>
<tr>
<td>Resulting in:</td>
</tr>
<tr>
<td>Amending budget</td>
</tr>
<tr>
<td>Carryover</td>
</tr>
<tr>
<td>Cancellations</td>
</tr>
</tbody>
</table>

(1) Gross underspending on payment appropriations for the year and appropriations brought forward. Source: Annual accounts 1999 to 2003.

2.13. The Court notes that it is unrealistic to expect 100 % implementation of the budget. Expenditure must be legal and regular and respect the principles of sound financial management. In the shared management areas of the budget (over 80 % by value) if requests are not forthcoming from Member States or other intermediaries the Commission cannot make payments. Even with directly managed expenditure the Commission often depends on claims from beneficiaries. The consequence of continued underspending is an increase in the build-up of outstanding commitments (see paragraphs 2.16 to 2.22) and a concentration of payments at the end of the programming period which is difficult to manage.

(7) Paragraph 2.10 of the Court’s 2002 Annual Report.
THE COURT’S OBSERVATIONS

More realistic carryover of appropriations from year to year

2.14. As the Court pointed out in its 2002 Annual Report (8), the carryover of appropriations from one year to another complicates the management, accounting and reporting of the budget unnecessarily. The carryover of payment appropriations from 2002 of 5.0 billion euro, which considerably reduced the reported surplus in that year, was significantly in excess of the carryover in previous years (see Table 2.3). Of the amount carried over, 3.3 billion euro represented appropriations for the settlement of final claims on the 1994 to 1999 programming period for the Structural Funds. In its 2002 annual report (9) the Court warned that it was unlikely that the Commission would be able to liquidate these appropriations, and this proved to be the case: 1.9 billion euro of these credits were cancelled in 2003, adding to the surplus.

2.15. The carryover of payment appropriations from 2003 to 2004 is 2.2 billion euro, comprising 1.2 billion euro in respect of the operational budget and 1.0 billion euro in respect of third party funds (see paragraph 2.37). Compared with 2002 this represents a more realistic level of carry forward of credits.

Outstanding commitments continue to increase

2.16. At the start of the programming cycle for expenditure subject to multiannual programmes it can take Member and beneficiary States a considerable time to set up the required administrative and control procedures, identify and approve suitable projects for EU financing and provide the necessary national co-financing. Other than the payment of first advances, which precede underlying expenditure on a project, it is therefore often difficult for the Commission to make substantial payments from the budget until well into the programming cycle. The budget for payment appropriations should be more realistic by taking better account of the programme cycle and the ability of Member States to absorb expenditure. Commitments are made at the beginning of the programme (except in the case of the Structural Funds where they are made on an annual basis — see paragraph 2.33) and are carried forward (10) until the corresponding payments are made.

THE COMMISSION’S REPLIES

2.14. The Commission considers that the carryover procedure set by the regulatory framework is expedient, fairly simple, practical and transparent (see Commission’s reply to the 2002 annual report, paragraphs 2.11 and 2.48).

After the carryover, the amount of payment appropriations on the budget for the settlement of final claims for the 1994 to 1999 programme period was in line with the Member States’ forecasts of the payments they would claim on the commitments outstanding. The budget turned out to be more than required for two reasons. First, the forecasts underestimated the amount of commitments that would not be claimed and would have to be decommitted. In the event, some EUR 2.8 billion of commitments were decommitted in 2003 in addition to the EUR 3.5 billion paid. Secondly, the closure documents (most of which were received just before the deadline of 31 March 2003) were of uneven quality, requiring clarifications and further work by Member States in many cases and delaying closure in these cases until 2004.

2.15. The Commission considers that the budget for payment appropriations should be more realistic by taking better account of the programme cycle and the ability of Member States to absorb expenditure. The payments budgets presented by the Commission represent its best estimates of the actual payment needs. As reliance on Member States’ payment forecasts led to an over-estimation of needs, the Commission has resorted to budgeting more in line with its own estimates, based on recent patterns in implementation and foreseeable trends. As a result, implementation rates have improved in the last few financial years.

The overlap of programme cycles for multiannual programmes tends to smooth the pattern of payments over time. For example, at the beginning of a new Structural Fund programme, period payments made in respect of programmes of the previous period normally compensate for the still low

(8) Paragraph 2.11.
(9) Paragraph 2.26.
(10) Subject to certain conditions such as a final date for implementation set in compliance with the principles of sound financial management (Article 77 of the Financial Regulation) or specific measures such as the year n+2 rule in respect of the Structural Funds (see paragraph 2.35).
level of payments under current programmes before they reach cruising speed. This compensatory effect was less marked during the changeover from the 1994 to 1999 to the 2000 to 2006 periods, mainly because of the changeover in the payments system between the two periods from an advance-based to a reimbursement-based system. The Commission refers to its communication of 20 September 2002 ‘Evolution of budgetary execution of the Structural Funds, in particular outstanding commitments (RAL)’ (COM(2002) 528 final).

2.17. The higher the value of the outstanding commitments, the greater is the demand on the payments budget in future years. The lags inherent in the budgetary process are illustrated by Table 2.4. For ‘differentiated’ expenditure (11), payments in 2003 in respect of commitments made during 2003 totalled only 5.7 billion euro out of the 49.6 billion euro committed, or some 11%. In practice commitments can take many years to clear, and others never result in payment and have to be cancelled — see paragraph 2.21.

2.17. The time lag between commitments and payments of ‘differentiated’ expenditure, which is responsible for the ‘RAL’, is inherent in the budgeting of this expenditure. As noted in the reply to the previous point, the pattern of such expenditure is smoothed over time by the overlap of financial perspective periods.

Table 2.4 — Change in balance of outstanding commitments 2003

<table>
<thead>
<tr>
<th></th>
<th>Grand total</th>
<th>Non-differentiated expenditure</th>
<th>Differentiated expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Agriculture</td>
<td>Administration</td>
<td>Reserves</td>
</tr>
<tr>
<td>Commitments brought forward</td>
<td>99 820</td>
<td>231</td>
<td>473</td>
</tr>
<tr>
<td>Balance brought forward</td>
<td>- 35 590</td>
<td>- 210</td>
<td>- 376</td>
</tr>
<tr>
<td>Payments</td>
<td>- 4 138</td>
<td>- 3</td>
<td>- 11</td>
</tr>
<tr>
<td>Decommitments</td>
<td>- 102</td>
<td>- 19</td>
<td>- 83</td>
</tr>
<tr>
<td>Cancellations</td>
<td>-6</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Commitments made in 2003</td>
<td>99 775</td>
<td>44 462</td>
<td>5 545</td>
</tr>
<tr>
<td>Payments</td>
<td>-6</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Cancellations</td>
<td>104 791</td>
<td>292</td>
<td>613</td>
</tr>
</tbody>
</table>

Source: 2003 annual accounts.

(11) Expenditure on structural operations, internal policies, external actions and pre-adhesion aid.
2.18. At the end of 2003 outstanding commitments totalled 104.8 billion euro — see Table 2.4. This is equivalent to 94 % of the commitment budget for 2004 (EU25) and represents an increase of 5.0 % compared with 2002. The increase took place despite:

— decommitments of 4.1 billion euro, 2.7 billion euro of which related to a special procedure (see paragraph 2.21);

— a near-static commitments budget in 2003 (see paragraph 2.5); and

— the inclusion in the budget of additional payment appropriations specifically intended to alleviate the problem.

For differentiated expenditure the balance of outstanding commitments represents around 2.5 years of payments at the current spending rate. At a similar point during the previous financial perspective period (1996) the value of outstanding commitments on differentiated expenditure was 47.9 billion euro, representing just under one-and-a-half years of payments at the then spending rate.

2.19. However, the balance of outstanding commitments does not represent the full extent of legal commitments of expenditure made by the Union, due principally to the effect of the Structural Fund commitment process (see paragraph 2.33). The balance of expenditure legally committed at the end of 2003 on the 2000 to 2006 programming period, and disclosed as off balance sheet items in the annual accounts, but not yet appearing as commitments in annual budgets, amounts to some 95 billion euro (see paragraph 2.34). Taking this into account total commitments outstanding some three years before the end of the current programming period therefore stand at around 200 billion euro, or five years of payments at the current rate (12). Although the time limit for making payments goes beyond the end of the programming period (13), a high level of outstanding commitments will put pressure on the payments budget and may possibly delay the closure of the programmes. These factors risk influencing the budgetary implementation of the early years of the next programming period as has been the case in the past.

2.19. The Commission refers to its answer to paragraph 2.48.

(12) Notwithstanding the annual commitments to be made in the other budgetary areas over the period.

2.20. **Graph 2.1** shows the value of outstanding commitments on differentiated expenditure over the past ten years, compared with the commitment budget for each year. Over the last five years there has been a 47% increase in the value of outstanding commitments for differentiated expenditure. This was due to two factors: firstly, the years 2000 to 2003 are the start-up period for major programmes (14) (see paragraph 2.16); and secondly, continued underspending of payment appropriations (see paragraphs 2.12 and 2.13).

**Graph 2.1 — Outstanding commitments 1994 to 2003**

**Differentiated appropriations: 1994 to 2003**

- Total outstanding commitments
- Commitment budget

**NB:** Differentiated appropriations comprises expenditure on structural operations, internal policies, external actions and pre-adhesion aid.

---

(14) Structural Funds 2000 to 2006; Sixth framework programme for research and technological expenditure — 2002 to 2006.
2.21. For a number of years the Court has been highlighting the need for the Commission to identify and take action on old and dormant outstanding commitments which may never result in payments. At the end of 2002 in a joint declaration the Budgetary Authority and the Commission undertook to deal with ‘potentially abnormal’ outstanding commitments (15) by the end of 2003. During 2003, of the 17.3 billion euro identified as ‘potentially abnormal’, payments were made on 4.0 billion euro, 2.7 billion euro were decommitted and 10.6 billion euro were found to be valid and therefore maintained.

2.22. The current budget data and its analysis provides little information on the consequence of the high level of outstanding commitments, as well as on the cumulative state of implementation of the different Community programmes. The high level of outstanding commitments represents a significant demand on future payments which may be difficult to manage in the context of the budgetary process, and in terms of respecting the financial perspective ceiling.

2.22. For the Structural Funds the Commission already provides information, inter alia, on the cumulative state of implementation in its annual ‘Analysis of the budgetary implementation of the Structural Funds’. The Commission is, however, ready to provide further information (see reply to paragraph 2.50). The demand on future payments should be reduced by the ‘n+2’ rule (see reply to paragraph 2.48).

SPECIFIC OBSERVATIONS

Community revenue

2.23. Table 3.1 summarises Community revenue for 2003 and Graph 3.1 shows the distribution of the different types of revenue. Graph 3.2 illustrates the evolution of actual revenue over the period 1989 to 2003. In particular, traditional own resources and the VAT resource declined in importance; the Gross National Income (GNI) resource rose. Amending budget No 6/2003 of 4 December 2003 reduced the amount of the revenue required for 2003 by 5.0 billion euro.

2.24. The amounts of the VAT-based resource collected fell by 5.0% compared with 2002 due to adjustment of the VAT bases of previous years, the fluctuations in the pound sterling/euro exchange rate and a lower-than-previous uniform rate of call. In addition a decrease of 2% of the GNI forecasts impacted the VAT resource through the capping procedure (16).

(15) Defined as commitments for which no payments have been made for the last two years, and commitments that have been in the budget for at least five financial years.

(16) The VAT resource is derived from the VAT base which is defined as the total value of goods and services liable to VAT according to the 6th Directive. This base is capped so that it will not exceed 50% of GNI in each country. If GNI falls then so does the VAT resource.
Agriculture

2.25. Total available appropriations for commitment and payment for agriculture in 2003 amounted to 44.9 billion euro and 45.1 billion euro respectively (\(^\text{17}\)) , an increase of 1.2 % compared with 2002. Final expenditure was 44.5 billion euro for commitments (99 % implementation rate) and 44.4 billion euro for payments (98 % implementation).

2.26. The lowest rate of spending (64 %) was on a variety of measures which collectively accounted for 3 % of the total authorised appropriations, including export refunds on processed products, food programmes and veterinary measures (‘ancillary expenditure’). The underspending was mainly due to delays in implementing veterinary and plant health measures. Such expenditure also comprises the bulk of the amount carried over to 2004. Implementation in the other areas of the budget, including rural development (\(^\text{18}\)), was almost total.

Structural operations

2.27. The commitment budget for the year increased by 0.4 % compared with 2002. The payment budget increased by 3.2 % compared with 2002. The overall spending rate for payments (after the cancellation referred to in the following paragraph) was 90 %, which represents a significant increase on implementation in 2002 (74 %).

2.28. Gross underspending compared with the original budget was 8.3 billion euro, a similar level to 2002 (see Table 2.2). However the effect on the overall surplus was reduced by the cancellation of 5.0 billion euro of payment appropriations that the Commission realised could not be spent (see paragraph 2.31). Despite the net underspending of 3.3 billion euro for structural operations overall, a large increase in spending took place in respect of Objective 2, where the rate of implementation increased from 48 % in 2002 to 91 % in 2003 (based on a 1.1 % higher budget).

\(^{17}\) Including amounts carried over from 2002.

\(^{18}\) Unlike in 2002, when there was a significant underspending on rural development: paragraph 2.19, Court’s 2002 Annual Report.
2.29. For Community Initiatives, which are programmes carried out in Member States at the initiative of the Commission, implementation in 2002 was only 25 % and the budget was reduced by 2 % in 2003. The spending rate in 2003 was 48 %, largely due to delays in the closure of the 1994 to 1999 period programmes (30 % spending rate) because of the late submission of final claims by Member States. For payments in 2003 related to the 2000 to 2006 period the spending rate was 75 %.

2.30. For on-going payments under the current Structural Fund programmes (2000 to 2006 period), which represent about 74 % of the total initial budget for the area, the spending rate was around 96 %, an increase on the 91 % achieved in 2002. The spending rate was much lower for the closure of the 1994 to 1999 programmes. Some 11.0 billion euro of payment appropriations were available for the year: only 3.5 billion euro (32 %) were used (19). The Commission responded by cancelling 5 billion euro of payment appropriations relating to the pre-2000 programmes in an amending budget which increased the overall spending rate (see paragraph 2.27).

2.31. In its 2002 Annual Report (20) the Court highlighted poor forecasting by Member States as one of the main reasons for the Commission not being able to take appropriate and timely action on underspending. Efforts were made in 2003 to improve the forecasting process and the overall forecasting error for the Structural Funds fell from 73 % to 50 %. However, this still represents a difference between forecast and actual payments of 13.0 billion euro. For the 2000 to 2006 programmes the best Member State estimate was 12 % higher than actual needs, and the worst estimate was over two-and-a-half times actual needs — five Member States had forecasting differences of over 1 billion euro.

2.30. In addition to payments for 1994 to 1999 programmes of EUR 3.5 billion, some EUR 2.8 billion were decommitted. The combined effect of payments and decommitments reduced the ‘RAL’ for 1994 to 1999 programmes from EUR 15.4 billion at the end of 2002 to EUR 9.1 billion at the end of 2003, a reduction of 41 %.

2.31. The Commission refers to its answer to paragraph 2.16.

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(19) As reported in paragraph 2.26 of the Court’s 2002 Annual Report delays were experienced by the Commission in closing programmes due to most claims being received close to the deadline (31 March 2003) and the often incomplete nature of those claims, leading to the significant risk that payments could only be made in 2004. The Commission’s forecasts did not take the possibility of these delays sufficiently into account.

(20) Paragraph 2.24.
THE COURT’S OBSERVATIONS

2.32. Despite measures to ensure that applications for payments are received from Member States evenly throughout the year (21), during 2003 over half of the payments were made between September and December, and one quarter in December alone. This concentration of processing of transactions at the year end makes an unreasonable demand on the Commission’s management resources.

2.33. The commitment appropriations for the 2000 to 2006 Structural Fund period have to be entered in the budget according to the allocation of the financial perspective, as determined by the European Council meeting in Berlin. The overall allocation for the seven-year period is 230,2 billion euro (22) (both Structural Funds and Cohesion Fund together). Of the 210,6 billion euro relating to the Structural Funds, 201,1 billion euro (23) were allocated to Member States (i.e., legal commitments were made) through expenditure programmes agreed between 2000 and 2002. Budgetary commitments are then made annually over the seven-year programming period. Because of the delays in adopting the new programmes the planned level of legal commitments could not be made, so the financial perspective ceilings from 2002 onwards were increased by the appropriations not used in 2000 and 2001.

2.34. For the 2000 to 2002 period net underspending on structural operations payment appropriations totalled 26,6 billion euro (2000: 8,0 billion euro; 2001: 10,5 billion euro; 2002: 8,1 billion euro). Outstanding commitments for structural operations increased by 2,5 billion euro to 69,3 billion euro in 2003; nearly two-and-a-half years worth of payments at the 2003 spending rate. In relation to the 2000 to 2006 programming period outstanding commitments increased by 19 % to 53,2 billion euro — 2,3 times current spending. Moreover legal commitments made following the European Council meeting in Berlin, but not yet transformed into budgetary commitments (see paragraph 2.33), total 95 billion euro (24), giving a total outstanding commitment equivalent of over 164 billion euro, or nearly six years of payments.

THE COMMISSION’S REPLIES

2.32. The Commission has little influence on the pattern of expenditure declarations by Member States. The Regulation asks for payment claims to be submitted three times a year, the third one by the end of October, but does not provide for sanctions. The ‘n+2’ rule has an impact in both directions: it encourages Member States to file large payment claims just before the year-end; on the other hand, the Commission’s regular reminders of the situation of programmes with regard to the rule encourages them to accelerate claims.

Increase in outstanding commitments

(21) Article 32(3) of the general provisions of the Structural Funds requires that Member States ensure, as far as possible, that applications for interim payments are presented to the Commission in batches three times a year, with the last application being no later than 31 October.

(22) At 2003 prices.

(23) 8,4 billion euro was retained as a performance reserve, and 1,1 billion euro for technical assistance and innovative measures were not pre-allocated.

(24) See off-balance-sheet commitments in the annual accounts: item 5 of contingent liabilities.
2.35. For the 2000 to 2006 programming period, new rules were introduced to decommit commitments automatically for which no payment has been made within the two years following the year the commitment was made. The decommitments in 2003 following these rules amounted to just 31 million euro, representing 24 million euro for ESF and 7 million euro for EAGGF-Guidance. No decommitments were made for ERDF because intermediate expenditure claims were made by Member States. However, there is a risk of Member States claiming expenditure that is ineligible, in order to avoid the cancellation of commitments.

The Commission recognised the risk to which the Court refers and took action by increasing its checks on payment claims.

2.36. Expenditure falling within the Internal policies category of the financial perspective is mostly directly managed by the Commission and is dominated by research and technological development, which represented 58 % of payments in 2003. The approved payments budget showed an average 0.8 % increase on 2002, with a wide variation between the various headings. For example research and technological development expenditure was subject to a 2.7 % reduction in appropriations, whilst for Trans-European networks there was a 12 % increase. Approved commitment appropriations increased by an average of 3.4 %.

2.37. The payment spending rate was 78 %, representing a fall compared with 2002 (83 %). However, this underspending, which contributed 626 million euro to the overall surplus, is in large part explained by the special arrangements for ‘earmarked third party revenues’ (25). When third countries contribute to Community programmes the contributions are recorded in the year of receipt as both commitments and payments appropriations, even though the time needed to implement projects means that demand for payments is spread over several years. Unused payment appropriations are carried forward automatically until the funds can be used, which has a corresponding downward effect on the spending rate. Of the 1.6 billion euro gross underspending for the year, 0.8 billion euro was contributed by the third party revenue-linked expenditure (27 % spending rate), and utilisation of the standard budgetary appropriations — with a spending rate of 93 % — contributed the balance.

(25) See paragraphs 2.32 and 2.33 of the Court’s 2002 Annual Report.
2.38. Outstanding commitments at the end of the 2003 financial year amounted to 12.2 billion euro — an 8.9 % increase on 2002 — which represents over two years of payments at the current spending rate. This reflects the higher increase in commitments than payments for the year (3.4 % versus 0.8 %) and is partly explained by the fact that 2003 was near the beginning of the 6th framework programme (FP6) for research and technological development (2002 to 2006).

External actions

2.39. Expenditure on external actions is mostly directly managed by the Commission and comprises a large number of different headings, with no single heading representing more than 16 % of the total. The approved budget for commitments was 3.0 % higher than in 2002. In the case of payments the increase was 3.8 %. The spending rate for payments was 87 %, similar to that in 2002 (89 %), which indicates that the extra budget was absorbed, but no more.

2.40. At the end of 2003 the outstanding commitments amounted to 12.9 billion euro, an increase of 1.0 % compared with 2002. The balance of outstanding commitments represents three years’ worth of payments at the current spending rate.

Pre-accession aid

2.41. Pre-accession aid comprises amounts paid to accession and candidate countries to the European Union and is mostly managed in cooperation with the beneficiary states. Only 67 % of payment appropriations were spent in 2002. In the 2003 budget, commitment and payment appropriations increased by 1.7 % and 4.3 % respectively. In 2003 payments totalled 2.2 billion euro, representing a spending rate of 80 %. Underspending, though proportionately less than in 2002, contributed 0.5 billion euro to the overall surplus.

2.42. For phare expenditure was 1.5 billion euro, representing a spending rate of 94 %, and a substantial increase from the 69 % rate in 2002.
2.43. Sapard (26), the smallest of the three pre-accession instruments, received a year-on-year increase in payment appropriations of 20 % (73 million euro out of the overall 112 million euro increase), despite a spending rate of just 34 % in 2002. Payments made to beneficiary states in 2003 increased to 264 million euro (a rate of 61 %), but not by nearly enough to absorb the increased budget. Implementation depends on requests for payment from the beneficiary states, and these were received later than expected. By the end of 2003, 323 million euro had been transferred to final beneficiaries. This represents a substantial increase over 2002 (34 million euro) but cumulative payments to final beneficiaries of Sapard until the end of 2003 still only represents 15 % of available funds (2 % by the end of 2002).

2.43. The Commission’s answer to paragraph 2.39 of the Court’s 2002 annual report sets out the reasons for the under-utilisation of the budgets for Sapard, one of which was that greater priority was given to firm management of appropriations.

Overall spending rates in 2002 were low chiefly because Poland, Romania and Hungary, which together account for 70 % of the total Sapard budget, did not receive the Decision conferring management of aid (itself conditional upon the establishment of sound administrative and control systems by the national authorities) until the second half of that year.

Payments made and payment applications received by the Commission as at 1 July 2004 amounted to EUR 688,7 million (32 % of available funds for the 2000 to 2003 period) of which EUR 429,6 million have been transferred to final beneficiaries. The implementation of Sapard has now reached cruising speed.

2.44. The ISPA (27) spending rate of payment appropriations fell from 79 % in 2002 to 60 % in 2003. The low rate of implementation was due to a higher than needed budget and slower than expected project implementation. Delays were encountered in tendering and contracting procedures and in beneficiary state administrations making requests for first advance payments following project approval.

2.44. Tendering procedures were protracted in some cases because of the need to ensure a fair and transparent process. The Commission encouraged beneficiary state administrations to request their first advance payments quickly, but they were sometimes slow in doing so.

2.45. At the end of 2003 outstanding commitments on all pre-accession aid totalled 9,5 billion euro, representing over four years worth of expenditure at the current rate (the highest of any budgetary area). Despite the payments budget being increased to help reduce the level of outstanding commitments, the balance rose by 13,2 % compared with 2002.

2.45. The Commission refers to its reply at paragraph 2.48.

In pre-accession aid as in other budget areas, commitments in the budget are predetermined by the conclusions of the Berlin Council 1999 and the related Interinstitutional Agreement. Annual commitments are then made (for Sapard in the decisions authorising signature of each annual financing agreement) which give rise to a global commitment of the appropriations in the Community budget.

Consequently, the level of outstanding commitments (the difference between total available commitments and payments made) is not solely a function of future payments but also a result of administrative steps, predetermined by the relevant regulations. Payments are made upon receipt of eligible claims, where the beneficiaries have to demonstrate that eligible project expenditure has been incurred. The ratio of outstanding commitments to payments will continue to fall as payment rates improve.

(26) Instrument supporting sustainable agricultural and rural development in the central and eastern Europe Member States and candidate countries.

(27) Instrument supporting economic and social cohesion in the applicant countries, particularly in the fields of the environment and transport.
THE COURT’S OBSERVATIONS

2.46. Administrative expenditure mostly comprises staff and building costs. Two thirds of the budget is used by the Commission, with the other institutions and agencies making up the balance. For 2003 the budget increased by 3.5% (28) to meet the effects of inflation and prepare for enlargement, with the Commission receiving a 2.1% increase, the other institutions a 4.5% increase and pensions a 6.3% increase. The increase for the Commission was moderated by the front-loading of expenditure on enlargement in the 2002 budget (29); without this measure the budget would have exceeded the financial perspective ceiling. The implementation rate was 87%, a small decrease on 2002 (89%).

CONCLUSIONS AND RECOMMENDATIONS

2.47. On the basis of implementation of the 2003 budget, management by the Commission can be judged a partial success: estimates were improved, underspending was reduced and action was taken to reduce appropriations before the year end. However, the surplus of the year of 5.5 billion euro (and the underlying underspending) remains large, and shows the potential for further improvement.

2.47. The annual payment budget is principally established through a 'bottom-up' procedure. For each commitment, the corresponding payment profile is determined, as a rule assuming a normal rate of implementation. Accordingly, unforeseen delays and downward adjustments of programmes lead to an under-implementation (i.e., an over-budgeting) of appropriations.

At authorising officer level, priority is given to safeguarding the availability of payment appropriations to be able to meet, at due date, all payment obligations. The need to safeguard the availability of appropriations is also partly due to the time-consuming procedures for transfers and supplementary budgets, which require the approval of the budgetary authority.

For the Structural Funds, by far the biggest source of aggregate under-implementation and/or over-budgeting in the last years, the payment budget has been based on Member States’ forecasts, with a substantial downward adjustment due to the Commission’s own estimates, as well as a need for an overall budgetary rigour, capping the annual growth of the payment budget. The past substantial forecasting uncertainties for the Structural Funds have been, to a large extent, related to the closure of the 1994 to 1999 programmes with unexpected large under-utilisation of the programme allocations by Member States.

However, within the above constraints, the Commission is looking at possibilities to reduce the aggregate over-budgeting of the past years. One possibility is to shorten the time span — and thereby the uncertainties — between the payment forecast, budget decisions and implementation. This can be done by revising forecasts during the budgetary procedure, before the budget is finally approved, however, only within the limits of the Financial Regulation. A second possibility is to make an active use of the ‘early warning system’, i.e., the annual budget implementation plan and

(28) The same for both commitments and payments as the administrative expenditure is non-differentiated.

(29) A similar frontloading exercise occurred in respect of the 2002 financial year involving the 2001 budget.
2.48. The value of outstanding commitments continued to grow in 2003 and reached 104 billion euro by the year end, despite measures taken by the Commission such as the provision of additional payment appropriations and specific action on all ‘potentially abnormal’ commitments. Furthermore, this balance does not reflect 95 billion euro of legal commitments entered into for the Structural Funds. The increasing time gap between commitments and payments, the likely extra demand on administration at the end of the current programming periods, and the potential demand on the future programming period are all areas that require urgent attention.

2.48. The time lag between commitments and payments of ‘differentiated’ expenditure, which is responsible for the ‘RAL’, is inherent in the budgeting of this expenditure.

For the Structural Funds, which account for the bulk of the ‘RAL’, the risk of an overhang that is difficult to manage in terms of settling payments at the end of the current programme period has been reduced, compared to the past, by the ‘n+2’ rule, which in effect involves closing annual commitments continuously during implementation some three years after they were entered in the budget. The ‘n+2’ rule should result in a stabilised level of outstanding commitments over the next few years, absorbing also the EUR 95 billion of legal commitments referred to by the Court as they fall due. A ‘RAL’ for the 2000 to 2006 period of 2.3 times current annual payments (see paragraph 2.34) is in line with the Commission’s forecast. The Commission refers to its ‘RAL’ communication of September 2002 (see paragraph 2.16) and to the joint declaration on the liquidation of old and ‘potentially abnormal’ commitments (see paragraph 2.21).

2.49. The continuing underspending should be contrasted with recurring increases in the budget over the same period. It is contradictory to increase the budget each year when there is not the ability to absorb the resources on multi-annual programmes within the timescale foreseen. The Court recommends that in the budgetary process realistic account of the ability to make payments is taken when setting both the commitment and payments budgets.

2.49. Past absorption problems are only one criterion in forecasting payments. For example, past delays in implementation may actually imply a need for future increases of appropriations.

2.50. The Court recommends that the Commission continues to improve its information on budgetary implementation. Its budgetary analysis should provide clear information on the cumulative state of implementation of Community programmes, taking into account the use of commitments, the level of payments to final beneficiaries and commitments still to be made. These improvements will require a considerable investment by the Commission and Member States in providing the necessary information. However the increased transparency should help improve management of the budget and improve accountability for the use of EU funds to the citizen.

2.50. The Budgetary and Financial Management Report has focused on annual implementation. In addition, the Commission has, in certain areas, provided more comprehensive reports. For the Structural Funds, the Commission prepares annually the document ‘Analysis of the budgetary implementation of the Structural Funds’, covering, inter alia, the cumulative state of implementation.

As in 2003 for the recommendation of inserting a section on own resources, the Commission is ready to follow this recommendation. It is willing in the next Budgetary and Financial Management Report to provide information on the cumulative state of implementation of the most important Community programmes, as well as the use of commitments and payments at different levels to the extent that this information is available to the Commission, as recommended by the Court. As this will require establishing new sources of information, it will take some time to fully implement the Court’s recommendation.
CHAPTER 3

**Own resources**

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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 (89 %). 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 (26 %), and own resources derived from the Member States’ gross national income (61 %). As regards budgetary management of own resources see paragraphs 2.23 and 2.24.

Table 3.1 — Revenue for the financial years 2002 and 2003

<table>
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<tr>
<th>Type of revenue and corresponding budget heading</th>
<th>Actual revenue in 2002</th>
<th>Development of the 2003 budget</th>
<th>Actual revenue in 2003</th>
<th>% change (2002 to 2003)</th>
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<tr>
<td></td>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
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<td>1 Traditional own resources</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>— Agricultural duties (Chapter 1 0)</td>
<td>9 214,0</td>
<td>12 140,3</td>
<td>10 906,2</td>
<td>17,8 %</td>
</tr>
<tr>
<td>— Sugar and isoglucose levies (Chapter 1 1)</td>
<td>886,4 (1)</td>
<td>879,8</td>
<td>1 011,8</td>
<td>14,1 %</td>
</tr>
<tr>
<td>— Customs duties (Chapter 1 2)</td>
<td>649,5 (1)</td>
<td>546,6</td>
<td>383,2</td>
<td>– 41,0 %</td>
</tr>
<tr>
<td>— Collection expenses adjustment for 2001 (Chapter 2 0)</td>
<td>– 2 023,0 (1)</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>2 VAT resources</td>
<td>22 388,2</td>
<td>24 121,3</td>
<td>21 748,0</td>
<td>21 260,1</td>
</tr>
<tr>
<td>— VAT resource from the current financial year (Chapter 1 3)</td>
<td>22 539,0</td>
<td>24 121,3</td>
<td>21 748,0</td>
<td>21 534,9</td>
</tr>
<tr>
<td>— Balances from previous years (Chapter 3 1)</td>
<td>– 150,8</td>
<td>0,0</td>
<td>– 274,8</td>
<td></td>
</tr>
<tr>
<td>3 GNI resource</td>
<td>45 947,6</td>
<td>59 404,0</td>
<td>51 356,7</td>
<td>51 235,2</td>
</tr>
<tr>
<td>— GNI resource from the current financial year (Chapter 1 4)</td>
<td>45 850,3</td>
<td>59 404,0</td>
<td>51 356,7</td>
<td>50 624,3</td>
</tr>
<tr>
<td>— Balances from previous years (Chapter 3 2)</td>
<td>97,3</td>
<td>0,0</td>
<td>610,9</td>
<td></td>
</tr>
<tr>
<td>4 Budgetary imbalances</td>
<td>148,2</td>
<td>0,0</td>
<td>280,1</td>
<td>89,0 %</td>
</tr>
<tr>
<td>— UK correction (Chapter 1 5)</td>
<td>149,0</td>
<td>0,0</td>
<td>281,1</td>
<td></td>
</tr>
<tr>
<td>— Final calculation of UK correction (Chapter 3 5)</td>
<td>– 0,8</td>
<td>0,0</td>
<td>– 1,0</td>
<td></td>
</tr>
<tr>
<td>5 Other revenue</td>
<td>17 736,4</td>
<td>1 837,4</td>
<td>8 513,9</td>
<td>9 836,1</td>
</tr>
<tr>
<td>— Surplus from previous financial year (Chapter 3 0)</td>
<td>15 375,0</td>
<td>1 000,0</td>
<td>7 676,8</td>
<td>7 676,8</td>
</tr>
<tr>
<td>— Miscellaneous revenues (Titles 4 to 9)</td>
<td>2 361,4</td>
<td>837,4</td>
<td>837,1</td>
<td>2 159,3</td>
</tr>
<tr>
<td>Grand Total</td>
<td>95 434,4</td>
<td>97 502,9</td>
<td>92 524,8</td>
<td>93 468,6</td>
</tr>
</tbody>
</table>

(1) These figures are presented net of the collection expenses of 2002 (3 725,6 million euro) that were brought to account in 2002 under Chapter 1. Under Article 42 of the new financial regulation the budget may not contain negative revenue. For 2003, therefore, both budget and actual figures for Chapters 1 0, 1 1 and 1 2 are net of collection costs, and Chapter 1 9 no longer exists.
(2) Chapter 2 0 appeared only in 2002, to permit the adjustment of collection expenses for traditional own resources from 10 % to 25 % that came into force during 2002 but with retroactive effect to 1 January 2001 (see the Court’s 2002 annual report, paragraph 2.16).
Source: 2003 revenue and expenditure account.
Graph 3.1 — Breakdown of actual revenue in 2003

Total revenue: 93 468.6 million euro

- Surplus: 8.2%
- Other: 2.6%
- Sugar levies: 0.4%
- Agricultural duties: 1.1%
- Customs duties: 10.1%
- GNI resource: 54.8%
- VAT resource: 22.7%

Source: 2003 revenue and expenditure account.

Graph 3.2 — Evolution of sources of actual revenue 1989 to 2003

(1) Contains surplus from previous financial year and miscellaneous revenue.
Source: 2003 revenue and expenditure account.
3.2. The other revenue consists mainly of the surplus from the previous financial year. In the last three years (2001-2003) this component has been much greater than previously; the matter is discussed in paragraphs 2.9 to 2.13.

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Traditional own resources

Introduction

3.3. 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). Member States must aggregate the data arising from the individual customs entries into the so-called A account, and pay the total amounts of duty established, less collection costs, to the Commission's account by a specified date in the second month following the month in which the entitlement was established. As an exception, duty that remains unpaid and unsecured, or is secured but under appeal, need not be made available until it is in fact collected. If Member States exercise this option, the duty concerned is not registered in the A account but must instead be entered in a separate account (2) (the so-called B account).

3.4. The risks to the collection of traditional own resources are evasion of duty by misrepresentation or simply by smuggling, mis-calculation or failure to establish duty because of undetected mistakes or weaknesses in systems, and errors or omissions in Member States’ accounting for duty received that result in misstatements to the Commission of the amount to be made available.

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3.5. The Court's audit work included evaluation of supervisory systems and controls, both in the Commission and in Member States, as well as direct testing of customs declarations and national accounting systems. It consisted of:

a) a review of the organisation of customs supervision in twelve Member States (3), which together were responsible for 96 % of the import duties collected in 2003, in order to evaluate whether the arrangements in place gave reasonable assurance of completeness. The Court examined in particular the management of agricultural tariff quotas in six Member States, customs control over imports under preferential trade arrangements in seven Member States, and customs supervision at seaports in ten Member States;

b) examination of the Commission's accounts for traditional own resources and the underlying national accounting systems in twelve Member States (3), and analysis of the flow of duties from all Member States in order to gain reasonable assurance that the amounts recorded at each stage were complete and correct. The work included evaluation of internal controls, reconciliations, and audit of a sample of transactions at each level.

3.6. The Court emphasises that its audit cannot cover either undeclared imports or those that have escaped customs surveillance and for which duties remain unrecovered.

Evaluation of supervisory systems and controls

Commission supervisory systems and controls

3.7. The Commission may request Member States to carry out inspections concerning 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 (4). 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 (5). An overall report on the functioning of the inspections is drawn up every three years and presented to the budgetary authority (6).

(3) Belgium, Denmark, Germany, Greece, Spain, France, Italy, the Netherlands, Austria, Portugal, Finland and the United Kingdom.


(5) The Advisory Committee on Own Resources (ACOR), established by Article 20 of Council 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.

3.8. The Court has reviewed the work of the Commission unit that carried out these inspections. As in previous years, its methodology was found to be soundly-based and the documentation of its work is good. Themes for inspection are selected on the basis of risk analysis. In 2003 a priority subject of the unit’s work was the monitoring of the traditional own resources collection systems in the acceding countries. The Court also reviewed this subject, and did not identify in these countries substantial shortcomings other than those mentioned in the monitoring reports of the Commission to the Council (see paragraphs 3.63 to 3.68).

3.9. In addition, on the basis of its ongoing risk analysis of traditional own resources, the unit carried out inspections in all Member States of the B-account and write-off procedure, and of the management of customs declarations made electronically. On B accounts the unit’s results match those of the Court (see paragraph 3.40); on electronic declarations the unit found that the systems were on the whole satisfactory, and that computerisation brought benefits and should be extended. It is not the role of the Commission’s inspection services to give overall assurance that the accounting is correct and that all amounts due are identified and established. The results of their work are nevertheless taken into account by the Court.

Supervisory systems and controls in Member States

3.10. The supervisory systems and controls for traditional own resources in Member States consist in the first instance of supervision by the customs authorities, defined by the Community Customs Code (7) as ‘action taken in general by those authorities with a view to ensuring that customs rules and, where appropriate, other provisions applicable to goods subject to customs supervision are observed’. Community legislation does not generally prescribe either particular methods or the level of customs control, this being at the discretion of the Member States. The following observations arise regarding certain aspects of customs supervision.

Agricultural tariff quotas

3.11. The Court carried out an examination of the management of the agricultural tariff quotas. Under these quota arrangements, certain agricultural products can be imported into the Union at reduced or zero rates. The objective of the Court’s audit was to obtain assurance that the quotas were legally and regularly allocated, and to assess the managing and monitoring activities related to the different quota arrangements.

3.11. - 3.12. Tariff quotas are managed:

—— either by import certificates, giving a right to import at a reduced or zero tariff for a specified amount of products within a specified period. This system gives commercial security to importers;

—— or by the ’first come/first served’ system based on customs declarations, giving a right to import at a reduced or zero tariff for the quantity shown on an import declaration in so far as the import quota has not been exhausted on the day of declaration.

THE COURT’S OBSERVATIONS

3.12. The quotas are managed by the Commission, through competent authorities in the Member States. Importers apply to the national authorities for import licences. After the Commission has confirmed that a quota allocation is available, the national authority issues the import licence, which must be presented to the customs authorities by the importer, together with the goods declared for importation. The customs services are responsible for verifying that the imported goods comply with the import licence. Once the whole quantity for which the licence has been issued has been imported, the licence is returned to the issuing authorities. National authorities inform the Commission about actual imports under quota arrangements.

3.13. The Court examined quota management both in the Commission and in six Member States (Belgium, France, Germany, Spain, the Netherlands and the United Kingdom). The most important market sectors were subject to this audit. The Court draws attention to the following issues that will need further action by the Commission.

3.14. The multitude of quotas (*) and different procedures related to them puts a heavy burden on the managing services in both the Commission and the Member States, and increases the risk of irregular applications and inefficiency. The Court therefore invites the Commission to streamline and harmonise the procedural framework related to the quotas.

THE COMMISSION’S REPLIES

3.14. Awareness of the problem raised by the Court was one of the reasons which led to the start of work on the AMIS-Quota project in 2002. The project foresees a central and integrated IT system that will help to manage agricultural import tariff quotas other than those managed by the ‘first come, first served’ system. The project will allow the national competent authorities to feed the newly developed computerised system directly with data concerning the quantities covered by import licences (requested, issued, used, and unused). AMIS-Quota will reduce the workload necessary for managing quotas and will contribute to the monitoring and transparency of the management process by centralising all relevant quota management information.

The Commission is currently examining the regulations and systems relating to tariff quotas and import/export licences, with a view to making appropriate simplification proposals. It is intended that the implementation of AMIS-Quota, together with the outcome of the simplification study, will provide a positive response to the problems raised by the Court.

As far as monitoring is concerned, since 2001, 64 quotas concerning agricultural products have been transferred to the ‘first come, first served’ system with the aim of facilitating the management and corresponding monitoring.

(*) At the time of the Court’s audit there were about 950 quota measures in force.
THE COURT’S OBSERVATIONS

3.15. From its audit the Court has found that the system for providing Member States with appropriate and up-to-date information in respect of official stamps used by the national authorities competent to issue licences (9) has not been properly applied in four of the six Member States visited. It recommends that the Commission should review the procedures for informing Member States and take appropriate remedial action.

3.16. Currently, certain quotas allow large numbers of importers, all linked to a main operator, to introduce their own licence requests to ensure a maximum quota allocation. This causes unnecessary paperwork and delays in the application procedures. The Court therefore recommends the Commission to issue additional provisions, to prevent this from happening.

3.17. For French overseas departments (Guadeloupe, French Guiana and Martinique) the Court found that for importation of certain products under quota arrangements, no quota allocation was requested at the Commission by the French authorities. Neither was information about imported quantities submitted to the Commission by French customs. This implies that imports can take place in excess of the available quotas. The Court invites the Commission to investigate and correct these shortcomings in the quota management in the French overseas departments.

3.18. The Court has also identified shortcomings in the implementation of the quota rules and in the controls related to imports under quota arrangements in several other Member States. The Court invites the Commission to follow up these cases.

THE COMMISSION’S REPLIES

3.15. The Commission supplies Member States on a regular basis with all information available concerning the ‘licence issuing’ agencies and prints of their official stamps via the Member States’ representatives on the Management Committee on Trade Mechanisms.

The Commission will remind Member States of the necessity of making the information available to those customs offices responsible for verifying the licences.

3.16. In an effort to counter this, the Commission proposed prohibiting access to certain quotas for known linked persons under Article 143 of Regulation (EEC) No 2454/93 (Implementing provisions of the Customs Code). This proposal has been vigorously opposed by almost all Member States.

In the beef sector the requirements (1) as to who can apply for the quota have been tightened. Proofs must be presented of independent activity by the importer, coupled with a high security to be forfeited if appropriate documents are not produced.

3.17. The Commission is considering the appropriate action to take in the light of the French authorities’ extensive and detailed responses to the Court’s comments.

3.18. The Commission is continuing to follow up the implications of these findings with the relevant Member States. Five of the points have been satisfactorily resolved including financial corrections, where required.

Customs controls over imports under preferential trade arrangements

3.19. The Community is involved in various forms of preferential trade arrangements (some 40 concerning around 150 countries). Preferential treatment was claimed for 21 % by value of all Community imports in 2001. Preferential trade arrangements are based on the concept of origin, which means that only goods originating in the beneficiary countries are entitled to preferential treatment.


3.20. Origin rules are complex, and it is widely recognised that it is difficult for customs authorities to check that the arrangements are being used properly. In a Green Paper on preferential origin rules issued in December 2003 (10), the Commission noted that the rules needed to be fundamentally reviewed, and launched a consultation exercise.

3.20. The consultation period on the Green Paper on preferential origin rules is now closed and the Commission is preparing a synthesis of the replies received and orientations both for determining origin and revising administrative management and control.

3.21. The main features of the current preferential arrangements are certification of originating status by the competent authorities of the exporting country or (under certain conditions) the exporter himself and subsequent verification of preferential origin by the country of export, at the request of the importing country.

3.22. Monitoring compliance with preferential rules is based on a division of duties and mutual trust between the different national authorities concerned. In this context the Court notes that in his declaration for 2003, the Director-General for Taxation and the Customs Union issued a reservation on the supervision of preferential trade, specifically in relation to sugar imported from Balkan states, for which the amount of own resources involved is not in itself material, but which illustrates the need for effective administrative cooperation between the authorities concerned.

3.22. The Director General’s reservation demonstrates the Commission’s awareness of the need for assurance of the proper application of rules of origin by exporting countries worldwide despite a lack of sufficient resources to monitor all preferential partner countries. The Commission intends to ensure proper follow-up of the Director General’s reservation.

3.23. The correct balance is needed in three areas, namely the criteria for acquiring originating status and their legal framework, the supervision of their application, and the procedures put in place. In 2003 the Court focused on the existing systems for preferential imports in the seven Member States that are the most significant importing countries (11). The Court’s examination covered customs controls upon importation, the use made of subsequent verification requests, and customs control strategy.

Customs controls on importation

3.24. The main control at importation is a check that the certificates of origin are genuine. Arrangements provide for exporting countries to supply the names and addresses of the authorities issuing certificates, together with copies of the stamps they use, so that importing countries can check the certificates.


(11) Belgium, Germany, Spain, France, Italy, the Netherlands, the United Kingdom.
3.25. However, in two Member States (Germany and Spain) there was found to be a systematic problem with the copying and distribution of these specimen stamps to local customs offices. The copies that reached the local customs offices were delayed, or illegible, making it impossible to check certificates properly. There is thus a risk that ineligible imports are accepted for preferential treatment.

3.25. The Commission supplies Member States with complete and prompt information on exporting countries' competent authorities and the stamps they use through a new electronic interface called 'SMS'. In addition the Commission has now received assurance from both Member States that solutions to the problem have been identified and implemented. This may be the subject of future scrutiny.

3.26. A sample of import declarations for selected products from certain third countries was examined. It was noted that all the certificates of origin from certain countries in the sample had been issued retrospectively, that is, after the goods had left the exporting country. This should only happen in exceptional cases (12), since it implies that the exporting countries' authorities had no possibility of controlling the goods before shipment. However, subsequent verification had not been requested by the Member States' customs authorities for any of these certificates.

Subsequent verification

3.27. The arrangements provide that subsequent verifications of certificates of origin and invoice declarations are to be carried out 'at random' or whenever the customs authorities have 'reasonable doubts' as to the authenticity of such documents (13). Enquiries about the authenticity of certificates of origin rely on the effective cooperation of the issuing authorities.

3.28. For the cases selected randomly by Customs the number of subsequent verification requests that received no reply from beneficiary third countries was very high compared to that for reasonable doubt cases. For example, for one Member State (Belgium) only 40% of random verification requests received an answer within the prescribed time limit of six months. Under the current provisions, 'no reply' means, for a 'random' verification, that the preferential status of the goods is maintained and as a consequence undue preferential treatment may be granted. On the other hand it was noted that two Member States (Spain and the United Kingdom) regarded all subsequent verifications as 'reasonable doubt' cases, and withdrew preferential treatment if there was no reply.

3.28. It is important to distinguish between the different purposes behind the two methods of selecting certificates for post-clearance verification by the country of issue. Reasonable doubt is for use where the customs authorities have a concern about the bonafides of a certificate but insufficient grounds for refusing preferential treatment immediately. In these circumstances the absence of any or a satisfactory response within a specific time period then it is appropriate to require payment of the full rate of duty. Verifications of randomly selected certificates merely provide an indicator of the overall level of reliability of the system. In these circumstances the absence of a prompt response from the issuing country does not provide grounds for charging the importer the higher rate of duty. The Commission is however aware that the frequent use of randomly selected verification requests might prove counter-productive, and the need for such checks will be revisited when the Commission services' consider the action to take on the Green paper.

In recent years the Commission has paid attention during its inspections of traditional own resources to the proper selection and prompt follow-up of verifications on the basis of reasonable doubt. The Commission notes that the Court's examination of this area appears to indicate that these efforts have been largely successful. The Commission has been assured by Spain and the United Kingdom that procedures are now in place to request occasional verifications on a random basis and will encourage Belgium to tackle the level of non-response noted by the Court.


THE COURT’S OBSERVATIONS

Customs control strategy

3.29. As Member States make progress in introducing paperless electronic customs clearance systems (14), checks on origin certificates are transferred from the import stage to post-import control. This reduction in the level of checks at the time of importation in Member States is mainly countered by post-clearance controls; however an increase in subsequent verifications of certificates of origin could also play a part in compensating for the change. No evidence that there had been such an increase was found. For example, in two Member States visited (Belgium and Spain), the rate of subsequent verifications was less than 1 % of preferential imports.

3.30. When post-import controls show that imports were not eligible for preference, an importer who has certificates of origin and can demonstrate that he acted in good faith may be entitled to relief from the duty otherwise due. This possibility is not available when invoice declarations (15) are used as the proof of origin, since they engage the responsibility of the exporter rather than of national authorities. Increased use of invoice declarations as the document to certify origin would thus present advantages from the own resources point of view, and the Court notes that this is among the options put forward in the Commission’s Green Paper mentioned above.

3.31. The Court examined customs clearance through selected ports in 10 Member States (16) where the import duty collected constitutes a major revenue stream representing, at national level, between 10 and 50 % of total duty collected. The audit concentrated on an evaluation of the customs surveillance and control procedures that are intended to ensure that all goods are declared properly and in due time, and that import duties are correctly established.

3.32. With the exception of the weakness at Antwerp (Belgium), which is described in the following paragraph, it was found that in general there were satisfactory procedures for ensuring that goods arriving were properly declared and that import duty due was correctly identified.

THE COMMISSION’S REPLIES

Customs surveillance of arrivals of goods at ports

3.29. As the Court itself remarks in paragraph 3.10 Community customs legislation rarely prescribes specific levels of customs control. In line with this approach no rates have been set for such verifications. The arrangements for verification by third countries are just one of the tools available to Member States to meet their obligation to ensure the proper application of that legislation.

3.30. As already indicated in reply to paragraph 3.20 the Commission is considering the follow-up to be given to the Green Paper.

(15) Invoice declarations are a simplified form of preference document, accepted as proof of origin for imports from certain countries (usually subject to limits on value), in place of certificates issued by official bodies. They consist of a statement using prescribed text, made by the exporter on the invoice or other commercial document. They are subject to subsequent verification in the same way as other proofs of origin.
(16) Belgium, Germany, Greece, Spain, France, Italy, the Netherlands, Portugal, Finland and the United Kingdom.
3.33. At Antwerp a high number of containers selected by Customs for x-ray scanning were not presented. Over a period of months the number of non-presented containers showed an increase, and for the month of August 2003 reached a level of 16% (197 out of a total of 1,251 selected containers). Such evasion of a customs control represents a serious impairment of customs supervision. In general such non-presentation is only subject to a fine of 125 or 250 euro. It was also noted at Antwerp that a rate of less than 50% was achieved for 16 out of 36 targets in the control plan.

3.33. Once the Commission has had the opportunity to examine the Belgian authorities’ comments it will take any necessary follow-up action.

Time limits on temporary storage

3.34. Cargo arriving by sea may be put in separate temporary storage for a maximum of 45 days before it is assigned to a customs-approved treatment or use. The Court noted considerable differences between different Member States’ practices regarding this time limit. In Portugal the time limit is strictly applied, with fines of 5% of the customs value in case of infringement. However, in several other Member States customs control over the time limit is light and in Hamburg (Germany) for example, no listing was made of over-45-day cases; at Helsinki (Finland) consignments more than a year old were still in temporary storage, and local instructions on the rule needed updating.

3.34. The Commission will follow-up the Court’s findings in Germany and Finland and will use those from the two locations in Portugal in its current correspondence with the Portuguese authorities about anomalies in the control of temporary storage found in other ports during Commission inspections.

Results of controls carried out on customs declarations and national accounting systems

3.35. As mentioned above (see paragraph 3.5(b)), the Court examined the accounting for traditional own resources at the Commission and in Member States, and analysed the flow of duties. No major problems were found in the accounting and making available to the Commission of the main flow of import duties through the A accounts. However, the following observations arose as regards the B accounts.

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

3.36. Established entitlements for which no security was required, together with 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 balances are included in the Communities’ balance sheet under ‘Amounts owed by Member States’.
3.37. At 31 December 2003 the gross balance for the B accounts standing in the Commission’s books, namely 2 364.3 million euro, was 1.9% greater than the equivalent figure at 31 December 2002 (2 321.2 million euro) (17).

3.38. The B-account balance includes some long-standing entries for which full recovery must now be regarded as very doubtful. In paragraph 1.19 of its 2000 Annual Report, the Court commented that no useful purpose is served by maintaining items in the B accounts indefinitely if they are unlikely to be recovered. Accordingly, in its Opinion No 7/2003 (18) the Court welcomed a Commission proposal (19) for amendments to the Regulation, including a requirement that Member States write off amounts of traditional own resources that are not recovered by a specific deadline (five years) following the date on which the demand for payment became definitively enforceable. Until this amendment is adopted, the B-account balance will contain an increasing sum, made up of amounts which may never be recovered.

3.38. The Commission anticipates that the amendment introducing a specific deadline will be adopted by the Council in the latter part of 2004.

3.39. In order to take account of this problem the Commission has entered in its balance sheet a write-down of 1 043.9 million euro which reduces the net B-account balance by 58.9% to 729.3 million euro. The Court has examined the method used to calculate the adjustment and finds it reasonable in the circumstances.

3.40. As in previous years (20), both the Court, and the Commission in its inspections (see paragraph 3.9), found systematic problems with B accounts, including delays in making entries, erroneous entries, omissions and incorrect cancellations, in several Member States (Belgium, Germany, Greece, Portugal, Finland and the United Kingdom). Germany removed entries totalling 40.1 million euro from its B account, but a full explanation of this reduction has not yet been received. Furthermore, anomalies were noted in reporting of B-account balances to the Commission (Belgium, Italy, Sweden).

3.40. As the Court acknowledges the Commission is continuing to examine Member States’ management of the B account and to require remedial action where necessary. As has already been alluded to in the Commission’s responses to paragraph 3.38, the Commission is also pursuing amendments to the regulations governing the operation of the B account with a view to improving its accuracy and reliability.

(17) Figures given are before deduction of collection costs (25%).
(20) See the Court’s 2002 Annual Report, paragraph 3.12.
Work of other auditors

3.41. The use of work done by other auditors, where available, to inform the Court's own audit work and conclusions represents a valuable support for the assessment in the context of the statement of assurance. In the audit of customs supervision at seaports (see paragraphs 3.31 to 3.34), concrete cooperation took place with the German Federal Court of Audit (Bundesrechnungshof). A common audit approach was adopted, using the same audit questionnaires, and the Court has taken into account the findings, confirmed by the supporting documentation made available. In several Member States (Denmark, Greece, Spain, Italy, the Netherlands, Finland) audit documentation on issues related to the statement of assurance was made available to the Court, and has been used in this way. In a number of Member States, however, documentation of the work done by audit and inspection bodies dealing with customs matters is, as a matter of policy, not available to the Court.

VAT/GNI own resource

Introduction

3.42. In contrast to the EU’s revenue from traditional own resources, the VAT and GNI own resources reflect macroeconomic statistics whose underlying data cannot be tested 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 real figures) and seeks to assess the Commission’s system for handling the data until they are ultimately included in the final accounts. Specific aspects of the underlying statistical data of the VAT/GNI own resources may, however, be the subject of separate audits by the Court, like the one carried out this year on corrections and compensations in Member States’ VAT statements.

3.43. The Court’s audit concerning the VAT and GNI own resources thus covered supervisory systems and controls, corrections and compensations in the Member States’ VAT statements and the establishment of the budget and its implementation in the following areas:

— monthly payments by Member States,

— balances and adjustments to balances in respect of previous years,

— calculation of the United Kingdom correction and its financing in 2003 plus the final calculation and its financing for 1999,

— refunds to Member States.
3.44. The Commission inspection activities (21) carried out in cooperation with the Member States constitute an essential element of the control system for VAT/GNI-related own resources. The Court reviewed the work of the units carrying out these inspections.

3.45. In respect of the VAT own resource, the Commission’s on-the-spot inspections carried out during the financial year 2003 led to nine new reservations (see paragraph 3.56) in respect of specific elements of Member States’ VAT statements (22). Progress was made in reducing the number of reservations (20 were lifted during the year), but 74 remained at the end of 2003 (see also paragraph 3.57) (23).

3.45. The Commission recently decided to sub-divide some reservations where this seems likely to enable separate elements of complex problems to be resolved one-by-one. Where this is done, absolute numbers of reservations may appear to diminish more slowly, even though there remain fewer real problems.

3.46. The preparation and the reporting of these inspections, which focused on Member States’ VAT statements, are of good quality, as is the follow-up of the audit observations. However, the Court notes that the effectiveness of the inspections could be further increased if the VAT statements were produced in a clear regulatory and procedural framework and if a clear policy was established for the management of reservations by the Commission (see paragraph 3.57).

3.46. The present legal framework enables Member States to reflect their particularities and the Commission’s controls must necessarily take account of national variations. Nevertheless, the Commission will continue to encourage national administrations to present data in a clear, readily understandable, rigorous and more uniform way. For the policy regarding reservations, see the reply to paragraph 3.57.

3.47. Concerning the GNI own resource, the Court pointed out in its observations in the Annual Report for the financial year 2002 (24) that the exact nature of the checks (25) in respect of the annual GNI questionnaires carried out by the Commission beyond the simple initial arithmetical test was unclear, as there were no specific guidelines on the nature and scope of these checks. Following the Court’s recommendation the Commission has introduced specific checklists for checking the data in GNI questionnaires.


(22) The VAT statement is a document drawn up by the Member States which must contain 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 (ECC, Euratom) No 1553/89).

(23) Taking into account the subdivision introduced by the Commission in 2003 the actual number of reservations is 85.


THE COURT’S OBSERVATIONS

3.48. However, there is still limited direct verification by the Commission of the underlying national accounts which provide the figures presented in the GNI questionnaires.

3.49. Portugal and Sweden were late in paying their contributions for VAT and GNI own resources, which were due by the first working day of December 2003. Portugal paid its outstanding contribution of 113 million euro on 2 January 2004. Sweden paid its outstanding contribution in two amounts, 715.2 million SEK (79.1 million euro) on 19 December 2003 and 2 546.2 million SEK (280.5 million euro) on 2 January 2004. In all cases, the Commission requested interest for late payment which was paid by Portugal and Sweden in due time.

3.50. Furthermore, an increasing number of Member States were late in submitting their VAT statements to the Commission. Nine Member States did not respect the deadline of 31 July 2003 for submitting the VAT statements for the year 2002. Moreover, three Member States did not respect the deadline of 22 September 2003 for presenting the GNI questionnaires. The Court points out that not respecting the Community timescales could hamper the work of the Commission in respect of the calculation of Member States’ own resources contributions and in respect of its own VAT/GNI inspections.

Results of controls carried out on the corrections and compensations in the VAT statements produced by Member States

3.51. The Court examined the calculation and presentation of corrections and compensations in the VAT statements produced by Member States which, like the collection of VAT by Member States examined by the Court last year, are an important element in the calculation of the VAT own resources. The Court also reviewed the Commission’s management activities relating to the correct application of legislation concerning the VAT own resource.

3.52. Corrections and compensations must be calculated by Member States in order to obtain the harmonised VAT base from which the VAT own resource is calculated, as laid down in Community legislation (26).

THE COMMISSION’S REPLIES

3.48. Verification of the national accounts is carried out through the analysis of countries’ inventories of sources and methods used to compile GNI. The Commission does little direct verifications of data in the sense indicated by the Court, but is investigating the possibility for carrying out more direct verifications in the future.

3.49. The Commission shares the Court’s concern about these instances of delayed payment.

Making use of systematic monitoring and rigorous follow-up action, the Commission seeks to ensure that Member States respect Community rules for own resources payments.

3.50. The Commission’s records show that six VAT statements met the deadline of 31 July. Two more arrived on 1 August and by 31 August only two statements were lacking, although one Member State had sent only a summary. The penultimate statement was received on 12 September and the Portuguese statement on 1 April 2004, following the opening of infringement proceedings.

The Commission has recently increased pressure on Member States to respect the deadlines, even if in practice control work has not been significantly hampered by these mostly minor delays.

3.53. The importance of corrections and compensations for VAT own resources can be seen from their total absolute value (27), which for the financial year 2002 amounted to approximately 245,137 million euro or 5.85% of the harmonised VAT base.

Observations

Presentation and use of methodologies and data

3.54. The Court has noted differences in the treatment of corrections and compensations presented by Member States in the annual VAT statements. These differences can affect the harmonised and accurate calculation of the corrections and compensations and may lead to unequal treatment of Member States. They concern the amount of supporting details given with the calculation and the age of the data used. They are exacerbated by the absence of clear rules (28) on how corrections and compensations are to be calculated, how the calculations and related data are to be presented and which data sources may be used.

3.54. Corrections and compensations are made because Member States do not apply Community VAT provisions in the same way. This implies a special effort on national administrations’ part if data are to be presented in the same clear and consistent way, especially as they may not possess the same information about taxes and taxpayers for reasons often related to differing national circumstances (cultural factors, data protection rules, etc.). The Commission continues its efforts to ensure the use of precise, uniform methods and reliable, up-to-date sources.

3.55. Although it is the responsibility of the Member States to produce correctly calculated corrections and compensations and to inform the Commission about the methodologies used in their calculation, Member States rely heavily on the outcome of the Commission’s inspection visits for adjusting or updating their methodologies and data sources.

3.55. Member States raised numerous questions of methods and sources with the Commission following the introduction of the VAT resource and newer Member States did so following successive enlargements. They tend to stop doing this after an initial period. Radical adjustments are now rare and the Commission is satisfied that its services have not failed to discuss any changes, which are often made at the Commission’s urging, with the Member States concerned. Nevertheless, the Commission will remind Member States of the legal requirement for them to take the initiative in reporting significant changes rather than waiting for the Commission to raise the matter.

Management of reservations

3.56. If corrections or compensations have not been calculated in accordance with Community legislation, the Commission has the possibility of formulating a reservation, which makes it possible to adjust these corrections and compensations after the legal deadline (29).

3.56. If corrections or compensations have not been calculated in accordance with Community legislation, the Commission has the possibility of formulating a reservation, which makes it possible to adjust these corrections and compensations after the legal deadline (29).

(27) The total absolute value of the corrections and compensations for the financial year concerned has been calculated as the sum of the positive and negative corrections to the VAT receipts, regardless of their signs, divided by each Member State’s weighted average rate, plus the sum of the positive and negative compensations to the intermediate VAT base.

(28) The procedural framework for calculating and presenting corrections and compensations is largely laid down in Council Regulation (EEC, Euratom) No 1553/89 on the definitive uniform arrangements for the collection of own resources from value added tax and in an internal guide on the determination of own resources from VAT, drawn up by the Commission for the benefit of EU officials and the administrations of Member States.

THE COURT'S OBSERVATIONS

3.57. The Court has observed inconsistencies in the setting and lifting of reservations concerning corrections and compensations, and reservations can remain in force for long periods. This may lead to unequal treatment of Member States, which could have an impact on the VAT base. The Court recommends the Commission to review and document its policy guidelines for reservation management.

Annual activity reports and declarations of the Directors-General

3.58. The Court has examined the annual activity reports and declarations of the Directors-General for DG Taxation and Customs Union (see paragraph 3.22), DG Budget and Eurostat. Though the annual activity report for DG Budget mentions control activities related to traditional own resources and the VAT own resource, it does not make any specific reference to control activities related to the GNI own resource, even though it is this resource that provides more than half of the revenue. The Eurostat annual activity report likewise does not refer to control activities on the GNI data used by DG Budget in calculating the GNI own resource.

Conclusion and recommendations

3.59. Taking into account the scope of the audit (see paragraphs 3.5 and 3.6), and with the exception of the B-account matters noted in paragraph 3.40, the checks and systems analysis carried out by the Court gave satisfactory overall results concerning the reliability of the accounts recording traditional own resources (see also monitoring elements in Annexes 1 and 2). The audit work carried out on the systems and related transactions which underlie the accounts also gave satisfactory overall results as far as the legality and regularity of the underlying transactions is concerned, but leads to the following recommendations on systems:

a) as regards agricultural tariff quotas the Court found a number of issues where the Commission and Member States could improve the quota management (see paragraphs 3.11 to 3.18);

b) as regards preferential trade (see paragraphs 3.19 to 3.30), the Court notes that control of compliance depends on cooperation and that many verification requests receive no replies from the authorities of the beneficiary third countries. The consultation procedure launched by the Commission will need to take this problem into account, as well as examining the limitations of a document-based evidencing system, particularly in the light of the move towards paperless systems;

THE COMMISSION'S REPLIES

3.57. Reservations are not normally placed where the financial consequences of a requested change are judged negligible, where a method has been accepted in the past but needs adjustment or where a change of sources and/or methods is expected to be agreed before the next control visit, provided that there is no risk that the VAT statement in question will be time-barred. Reservations are lifted when the Member State has met the Commission’s demands. Where questions of principle or interpretation are at stake, the Commission has stated its intention to instigate legal proceedings in the European Court of Justice. The Commission can agree to review and document this policy.

3.58. Annual activity reports present the activities of Directorates-General at a high level of aggregation and tend to deal with specific activities mainly if they are priorities or have given rise to particular problems. It is therefore not surprising that the activity of verifying GNI data is not explicitly visible in the reports from the two services. This activity appears in its rightful place in the annual management plans of the two services, which set out the work programme for the year and are subject to regular internal monitoring and review.

3.59. The Commission has explained in its reply to paragraph 3.40 its ongoing efforts to improve Member States’ management of the B account together with the regulatory amendments expected to be in place by the end of 2004.

a) As stated in the replies to paragraphs 3.17. and 3.18., the Commission will do all in its power to improve matters.

b) The Commission’s Green paper was a root and branch exploration of the whole concept of proof of preferential origin as it now applies, the way it is established and the respective responsibilities of economic operators and public authorities in managing and controlling it. Progress in this area will be an important part of following-up the Green Paper, as has already been indicated in response to point 3.20.
c) as regards ports, except for the weaknesses at Antwerp (see paragraph 3.33), the Court found that customs supervision was generally satisfactory. There is, however, scope for standardising the approach to the time limit on temporary storage (see paragraph 3.34).

3.60. In relation to the scope of the audit, as set out in paragraphs 3.42 and 3.43, the Court found that the VAT and GNI resources were being correctly calculated by the Commission and entered in the Community accounts.

3.61. The audit of the corrections and compensations in VAT statements produced by Member States has however identified two weaknesses in the system (see paragraphs 3.54 to 3.57) which, as well as the reservations mentioned in paragraph 3.45, cast some doubts on the accuracy and reliability of the VAT statements produced by the Member States:

a) there is no precise and clear regulatory and procedural framework on how corrections and compensations are to be calculated, how the calculations and related data are to be presented and which data sources may be used. The Commission should make proposals, either in the form of changes to the legislation or through the issue of binding instructions or guidelines, which would ensure a more transparent and uniform treatment of corrections and compensations by Member States, and provide a more structured framework for the Commission's inspections;

b) inconsistencies in the setting and lifting of reservations concerning the corrections and compensations have been noted. The Commission should review and document its policy for the management of reservations, so as to ensure transparent, coherent and equal treatment of Member States.

3.62. In respect of the GNI-related own resources, the Court repeats the recommendation made last year (30) that the Commission increase its direct verification activities regarding the underlying national accounts data which feeds into the GNI questionnaires, in order to increase the reliability of the calculation of the most important own resource (see paragraph 3.48 and monitoring elements in Annex 2).

OWN RESOURCES PREPAREDNESS OF THE ACCEDING COUNTRIES

3.63. In view of the accession of the ten new Member States to the European Union, the Court reviewed these countries' preparations for accession, taking into consideration that they would have to apply Community legislation in respect of own resources from the moment of accession.

(30) See paragraph 3.57 of the Annual report for the financial year 2002.
3.64. The aim of the review was to assess how the Commission monitored the adequacy and reliability of own resources-related activities in these countries and whether the identification and follow-up of remaining problem areas was appropriate and complete. All three types of own resources were subject to this review.

3.65. The review did not identify substantial shortcomings in these countries other than those mentioned in the Commission’s monitoring reports to the Council. The Court, however, wishes to draw attention to the following points that need further action or follow-up, both at the Commission and in the acceding countries.

3.66. At the time of the Court’s review, several areas of customs procedures were still under development, making it too early to assess their fitness for operation at the moment of accession. Customs information technology and interconnectivity questions were the largest pending issues in many countries. The projects had been subject to serious delays, and further delays could endanger the proper functioning of the customs services at the moment of accession and after it. The accounting procedures for customs duties had not been finalised, and the Court could not yet obtain assurance that the rules for accounting for traditional own resources and making them available to the Commission would be correctly applied. Efforts are also needed to ensure the systematic use of risk analysis techniques in customs control and the clearance of goods.

3.67. In respect of the VAT own resource, the Commission should consider whether ‘best practice’ examples from the existing Member States’ VAT calculations could be made available to the acceding countries. At present, it is not always clear for these countries how much information, in the form of calculations and supporting documents, should be given.

3.68. Phare projects on exhaustiveness and on GNI inventories directed by Eurostat to bring GNI estimates fully into line with ESA 95 have been delayed from their original timetable.
ANNEX 1  
Own resources-Development of key observations

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<th>Measures taken</th>
<th>Measures to be taken</th>
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| **Making available of own resources**  
Delays in making available of traditional own resources | The Commission unit charged with the inspection activities provided for in the Regulation (Council Regulation No 1150/2000) acts on all cases of delay, and Member States are invited to pay default interest when appropriate. In the course of its regular inspections the unit has increased its emphasis on accounting matters, and systems problems have been addressed when found either by the Court or by the Commission. | The Commission's actions are satisfactory. |
| **Amounts established but not yet made available**  
Content of the accounts | Entries in the B accounts contain errors including late and duplicated entries, incorrect amounts and entries that should have been made in the A accounts. | The Commission unit charged with the inspection activities provided for in the Regulation (Council Regulation No 1150/2000) has devoted considerable resources to B accounts, and has reported on the problems found, but in several Member States systematic problems remain. | Certain Member States need to devote resources to improving the bookkeeping systems concerned. |
ANNEX 2

Supervisory systems and controls

Area: Own resources
System: Traditional own resources and VAT/GNI resources

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<td>— compliance with standards</td>
<td>A</td>
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<tr>
<td>— taking into account of experience</td>
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<td>Actual operation</td>
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<tr>
<td>— compliance with standards</td>
<td>A</td>
<td>A</td>
<td>B</td>
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<tr>
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<td>Results</td>
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<td>A</td>
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<td>— preventive effect</td>
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<tr>
<td>Overall assessment</td>
<td>A</td>
<td>A</td>
<td>A</td>
</tr>
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</table>

A  Works well, few or minor improvements required.
B  Works but improvements necessary; more direct verification of GNI data required.

Notes:
— The supervisory systems predate the Commission’s reform.
— The assessments are based on detailed review of the monitoring units and of their reports.
CHAPTER 4

The common agricultural policy

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INTRODUCTION

4.1. Expenditure in 2003 on the common agricultural policy (CAP), i.e. the European Agricultural Guidance and Guarantee Fund (EAGGF Guarantee Section), totalled 44,378 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. Direct payments to farmers, based on the amount of land they farm or the number of livestock on their farms, constitute the greater part (58%) of CAP spending. These payments, which have been an important part of the CAP since its reform in 1992, 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. For most expenditure the process 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 these claims to administrative checks and, on a sample basis, 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 or to ask for more work to be performed or information provided;

(f) the Commission may then examine payments made by the paying agencies and, if they were irregular, or if financial controls were weak, 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 ‘disallows’ such expenditure as part of the ‘clearance of accounts’ in ‘conformity decisions’). When it disallows expenditure the Commission reduces its payments to paying agencies accordingly.
Graph 4.1 — Breakdown of EAGGF-Guarantee expenditure by economic category — financial year 2003

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

(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 advances and milk levies).

The total of area aid, animal premiums together with other direct aid gives an overall total for direct aid of 67 % of CAP expenditure.

Source: The Commission’s annual accounts for 2003 — gross data.

Graph 4.2 — Breakdown of EAGGF-Guarantee expenditure by sector — financial year 2003

Source: The Commission’s annual accounts for 2003 — Volume II.
THE COURT’S OBSERVATIONS

4.4. The Commission’s Director-General for Agriculture produces each year an activity report on the Directorate-General for Agriculture’s (DG AGRI) spending and a declaration on its legality and regularity.

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Scope of the audit

4.5. The Court:

(a) reviewed the work of the certifying bodies (see paragraphs 4.7 to 4.8);

(b) evaluated supervisory systems, notably IACS and post-payment checks (see paragraphs 4.9 to 4.16);

(c) tested transactions directly (see paragraph 4.17);

(d) examined the report and declaration by the Director-General for Agriculture (see paragraphs 4.18 to 4.23).

4.6. Paragraphs 4.24 to 4.46 set out the Court’s assessment of the legality and regularity of expenditure under the CAP, based mainly on the above sources of evidence. Observations on the reliability of the accounts are set out in Chapter 1, paragraphs 1.10 and 1.11.

Work of the certifying bodies

4.7. The certifying bodies’ audit of the paying agencies covers their accounts, their processing of, and checks on, claims for payment of CAP subsidies, and whether they comply with the criteria for accreditation (see paragraph 4.53). The relevant EU legislation does not require the certifying bodies to examine claims at the level of farmers or traders (see paragraph 4.8.(c)).

4.8. The Court has examined the work of certifying bodies covering 80% of expenditure in 2003 as part of its annual examination of the clearance of accounts process (see paragraphs 4.55 to 4.61). Although the Commission had concerns about the work performed by a number of the certifying bodies (see paragraph 4.65), for the purpose of the Statement of Assurance the Court has drawn the following general conclusions from their work:

(a) the reports provide assurance that financial information provided by the paying agencies (and incorporated in the Commission’s accounts) is materially accurate, but this assurance does not extend to information on debtors for a number of agencies (see paragraph 4.61):
THE COURT’S OBSERVATIONS

(b) overall, the reports provide assurance that claims for payment are checked and processed by the paying agencies in accordance with the applicable rules, but a significant number of certifying bodies qualify their audit opinion in respect of certain areas of spending (see paragraph 4.54);

(c) the work of the certifying bodies (as defined by Regulation (EC) No 1663/95) is however 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.

IACS

4.9. IACS comprises a computerised database of holdings and aid applications, systems for identifying parcels of agricultural land and identifying and registering animals, and a set of administrative checks and on-farm inspections. IACS covers expenditure on area aid schemes (see paragraphs 4.24 to 4.30) and animal premium schemes (see paragraphs 4.31 to 4.34) directly. Claims for a number of other schemes must be compatible with the system (see paragraph 4.35).

4.10. The Court has continued to examine the operation of IACS (see paragraphs 4.9 to 4.13 of the Court’s 2002 Annual Report). This year it examined the way IACS is implemented by a further seven agencies (Niedersachsen (Germany), Extremadura (Spain), Luxembourg, Austria, Finland, RPA and DARD (United Kingdom)) and returned to five agencies where problems were identified in 2002 (Bavaria (Germany), ONIC and Ofival (France), LASER (Netherlands) and AGEA (Italy)).

4.11. The main findings of the Court’s audit are as follows:

(a) administrative checks (notably cross-checks to parcel or animal databases) were good or satisfactory in all paying agencies except Luxembourg (area aid and animal premiums) while some penalties on claims for animal premium were not calculated or applied correctly in Austria and Northern Ireland;

(b) risk analysis and selection procedures for on-site inspections were generally weak (see also 4.26);

THE COMMISSION’S REPLIES

(c) The work of the certifying body is to give assurance on the integral-ity, accuracy and veracity of the accounts.

(a) The aspects raised by the Court in respect of Austria and Northern Ireland are being followed up in the context of the clearance of accounts procedure. The situation in Luxembourg is being dealt with in the clearance of accounts procedure.

(b) The Court’s remarks are in line with the Commission’s own findings, which have resulted in detailed discussions with the Member States and a significantly reinforced IACS legislation with effect from claim year 2004.
THE COURT’S OBSERVATIONS

(c) most on-site inspections were satisfactorily performed, but some weaknesses were apparent at most paying agencies, and the quality of inspection was lower for animal premiums than for area aid (for example, DARD (Northern Ireland, United Kingdom) where excessive notice of inspection visits was given);

(d) reporting of the results of inspection was weak at many agencies. Errors and anomalies in the figures sent to the Commission were significant for Niedersachsen, Luxembourg and RPA England (all animal premiums). Reporting is less reliable for animal premiums than for area aid claims.

Annexes 2 and 3 set out further details of the Court’s findings.

THE COMMISSION’S REPLIES

(e) The two regimes are substantially different. In particular, the various bovine premia are directed towards different types of animals and involve different conditions. This, in addition to the need to check the movements of animals, has a significant impact on the nature of the inspections.

(d) The Commission has also identified the discrepancies mentioned by the Court. Overall, the statistics are considered as reliable as necessary for the purpose in hand i.e. to verify compliance with governing legislation on eligibility and control regimes. The Court uses data requested and collated by the Commission, and the tabulated presentation and information is generally taken from data the Commission has itself produced. The animal premium sector is more diverse than the arable crop sector, explaining the difficulties in reporting.

The Court correctly states that the information supplied by Member States is not always fully correct, or presented in the timely fashion required by the governing legislation, in which case the Commission ensures prompt follow-up and revision in the framework of the clearance of accounts. In the case of Niedersachsen revised information has been provided.

4.12. For those 14 Member States which had satisfactorily implemented IACS (not Greece), IACS inspection results represent an important source of evidence of the legality and regularity of CAP transactions. However, the errors noted above in the reporting of results, particularly for checks on animal premiums (see paragraphs 4.31 to 4.32), reduce the reliability of the figures produced, while the fact that inspection results sent to the Commission do not distinguish between the different area aid subsidies, and include checks performed on forage areas, reduces the usefulness of the information for area aid (see paragraphs 4.24 to 4.30).

4.12. The Commission considers the statistical reporting to be a very good tool to verify the legality and regularity of CAP expenditure. In short, such discrepancies are duly corrected under the clearance of accounts procedure.

While acknowledging that more detailed statistical information supplied by the Member States could provide a more secure environment, the benefits would be subject to ‘diminishing returns’ and there is a clear need to simplify administrative procedures.

Annexes 2 and 3 set out further details of the Court’s findings.

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

4.13. Member States are required to perform a programme of post-payment scrutinies 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. 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.
4.14. The Court examined the application of the regulation through visits to 11 Member States and to the Commission (1). The audit covered the period from July 2002 to June 2003, for which the Member States had to report by the end of 2003. This covered, in most Member States, payments made in 2001. For each Member State the planning, execution, reporting and monitoring of the checks was examined. The Court examined the quality of the systems which will be applied by Member States in the future to check and, if necessary, correct subsidies paid in 2003.

4.15. The Court found that:

(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, although Member States had reported a higher number to the Commission;

(b) one fifth of scrutinies examined by the Court were wholly unreliable. Fewer than one in three were considered wholly satisfactory in the Court’s view (2);

(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, notably because there is no legislative requirement to report differing rates of error in different areas of expenditure;

(d) the Commission had not put in place a programme of inspections to ensure the effectiveness of checks carried out (the last inspections were made in 1999/2000);

(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.

A further 33 % of the planned scrutinies were indicated as ‘ongoing’; the fieldwork for most of these had been already performed, and either the report remained to be finalised or a reply was awaited to a mutual assistance request made to another Member State. A deadline of up to six months is permitted for replies to mutual assistance requests.

(b) The Commission is not in a position to confirm the conclusion of the Court. The Commission will take these elements into consideration in its future work in relation to Regulation (EEC) No 4045/89 controls.

(c) Information received is analysed and treated by the Commission services in order to provide elements of comparison between Member States.

(d) Such programmes of inspections have taken place in previous years based on risk analysis and another round is currently being carried out.

Moreover, implementation of Regulation (EEC) No 4045/89 is also evaluated in the field of export refunds, the largest area of expenditure covered by the regulation. The recent audit enquiries on differentiated refunds, prefinancing and origin each included an assessment of the contribution made by Regulation (EEC) No 4045/89 scrutinies to addressing the specific risks involved.

(1) Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Netherlands, Portugal, United Kingdom.

(2) Wholly unreliable: not performed or not covering a number of risks or eligibility conditions; wholly satisfactory: covering all key risks and eligibility conditions.
THE COURT’S OBSERVATIONS

(e) the Commission made no written response to Member States on their risk analyses, scrutiny plans or annual reports (3).

4.16. Where they are performed properly, post-payment scrutini es provide a valuable tool in the identification of irregular CAP payments (see Graph 4.3). However, in the form in which they are currently reported by Member States, they do not assist the Commission in identifying and assessing the key risks of irregularity.

4.17. The Court examined a representative sample of 2003 payments drawn from the expenditure of 25 paying agencies (which were collectively responsible for 75% of CAP expenditure) as well as from the direct expenditure of the Commission.

THE COMMISSION’S REPLIES

(e) For the period under review, the Commission services obtained additional assurance through informal discussions and requests for information.

In the course of 2004 the Commission services implemented significant improvements in the monitoring and control of this aspect through formal letters to several Member States aiming in particular to improve the risk analysis proposed.

4.16. More than 3,000 scrutiny is performed annually. During the period in question 320 irregularities were detected by the end of 2003 and this number will increase when the ongoing scrutinies are completed. During the period 2001 to 2003 860 irregularities were communicated to OLAF as a result of application of Regulation (EEC) No 4045/89. The post-payment scrutinies are not only an important tool for identification of irregularities but also serve as a considerable preventive element.


Source: Commission.

The Court’s sample of transactions

4.17. The control systems for CAP expenditure generally provide for physical checks on a percentage of transactions, 100% documentary controls, dissuasive sanctions, and either post-payment checks according to Regulation (EEC) No 4045/89 or/and compatibility with IACS.

(3) According to Regulation (EEC) No 4045/89 ‘the programmes established by the Member States and forwarded to the Commission, shall be implemented by the Member States, if, within eight weeks, the Commission has not made known its comments’.
THE COURT'S OBSERVATIONS

Through these tests, the Court sought to obtain direct evidence that payments were properly made for an eligible activity. Such tests provide good evidence for expenditure on area aid subsidies and, to a lesser extent, animal premiums where physical evidence is usually available to the auditor. By contrast, in areas such as export refunds or aids paid on the basis of the quantity produced, the auditor can only check documents. The extent to which such documents provide reliable evidence is influenced by both the nature of the transaction and the control system concerned (see also paragraphs 4.36, 4.37 and 4.46).

Annual activity report of the Director-General for Agriculture

4.18. The activity report describes what DG AGRI has done during 2003 and contains a declaration by the Director-General that control procedures give assurance on the legality and regularity of underlying transactions. It seeks to provide management assurance that the system of internal control is working satisfactorily. The Director-General’s declaration includes five qualifications. Two of these relate to CAP expenditure: continuing concerns about the management and administration of the International Olive Oil Council; and the failure of Greece to fully implement the IACS. The report discusses progress made on these two issues since 2002 and concludes that despite the progress achieved, it is not yet possible to know whether the problems noted have been resolved.

4.19. For CAP expenditure where management is shared with the Member States the basis for the Director-General’s declaration is:

(a) the financial clearance decision for 2002 (not 2003);
(b) conformity decisions (see paragraph 4.70) taken during 2003, which do not include corrections in respect of 2003. (Conformity decisions on expenditure in 2003 will be taken in future years) (4).

4.20. In other words, the declaration is relevant to transactions undertaken in years previous to 2003. It is not designed to, and does not, provide assurance on which the Court can rely for the 2003 Statement of Assurance.

4.19 and 4.20. The declaration of assurance of the Director-General of DG AGRI is, as far as EAGGF Guarantee is concerned, based on the following elements:

The existence of an effective clearance of accounts procedure as foreseen by Article 53(5) of the Financial Regulation. Financial corrections imposed are based on the Commission audits carried out in Member States. The fact that clearance of accounts decisions are made 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.

The assurance which can be gained from the accreditation of paying agencies, the annual certification procedure and the IACS. These elements permit a great deal of reliance to be placed on the control over the expenditure declared.

A number of other elements contribute to the basis on which the assurance is obtained. These include results of audits made by the Commission’s Internal Audit Service and the Internal Audit Capability and possible information received from OLAF. The Directorate-General for Agriculture also takes account of information received from the Court of Auditors.

As can be seen from the above, the declaration does cover transactions in 2003.

(*) The Director-General’s declaration is drawn up in accordance with the Commission’s charter of tasks and responsibilities of authorising officers by delegation, issued in 2004. This states that, for expenditure under shared management, the annual activity report should be related, not to the accounts of the year for which the activity report is produced, but to accounts for earlier years. Article 60 of the Financial Regulation however provides that ‘the authorising officer shall be responsible for ensuring that the requirements of legality and regularity are complied with (…) and shall report to his/her institution on the performance of his/her duties in the form of an annual activity report (…)’.
4.21. The supervisory systems in place for the CAP provide DG AGRI with a large amount of data of relevance to the legality and regularity of the expenditure concerned. In particular IACS identifies many incorrect claims and blocks payments and can penalise farmers who significantly overstate claims for subsidies.

4.22. The annual activity report does not make reference to the results of checks under supervisory systems; nor to apparent weaknesses in these systems. Nor does it mention the Commission’s continuing postponement of the clearance of the accounts for 21 paying agencies for 2001 and 2002 (see paragraph 4.66), nor comment on the nature and budgetary impact of conformity decisions taken in 2003.

4.22. The annual activity report shall present the main achievements within the activities carried out by a service and evaluate to what extent they fulfil the programme announced in the annual management plan. The control systems in place shall be described and weaknesses identified and deemed to have a material impact on the statement of assurance of the Director-General shall be subject to a reservation and be duly qualified and quantified.

Among these control systems, the annual activity report of DG AGRI for 2003 provides information in particular about the clearance of accounts systems in place, the clearance decisions made by the Commission during the year and it quantifies the conformity decisions. There is an explicit effort made to keep the report relatively short and therefore not all items are reported on specifically. As the Court indicates, DG AGRI could consider adopting a broader approach in its future annual activity reports, including a more comprehensive description of the elements on which the assurance of the authorising officer by delegation is based.

4.23. 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. The Commission’s internal audit service carried out an in-depth audit of DG AGRI in October 2003, making a number of observations in respect of internal control standards. These recommendations were, for the most part, accepted by DG AGRI and remedial action was undertaken as described in the annual activity report.

The Court’s assessment of areas of CAP spending

Area aid schemes

4.24. Spending on arable crop subsidies paid on an area aid basis amounted to 16 340 million euro in 2003, 36 % of CAP expenditure. All of this expenditure is covered by IACS.
4.25. The IACS inspection results on declarations of area for 2002 (resulting in subsidy payments in 2003) are set out in Table 4.1. These results cover arable crops (56% of the total area inspected), and also forage areas (5%), which are not subsidised on the basis of the area cultivated. It is not possible to distinguish between inspection results for different crops (wheat, protein crops, durum wheat, etc.) or for forage areas (on which area aid is not paid). The overall figures given do not, therefore, relate solely to area aid schemes, and mask variations between different aid schemes.

4.26. The overall rate of error reported to the Commission is 1.7% (compared with 1.3% for subsidy payments made in 2002 and 2.4% for 2001). The overall total includes the results of checks on claims selected at random and on the basis of an analysis of risk. 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 (5).

4.27. 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. Some Member States report higher rates of error for tests based on risk analysis than for random testing (Sweden (3.3% error in risk-based checks, 1.5% at random), Italy (3.3% on basis of risk, 1.9% at random) and Austria (2.5% on basis of risk, 0.7% at random)). At the other extreme Greece reported 1.9% for risk-based sampling compared to 13.5% for random sampling.

As noted by the Court, the overall figures are influenced by the greater use of remote sensing in risk-based inspection in mainly Finland, France, Ireland and United Kingdom.

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.
Table 4.1 — Area aid, forage areas and other crops — Results of IACS field inspections and remote sensing in 2002, relating to claims paid in 2003

<table>
<thead>
<tr>
<th>Member State</th>
<th>Applications submitted</th>
<th>Applications checked</th>
<th>Applications with errors</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Area (ha)</td>
<td>Average size (ha)</td>
</tr>
<tr>
<td>Belgium</td>
<td>41 927</td>
<td>1 015 848</td>
<td>24</td>
</tr>
<tr>
<td>Denmark</td>
<td>51 147</td>
<td>2 332 595</td>
<td>46</td>
</tr>
<tr>
<td>Germany</td>
<td>319 167</td>
<td>14 243 441</td>
<td>45</td>
</tr>
<tr>
<td>Greece</td>
<td>324 667</td>
<td>2 162 368</td>
<td>7</td>
</tr>
<tr>
<td>Spain</td>
<td>435 039</td>
<td>18 028 312</td>
<td>41</td>
</tr>
<tr>
<td>France</td>
<td>420 222</td>
<td>23 690 759</td>
<td>56</td>
</tr>
<tr>
<td>Ireland</td>
<td>127 006</td>
<td>4 653 421</td>
<td>37</td>
</tr>
<tr>
<td>Italy</td>
<td>600 375</td>
<td>7 086 654</td>
<td>12</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2 007</td>
<td>122 626</td>
<td>61</td>
</tr>
<tr>
<td>Netherlands</td>
<td>46 898</td>
<td>662 488</td>
<td>14</td>
</tr>
<tr>
<td>Austria</td>
<td>129 277</td>
<td>2 458 617</td>
<td>19</td>
</tr>
<tr>
<td>Portugal</td>
<td>138 708</td>
<td>2 462 707</td>
<td>18</td>
</tr>
<tr>
<td>Finland</td>
<td>69 584</td>
<td>2 076 462</td>
<td>30</td>
</tr>
<tr>
<td>Sweden</td>
<td>59 705</td>
<td>2 730 135</td>
<td>46</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>129 188</td>
<td>14 229 365</td>
<td>110</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>Total 2001 (1)</td>
<td>2 935 273</td>
<td>98 275 675</td>
<td>33</td>
</tr>
<tr>
<td>Total 2000 (1)</td>
<td>2 973 806</td>
<td>96 176 722</td>
<td>32</td>
</tr>
</tbody>
</table>

(1) Amended figures following receipt of IACS inspection results for Greece.
NB 1: Remote sensing involves the use of satellite or aerial photography to check IACS application.
NB 2: Tests performed in year N are relevant to payments made in year N+1.
THE COURT'S OBSERVATIONS

4.28. Member States checked 8.6% of claims on the spot, representing 11.9% of the area for which claims were made. Member States found errors in more than one in three of the claims checked. Three fifths of checks were made using remote-sensing (typically aerial photographs), the remainder being classic on-site inspections. There were marked differences among Member States (see Graph 4.4). For example:

(a) Luxembourg found an error in 80% of the claims checked; Ireland, where most checks were of forage areas, found the lowest frequency of errors (9%);

(b) detected errors had the greatest impact on the area claimed in Greece and Italy where they amounted to 3.9% and 3.3% respectively of the area checked, followed by Sweden (2.9%) and Luxembourg (2.8%);

(c) Portugal (98%) made most use of remote sensing. Aerial photographs were not used at all by either Austria or Luxembourg.

4.29. Errors found by the IACS inspectors can result in the application of significant penalties. Where the error found is of 3% or lower, subsidy for the crop group concerned is paid for the amount claimed less the amount of error. Where inspection finds an error of between 3% and 20%, payment is reduced by the amount of the error, and a penalty equal to twice the amount of the error is applied. Where inspectors find an error exceeding 20% of the amount claimed, the entire subsidy for that crop group is withdrawn. Overall the Member States found errors exceeding 20% of

Graph 4.4 — Area aid. Results of field inspections: percentage of applications inspected which were overstated

NB: Tests performed in year N are relevant to payments made in year N + 1.
the amount claimed in nearly one in ten of claims inspected. Such errors were most frequently identified in Spain (one in five claims inspected), Portugal and Luxembourg (one in seven) and Greece (one in eight).

4.30. Taken as a whole, the results of the Court's testing of transactions (76 of which related to area aid payments) are broadly consistent with the results of random testing performed by the Member States, and the distribution follows closely the pattern of 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 (no more than double the 3% error rate for which no penalties are imposed under IACS (paragraph 4.29)). As in previous years, errors of this nature and scale, while frequent, have no marked impact on overall expenditure;
(c) a relatively small number of wholly or largely unjustified claims is a greater source of irregular expenditure than these small measurement errors (7).

Animal premium schemes

4.31. Spending on animal premiums amounted to 9 890 million euro in 2003, 22% 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. As discussed in paragraph 4.12, the Court considers these statistics to be less reliable than the equivalent statistics for area aid applications. In 2002 (i.e. in respect of claims paid in 2003), for the largest scheme, the suckler cow premium (see Table 4.2 and Graph 4.5), 14 Member States inspected 18.7% of the animals claimed, finding 2.0% of these to be missing or ineligible (in 2001, 6.4% were found to be ineligible). For the special beef premium the percentage of animals missing or disallowed was 3.8% in 2002, for the extensification premium 1.5% (8), and for the sheep and goat premiums 5.6%.

4.32. 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.

(7) For example, this year the Court's testing identified one claim by a farmer in Spain who had sought payment on a piece of land that was too densely planted with trees to be eligible for subsidy for arable crops. In 2002 the audit identified two payments where the error exceeded 20% of the area claimed (in Greece and France). And in 2001 the Court also identified two declarations which were largely or wholly unfounded, involving protein crops in Italy, and maize production in Greece. 

(8) Ireland, Italy, Austria and Finland all report no errors for extensification premiums. Overall results for this measure appear unreliable.
## Table 4.2 — IACS inspections for suckler cow premium — Results of on-the-spot checks in 2002, relating to claims paid in 2003

<table>
<thead>
<tr>
<th>Member State</th>
<th>Total number of claims submitted</th>
<th>Claims inspected</th>
<th>Inspected claims partially rejected</th>
<th>Inspected claims fully rejected</th>
<th>Total number of animals claimed</th>
<th>Animal inspected</th>
<th>Inspected animals rejected</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>%</td>
<td>Number</td>
<td>%</td>
<td>Number</td>
<td>%</td>
<td>Number</td>
</tr>
<tr>
<td>Belgium</td>
<td>15 999</td>
<td>9 999,9</td>
<td>21</td>
<td>1,3</td>
<td>17</td>
<td>1,1</td>
<td>396 431</td>
</tr>
<tr>
<td>Denmark</td>
<td>9 108</td>
<td>831</td>
<td>9,1</td>
<td>77</td>
<td>9,3</td>
<td>8</td>
<td>1,0</td>
</tr>
<tr>
<td>Germany</td>
<td>34 576</td>
<td>3 877</td>
<td>11,2</td>
<td>274</td>
<td>7,1</td>
<td>79</td>
<td>2,0</td>
</tr>
<tr>
<td>Greece</td>
<td>12 198</td>
<td>12 141</td>
<td>99,5</td>
<td>512</td>
<td>4,2</td>
<td>95</td>
<td>0,8</td>
</tr>
<tr>
<td>Spain</td>
<td>66 156</td>
<td>10 178</td>
<td>15,4</td>
<td>779</td>
<td>7,7</td>
<td>74</td>
<td>0,7</td>
</tr>
<tr>
<td>France</td>
<td>127 842</td>
<td>15 710</td>
<td>12,3</td>
<td>2 475</td>
<td>15,8</td>
<td>293</td>
<td>1,9</td>
</tr>
<tr>
<td>Ireland</td>
<td>64 250</td>
<td>5 282</td>
<td>8,2</td>
<td>272</td>
<td>5,1</td>
<td>35</td>
<td>0,7</td>
</tr>
<tr>
<td>Italy</td>
<td>58 068</td>
<td>12 117</td>
<td>20,9</td>
<td>503</td>
<td>4,2</td>
<td>1 987</td>
<td>16,4</td>
</tr>
<tr>
<td>Luxembourg (?)</td>
<td>(1)</td>
<td>(1)</td>
<td>(1)</td>
<td>(1)</td>
<td>(1)</td>
<td>(1)</td>
<td>(1)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>4 498</td>
<td>824</td>
<td>18,3</td>
<td>44</td>
<td>5,3</td>
<td>49</td>
<td>5,9</td>
</tr>
<tr>
<td>Austria</td>
<td>62 463</td>
<td>6 170</td>
<td>9,9</td>
<td>493</td>
<td>8,0</td>
<td>117</td>
<td>1,9</td>
</tr>
<tr>
<td>Portugal</td>
<td>27 093</td>
<td>3 173</td>
<td>11,7</td>
<td>125</td>
<td>3,9</td>
<td>120</td>
<td>3,8</td>
</tr>
<tr>
<td>Finland</td>
<td>1 469</td>
<td>159</td>
<td>10,8</td>
<td>8</td>
<td>5,0</td>
<td>2</td>
<td>1,3</td>
</tr>
<tr>
<td>Sweden</td>
<td>10 116</td>
<td>850</td>
<td>8,4</td>
<td>4</td>
<td>0,5</td>
<td>0</td>
<td>0,0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>45 257</td>
<td>5 194</td>
<td>11,5</td>
<td>469</td>
<td>9,0</td>
<td>57</td>
<td>1,1</td>
</tr>
<tr>
<td><strong>Total 2002</strong></td>
<td>539 093</td>
<td>78 087</td>
<td>14,5</td>
<td>6 056</td>
<td>7,8</td>
<td>2 933</td>
<td>3,8</td>
</tr>
<tr>
<td><strong>Total 2001</strong></td>
<td>581 293</td>
<td>81 921</td>
<td>14,1</td>
<td>10 469</td>
<td>12,8</td>
<td>1 058</td>
<td>1,3</td>
</tr>
</tbody>
</table>

(1) This information is not available as Luxembourg failed to provide the Commission with their results.

NB 1: A claim is fully rejected when a difference greater 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: DG AGRI - IACS 2002 Statistics, summarising inspection results provided by the Member States
4.33. The direct testing performed by the Court revealed both errors in the amount claimed and deficiencies in the operation of control systems:

(a) over-declaration of livestock (Italy) where inspectors had failed to detect that the farmer had fewer eligible ewes than he declared in his claim for subsidy;

(b) poor management of documentation and the recording of livestock data by beneficiaries (Greece, Spain, France, Italy and Portugal);

(c) differences in the number of animals present on the farm and recorded in the farm registrar by beneficiaries (Spain, France and Portugal).

4.34. Frequent animal movements and the complex conditions of the animal premium schemes are two of the reasons why the results of IACS checks in the animal sector show higher error rates than for arable crops. Both the results of IACS testing and the direct work of the Court indicate that there is inherent risk of overpayment of animal premiums.

4.33. The Commission is aware of these problems and through the clearance of accounts procedure has urged Member States to take the necessary actions to improve the situation. It is anticipated that such improvements will be forthcoming from claim year 2003 onwards.

4.34. The various bovine premia are directed towards different types of animals and have to comply with different conditions. There is also a wider variety in practices/conditions over Europe in the animal sector compared to the area aids. The risk that some farmers over-declare cannot be eliminated, but it is reduced by a dissuasive control and sanctions system.
Subsidies paid on the basis of quantity produced

4.35. The EU subsidises olive oil, cotton, tobacco and dried fodder production (€297 million euro, 12% of CAP expenditure in 2003) on the basis of the quantity produced, rather than the area used to grow the crop. Expenditure of this kind poses particular risks:

(a) quantities produced may be overstated (if the activities of producers are not properly supervised and/or their records are not reliable there is no other way of verifying the figures declared);

(b) producers have an incentive to understate the area devoted to the production of such crops, and to claim they used some of the area for the production of crops subsidised on an area aid basis.

4.36. To seek to reduce such risks, Community legislation provides 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 (*) 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.

4.37. The Court’s audit of a sample of transactions identified a number of errors and of deficiencies:

(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 (see paragraph 4.35(b)). Producers have an incentive to understate the area cultivated with crops paid on actual production and to overstate crops paid on an area basis;

(*) The geographical information system links parcel identification, registers and aerial photographs to allow administrative checks on the number and location of olive trees.

4.36. The Commission agrees with the Court’s view and has identified the same particular risks as regards production aid. The checking systems for the various COMs take account of these risks. If these systems are not applied correctly, financial corrections are applied as part of the clearance of accounts procedure.

4.37. The Commission is aware of the shortcomings of the IACS in Greece, which have resulted in a large number of financial corrections as regards field crops. The consequences of these shortcomings for checks on the schemes for production aid are taken into account when the accounts for those schemes are cleared.
THE COURT’S OBSERVATIONS

(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;

(c) in Greece the Court found a quantity of cotton rejected by a ginning mill which nevertheless received subsidy.

4.38. The findings of the olive oil control agencies are set out in Tables 4.3 and 4.4.

<table>
<thead>
<tr>
<th>Member State</th>
<th>Number of producers</th>
<th>Number of mills</th>
<th>Mills checked</th>
<th>Proposals to withdraw authorisation</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td>In depth</td>
<td>Summary</td>
<td>No</td>
<td>%</td>
</tr>
<tr>
<td>Greece</td>
<td>854 780</td>
<td>2 541</td>
<td>1 146</td>
<td>45,1</td>
<td>805</td>
<td>31,7</td>
</tr>
<tr>
<td>Spain</td>
<td>435 605</td>
<td>1 715</td>
<td>1 001</td>
<td>58,4</td>
<td>881</td>
<td>51,4</td>
</tr>
<tr>
<td>Italy</td>
<td>972 499</td>
<td>5 737</td>
<td>3 144</td>
<td>54,8</td>
<td>1 881</td>
<td>32,8</td>
</tr>
<tr>
<td>Portugal</td>
<td>142 464</td>
<td>710</td>
<td>449</td>
<td>63,2</td>
<td>449</td>
<td>63,2</td>
</tr>
<tr>
<td>Total</td>
<td>2 405 348</td>
<td>10 703</td>
<td>5 740</td>
<td>53,6</td>
<td>4 016</td>
<td>37,5</td>
</tr>
</tbody>
</table>

(1) Portugal do not carry out summary checks.

Source: Annual Reports for 2001 to 2002 of the Greek, Spanish, Italian and Portuguese olive oil agencies.

THE COMMISSION’S REPLIES

(b) Payments in 2003 were for the 2001/02 marketing year. Along with checks on mills, the olive tree register is one element in the system of checking production aid for olive oil. It is compulsory only from the 2003/04 marketing year. In earlier years, the lack of the register could be offset by on-the-spot checks on crop declarations. As far as the Commission is aware, the main Autonomous Communities used an olive tree register for 2001/02, and so carried out no on-the-spot checks. This point, along with the inspection system in Greece, is being considered as part of the clearance of accounts procedure.

(c) The Commission will look at the case the Court mentions.

Table 4.4 — Olive oil inspection agencies: checks on producers (2001 to 2002), relating to claims paid in 2003

<table>
<thead>
<tr>
<th>Member State</th>
<th>Number of producers</th>
<th>Number of producers checked</th>
<th>Producing units checked</th>
<th>Aid payments withdrawn or reduced</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>On site</td>
<td>Using documents</td>
<td>No</td>
<td>%</td>
<td>No</td>
</tr>
<tr>
<td>Greece</td>
<td>854 780</td>
<td>4 362</td>
<td>0,5</td>
<td>2 811</td>
<td>0,3</td>
<td>1 751</td>
</tr>
<tr>
<td>Spain</td>
<td>435 605</td>
<td>1 446</td>
<td>0,3</td>
<td>753</td>
<td>0,2</td>
<td>693</td>
</tr>
<tr>
<td>Italy</td>
<td>972 499</td>
<td>1 879</td>
<td>0,2</td>
<td>298</td>
<td>0,0</td>
<td>1 581</td>
</tr>
<tr>
<td>Portugal</td>
<td>142 464</td>
<td>2 519</td>
<td>1,8</td>
<td>1 621</td>
<td>1,1</td>
<td>898</td>
</tr>
<tr>
<td>Total</td>
<td>2 405 348</td>
<td>10 406</td>
<td>0,4</td>
<td>5 483</td>
<td>0,2</td>
<td>4 923</td>
</tr>
</tbody>
</table>

Source: Annual Reports for 2001 to 2002 of the Greek, Spanish, Italian and Portuguese olive oil agencies.
THE COURT'S OBSERVATIONS

4.39. A key part of the agencies’ work relates to checks on olive mills (producers are paid on the basis of quantities weighed and processed at the mills). Where the agencies find discrepancies (such as irregular accounting or reporting increased quantities or yields) 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. For example, in Greece, the ministry of agriculture only followed the recommendation of the olive oil control agency in four out of 241 cases (10). The report of the Italian agency provides an estimate of the discrepancy between the quantity of olives declared in demands for subsidy (663 200 tonnes) and the estimated quantity entering mills (573 500 tonnes). The quantity on which subsidy was claimed exceeds estimated production by 15.6 % in 2002, and by an average of 8.1 % over the period 1984 to 2002.

Rural development

4.40. Rural development expenditure amounted to 4 719 million euro in 2003, 11 % of CAP spending. This covers spending on agri-environmental schemes, forestry, investments, support for young and for retiring farmers.

4.41. Schemes of this kind frequently have relatively complex eligibility conditions which sometimes need to be checked over several years.

4.42. The certifying bodies have qualified their audit opinion on the accounts of three agencies which specialise in rural development measures (Bayern Umwelt (Germany), Cnasea (France) and Ifadap (Portugal)). Errors affecting rural development expenditure are involved in the audit qualification of a further five agencies (Bayern Landwirtschaft (Germany), INGA (Portugal), NRW Westfalen (Germany), Région Wallonne (Belgium), Saarland (Germany)).

4.43. The errors found by the Court include:
(a) reimbursement of ineligible costs (Germany and France);
(b) relatively small overstatements of the area claimed for environmental schemes (Finland, France and Austria).

(10) In 2001 to 2002 the Greek olive oil agency recommended withdrawing approval for 149 olive mills and in 2000 to 2001 for 211 mills. In 2000 to 2001 the Sanction Commission of the Ministry of Agriculture considered 144 recommendations and implemented the recommendations in four cases. In 2001 to 2002 it considered 241 recommendations, withdrawing approval from five mills.

THE COMMISSION'S REPLIES

4.39. The Commission monitors the Member States’ checks on the work of the inspection agencies. Account is taken of any shortcomings in the procedures for clearing the accounts relating to production aid for olive oil.
THE COURT’S OBSERVATIONS

Other expenditure

4.44. Expenditure not covered by the above headings amounts to 8 132 million euro. This includes export refunds, which are paid to cover the difference between EU and world market prices and allow surplus EU production to be disposed of on world markets, subsidies for the withdrawal and storage of excess production, a number of small subsidy schemes, and veterinary expenses.

4.45. The Court continues to find serious errors in these areas of spending, for example in subsidies for dried grapes (Greece), reported on in the 2002 Annual Report, and the treatment of direct expenditure on veterinary measures (France).

4.45. The Commission has and will continue to propose financial corrections for deficiencies found in subsidies for dried grapes, the aid for which is mainly concentrated in Greece.

As for the veterinary measures in France, the problem highlighted by the Court concerned the late submission of the request for the financial contribution. The late request was exceptionally accepted as priority was given to the eradication of TSE. The late submission was acknowledged and regularized in the corresponding Commission Decision concerning the financing of the TSE programs submitted by all the Member States, and therefore in the Commission’s view does not constitute an error.

4.46. The Court examined two control systems relevant to expenditure not covered by IACS and predominantly classified here as other expenditure:

(a) post-payment checks (see paragraphs 4.13 to 4.16) were found to be of a low standard in terms of both the performance of inspections (one in five proving wholly unreliable) and the reporting of errors (the Commission has no information on the type of expenditure most at risk);

(b) physical and documentary checks on goods at the time of export cover at least 5% of subsidised exports (11). 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.

(a) Scrutinies of commercial documents under Regulation (EEC) No 4045/89 are an ideal complement to front-line controls and offer increased assurance of the sound execution of the budget. These controls are separate from and additional to the pre-payment control and sanctions systems applying to all expenditure.

(b) The Court raised this matter in its 2002 annual report. The Commission, which was already aware of this necessity, has already taken steps to start collecting data on the financial volume of the exports subject to physical checks.

Conclusion

4.47. As in previous years, the Court found that CAP expenditure, viewed as a whole, and drawing on all available evidence, was materially affected by error. The Court notes, however, that different degrees of risk attach to the main categories of CAP spending:

(a) in the 14 Member States which in 2003 had satisfactorily implemented IACS, expenditure on arable crops appears to be the lowest risk category of CAP expenditure, and subject to the most effective control system;

(b) Council Regulation (EEC) No 386/90.
THE COURT’S OBSERVATIONS

(b) animal premiums are subject to a generally satisfactory and operational system of checks, which results in the rejection or correction of many claims made by farmers. However, largely because of frequent animal movements, final expenditure remains subject to a greater degree of risk than arable payments;

(c) categories of expenditure which cannot be checked through IACS pose greater risks because the systems available to control them are not as effective.

THE COMMISSION’S REPLIES

(b) The Commission has sought to switch support to direct payments to farmers as, inter alia, such a change in policy limits the risk to the Fund and helps to protect EU tax-payers’ interests. The 2003 CAP Reform, followed by the second wave of the Reform in 2004 on Mediterranean products, will further enhance this positive evolution. In addition, many of the schemes referred to by the Court became compulsorily IACS compatible from 1 January 2003. Regarding export refunds and some intervention measures, the Commission agrees that those schemes are exposed to greater risk. Nevertheless, the continuing reduction in the incidence of irregularities communicated by Member States seems to suggest that the effort made over the years to strengthen controls and sanctions has not been without effect.

4.48. The Court identified a number of ways in which the operation of supervisory systems could and should be improved (see paragraph 4.49).

Recommendations

4.49. The Commission should seek to:

(a) identify the reason for poor-quality checks of CAP spending (in particular for post-payment checks) and ways in which they could be improved;

(b) improve the format of reporting of the results for all supervisory systems, providing a breakdown of the information available on the number and value of payments checked and of errors found by budgetary chapter (for example, distinguishing between findings for area aid and for forage areas, and, within area subsidies, between results for the basic cereal subsidy and the supplement for durum wheat);

(c) use the information so provided to compare the results provided by the different Member States in order to:

(i) identify subsidies which are particularly subject to fraud and error;

(ii) evaluate the performance of the different paying agencies in preventing and detecting errors; and

(iii) propose changes to regulations and to systems aimed at eliminating areas of risk and reducing the rate of error.

(a) The Commission agrees that, in cases where controls have been poorly executed, improvements should be sought.

(b) The Commission services consider the current system of statistical reporting to be an efficient tool. When information supplied by Member States appears not to be fully correct, the Commission services ensure prompt follow-up and revision in the framework of the clearance of accounts.

(c) The Commission is in fact already implementing this recommendation in performing detailed analyses each year, when establishing the annual work plan.
4.50. In the light of the Court’s findings for 2002 and 2003, and the comments made by the Commission in the reply to last year’s report, the Court recommends that the Commission investigate the reason why, for IACS checks on areas, tests performed on a random basis continue to show a higher rate of error than those selected on the basis of an analysis of risk.

4.50. See reply to point 4.26.

In its efforts to improve the IACS, the Commission has amended the IACS Commission Regulation in January 2004 as regards risk analysis, especially in introducing an obligation for Member States to review annually the efficiency of the risk factors used.

4.51. The Court considers that a summary of the results of supervisory checks should be included in the Annual Activity Report of the Director-General for Agriculture (see also paragraph 4.22).

4.51. DG AGRI will take account of the Court’s recommendation for future annual activity reports.

CLEARANCE OF ACCOUNTS

Introduction

4.52. Clearance of accounts is a procedure designed to ensure that CAP payments have been legal and regular and that appropriate amounts are definitively charged to the Community budget (12). It involves:

(a) an annual ‘financial clearance’ decision, in which the Commission decides whether to accept the CAP paying agencies’ accounts for the preceding budgetary year in the light of reports by the ‘certifying bodies’ which audit them;

(b) ‘conformity decisions’ under which the Commission decides whether to ‘disallow’ expenditure (i.e. refuse to finance it definitively for the Community budget) and ‘make corrections’, (i.e. reduce payments to the Member States concerned accordingly). Such decisions relate to several EAGGF years. In most cases, disallowance takes place because the Commission has identified weaknesses in Member States’ control systems, and the Commission applies a scale of flat-rate corrections based on the seriousness of the management failure. The process is selective, not comprehensive. The Commission examines particular areas of expenditure in particular Member States as the basis for its conformity decisions.

The Court examined how these arrangements functioned in 2003.

(12) In cases of shared or decentralised management, in order to ensure that the funds are used in accordance with the applicable rules, the Commission shall apply clearance of accounts procedures or financial correction mechanisms which enable it to assume financial responsibility for the implementation of the budget in accordance with Article 274 of the EC Treaty and Article 179 of the Euratom Treaty; Article 53.5 of the Financial Regulation, Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002 (OJ L 248, 16.9.2002, p. 1).
4.53. The Court examined in detail the reports produced by the certifying bodies of the 25 paying agencies (see Table 4.5) from which transactions for substantive testing were selected by the Court for the Statement of Assurance purposes. These reports indicate whether, in the view of the certifying bodies, paying agencies’ accounts are true, complete and accurate (13); and whether the agencies’ control systems are satisfactory. In addition, the Court examined any other reports on paying agencies for which a qualified certificate was given. The Court sought to establish whether:

(a) reliance could be placed on the work of the certifying bodies;
(b) the Commission’s financial clearance decision took proper account of the work of the certifying bodies and was otherwise satisfactory.

Audit opinions of certifying bodies

4.54. For the financial year ending 15 October 2003, 64 paying agencies managing 32.9 billion euro received an unqualified audit opinion (see Table 4.5). The remaining 21 agencies, managing 11.3 billion euro, received a qualified or negative opinion because of:

(a) material levels of error in the expenditure of Ifadap (Portugal), Baden-Württemberg, Bayern Umwelt (Germany) and Catalunya (Spain) (14);
(b) the inability of some certifying bodies to provide assurance on certain areas of spending (scope limitation) because of specific weaknesses in control systems (Saarland and NRW-Westfalen-Lippe, Olival, Onilhor, Cnasea), difficulties in obtaining information from paying agencies or further information requested (Hamburg, Berlin and Bayern StMiLF) or decisions to audit advances paid during 2003 as part of the 2004 certification work (Olival (15));

(14) The French certifying body also made reservations for material level of errors amounting to 13.8 million euro on the accounts of Olival, Cnasea, Odeadom and SDE.
(15) Due to the 2003 droughts, five Member States (Germany, France, Italy, Luxembourg, Portugal) were authorised to make advance payments of 2004 aid to livestock farmers under specified schemes during the period 1 September to 15 October 2003. In total 501.4 million euro was made available for this purpose of which 225 million euro for France (Commission Regulation (EC) No 1621/2003 (OJ L 231, 17.9.2003, p. 7)).
30.11.2004

EN

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Table 4.5 — Paying agencies by expenditure declared in 2003
No

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Member State

Italy
France
Greece
United Kingdom
France
Ireland
Spain
Denmark
Germany
Austria
France
Spain
Spain
Finland
France
Portugal
Germany
France
Spain
Spain
Germany
Germany
France
Germany
Germany

Paying agency

Amounts declared in
million euro

AGEA
ONIC
Opekepe
RPA
Ofival
DAF
Andalucia
EU-direktoratet
Bayern, Landwirtschaft
AMA
ONIOL
Castilla — La Mancha
Castilla — Léon
MMM
Cnasea
INGA
Niedersachsen
Onilait
Extremadura
FEGA
Baden-Württemberg
Mecklenburg-Vorpommern
Oniflhor
Sachsen-Anhalt
Bayern, Umwelt
Subtotal ( )
2

26
27
28
29
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31
32
33
34
35
36
37
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39
40
41
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Sweden
Germany
United Kingdom
Belgium
Spain
Netherlands
Germany
Netherlands
France
Spain
Germany
Germany
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Italy
Netherlands
United Kingdom
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United Kingdom
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Belgium
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Portugal
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Spain
Netherlands
Ireland
Spain
Italy
Austria
Netherlands
Italy
Luxembourg
Spain
Italy
Spain
Netherlands
Spain
France
Germany
United Kingdom
Belgium
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Germany
Germany
United Kingdom
Germany
Germany
Spain

SJV
Hamburg-Jonas
SERAD
BIRB
Aragón
PZ
BLE
LASER
FIRS
Cataluña
Nordrhein-Westfalen Westfalen-Lippe
Schleswig-Holstein
Brandenburg
SAISA (ex DCCC)
HPA
DARD
Onivins
Thüringen
NAWAD
Région Wallonne
Hessen
Vlaamse Gemeenschap ALP
Sachsen
Rheinland-Pfalz
Canarias
Valencia
Odeadom
Navarra
Galicia
Nordrhein-Westfalen Rheinland
ENR
IFADAP
Murcia
AGREA
Asturias
País Vasco
DLG
DCMNR
Madrid
Region Lombardie
ZA Salzburg
PT
ARTEA (Toscana)
Ministère de l’Agriculture
La Rioja
AVEPA (Veneto)
Cantabria
PVVE
Baleares
ACCT/SDE
Saarland
FC
Vlaamse Gemeenschap ALT
Ofimer
Hamburg
Nordrhein-Westfalen LfEJ
CCW
Bremen
Berlin
FROM

% of total

4 891,34
4 594,60
2 765,73
2 758,04
2 380,50
1 893,02
1 741,57
1 219,66
1 074,78
1 074,97
936,40
932,60
915,23
874,40
797,76
744,13
652,57
631,07
607,96
473,35
446,75
309,15
263,92
254,70
22,32

11,06
10,39
6,26
6,24
5,38
4,28
3,94
2,76
2,43
2,43
2,12
2,11
2,07
1,98
1,80
1,68
1,48
1,43
1,38
1,07
1,01
0,70
0,60
0,58
0,05

33 256,52

75,22

864,38
586,24
569,01
559,35
527,45
518,11
432,82
402,24
375,11
371,92
352,50
335,72
312,32
300,30
290,18
283,85
283,75
272,08
246,02
237,53
228,83
204,06
199,81
187,08
161,30
150,68
142,56
137,29
133,71
124,31
109,38
104,75
90,06
68,07
63,73
59,50
58,73
52,76
52,46
50,71
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47,15
45,23
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19,82
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7,92
7,82
7,28
4,57
4,53
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0,90

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1,19
1,17
0,98
0,91
0,85
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0,71
0,68
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0,04
0,04
0,02
0,02
0,02
0,01
0,01
0,01
0,00
0,00

Subtotal

10 955,73

24,78

Total

44 212,25

100,00

(1) Accounts disjoined from the financial decision taken on 29 April 2004.
(2) The Court examined the reports and certificates of these 25 paying agencies in respect of which a sample of transactions was selected for testing.
NB: The exchange rates for Member States outside euro zone: Denmark: 7,428, Sweden: 9,1458, United Kingdom: 0,6842.
Source: Summary report of the Commission on the financial clearance of the EAGGF Guarantee Section accounts for 2003.

Qualified accounts

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Disjoined accounts (1)

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11 266,58

19 042,73


(c) breaches of the criteria for the accreditation of paying agencies which do not have a direct financial impact (16) and other control weaknesses — Opekepe (Greece), Vlaamse Gemeenschap (Belgium), SDE (France), Ministry of Agriculture (Luxembourg);

(d) some certifying bodies’ inability to give an opinion on the completeness of the debtor’s statement (SERAD, Niedersachsen, Ifdap and Opekepe).

Analysis of the work of certifying bodies

4.55. The Commission seeks to ensure that the certifying bodies properly audit expenditure managed by the paying agencies by establishing guidelines (including on the sampling of transactions in order to establish whether there is a material level of error (17)), and by reviewing the reports of the certifying bodies to ensure that this guidance has been applied.

Audit of expenditure

4.56. The certifying bodies reviewed the procedures put in place by paying agencies to administer CAP expenditure. In the case of 69 paying agencies, responsible for 40 billion euro of expenditure, they also tested a statistical sample of the paying agencies’ documents relating to CAP payments. Some 24 000 transactions were tested in this way.

4.57. The Commission concluded that, in addition to the qualifications noted in paragraph 4.54:

(a) there was a material level of error in the expenditure of three other paying agencies (Madrid, Cantabria and Mecklenburg-Vorpommern);

(b) the French certifying body had not used the required approach to sampling;

(c) the United Kingdom certifying body had not tested a sufficiently large sample of transactions;

(d) the reports for HPA and LASER (Netherlands) did not provide the required information about sampling and the treatment of errors.

(16) For example, delegation of the authorisation function and/or the technical service; adequacy of the internal audit service.

(17) Materiality is defined for these purposes as 1 % of the value of the population from which the sample is taken.
THE COURT’S OBSERVATIONS

4.58. For its part the Court identified:

(a) that the report for Luxembourg suffered from the same weaknesses as those for HPA and LASER;

(b) that there was inadequate information in nine of the reports for Spanish paying agencies. However the Commission obtained additional information which enabled it to clear the accounts. The Court reviewed the work of two of the certifying bodies concerned on the spot. One of these had performed a thorough audit of the accounts and was able to provide full documentation of the work carried out (Castilla-La Mancha). For the other agency (Andalucía, the largest in Spain) the situation was unsatisfactory. The certifying body had contracted out the audit in November 2003 leaving the contractee very limited time to perform the audit. There was little audit evidence to support the work carried out and supervision was inadequate. Compliance testing was performed too late and at a negligible level.

Debtors

4.59. Paragraphs 4.113 to 4.121 summarise a Special Report by the Court on CAP irregular payments and debts.

4.60. The total value of debts as at 15 October 2003 was 2.3 billion euro (similar to the previous year). Four certifying bodies qualified the debtors’ statement (see paragraph 4.54) and many others noted significant weaknesses in the management, recording and recovery of debts (17 paying agencies).

4.61. Reports for several of the paying agencies indicate that the work performed by the certifying bodies is not sufficient to ensure that all debts are reliably recorded. In addition, the Commission guideline (18) on the valuation of debt requires certifying bodies to form an opinion on the value of debts to the paying agencies which are likely to be recovered. Four did not do so.

THE COMMISSION’S REPLIES

4.58. (a) The accounts for Luxembourg have been disjoined — due to lack of reporting on the measures taken in response to previous year’s recommendations. The issues mentioned by the Court will also be taken into consideration before the final clearance decision for this Member State.

(b) Regarding the late appointment of the auditor by the certifying body in Andalucía, the Commission agrees that such decisions should be made in good time. It will insist (as has already been done in the past for other paying agencies) on the importance of early appointment of audit firms.

As far as the limited level of compliance testing is concerned, the Commission makes its clearance proposal taking into consideration the whole work performed by the certifying body.

Finally, with regard to the questions of the limited audit evidence and supervision, the Commission will insist on the need to ensure that both aspects receive sufficient attention by certifying bodies (in particular when audit firms are appointed to perform all or part of the audit work).

4.60 and 4.61. The Commission shares the view of the Court as regards the importance of this issue. It is aware of the difficulties of debt management in a number of paying agencies and also of the improvements introduced. This question has received particular attention since 1999 and will continue to be the subject of further review and action. Nevertheless, having taken all the available information into consideration, the Commission was able to propose clearance of the paying agencies’ accounts, despite the existence of some difficulties. The Commission has always taken note of problems identified and will further insist on the necessity of clear opinions from certifying bodies on this subject.

The Commission continues to closely supervise this issue, and four visits to Member States have been organised for the second half of 2004.

The Commission’s decision

4.62. The Commission analysed and evaluated the accounts, certificates and reports for all paying agencies except for six which were submitted late or in an incomplete state (19). The Commission carried out a series of checks on individual payment data in order to identify possible double payments (20).

4.63. The Commission took its financial clearance decision on 29 April 2004 (21), within the deadline laid down in the regulation.

4.64. The Commission accepted the accounts of 56 paying agencies which together account for 25.2 billion euro (57 % of the total declared). Where there are quantifiable errors in the accounts of paying agencies the Commission has indicated that it will make appropriate financial corrections.

4.65. The Commission postponed its decision on the accounts of 29 paying agencies representing 19 billion euro (43 % of the total declared). The reasons given by the Commission for postponing its decision on the accounts common to more than one paying agency were:

(a) a failure by the certifying bodies to respect the sampling guidelines (the use of too low a confidence level/sample size too small) (15 accounts); or

(b) insufficient details given by the certifying bodies about the sampling method used (two accounts) (22).

4.66. It is standard practice for the Commission to delay its approval of the reports of certifying bodies where it has doubts about the adequacy of their work. The accounts of four paying agencies were omitted from the financial decision for 2001; and those of 17 paying agencies from the financial decision for 2002.

4.67. On no occasion in the past has the Commission however postponed its decision in respect of such a large number of paying agencies, representing such a large proportion of expenditure.

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(19) Sweden, NAWAD (United Kingdom), Berlin, Hamburg, Niedersachsen and Bayern SMiLF.
(20) The results of this exercise have not been made available to the Court. The Commission has asked certifying bodies to pay particular attention to the risk of duplicate payments as part of their 2004 work.
(22) The Court raised this issue in its Special Report No 22/2000 on evaluation of the reformed clearance of accounts procedure.
4.68. It is not clear at what stage the Commission will be able to accept the paying agency accounts not included in its decision of 29 April 2004. Past experience suggests that the delay could be considerable, the 2000 accounts for the former Greek paying agency were not approved until 2003, when the agency had ceased to exist. None of the accounts not included in the 2001 and 2002 financial decisions had been approved by April 2004. The accounts of 10 paying agencies (23) remain uncleared for two out of the past three years.

4.68. By the end of this year the Commission expects to clear the accounts for the four paying agencies disjoined for 2001, plus more than half of the paying agencies disjoined for 2002 (for which all necessary information has been provided).

4.69. Postponing the financial clearance decision does not have any financial consequences for the Member States concerned, nor does it prejudice any future decision on the eligibility of expenditure to Community financing. Nevertheless, the Commission could not reach a conclusion on the accounts of the paying agencies covering 43 % of the expenditure declared for 2003 by the due date.

Conformity decisions taken in 2003

4.70. In 2003, the Commission took three conformity decisions in respect of expenditure declared from 1996 to 2002 (24), refusing to finance 377 million euro, of which the Court examined an amount of 366 million euro and has sought to establish whether the corrections were:

(a) adequate and well founded;
(b) made in good time.

Adequacy of corrections

4.71. The Court concluded that in respect of 308 million euro of disallowed expenditure, the Commission’s procedures were well founded and the amounts disallowed consistent with its normal scale of flat-rate corrections (25).

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(23) Baden-Württemberg, Bayern Umwelt, Opekepe, SDE, Ofival, ONIC, Onilhlor, FIRS, Onivins and NAWAD.
(25) 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.
4.72. In the following cases, the Court took the view that a more rigorous application of the Commission's own rules would have been justified (and would have increased the sum disallowed by 65 million euro):

(a) olive oil in Italy, correction of 13 million euro. The Commission applied a 2 % flat-rate correction to expenditure incurred in 2000, thus relating mainly to the 1998/99 marketing year. The correction is mainly for significant weaknesses found in the checks carried out at the mills and a lack of rigour in the performance and follow-up of compatibility checks on the quantities of olive oil produced. In addition the Geographical Information System (GIS) was not complete and operational when the expenditure was incurred; and, the minimum number of alternative checks required (26) during the marketing year 1998/99 were not made. The Commission has classified these checks as key controls. A correction rate of 5 % would have been consistent with the Commission's scale of flat-rate corrections;

(b) olive oil in Greece, correction of 45.1 million euro. Since 1994, the Commission has applied a 5 % correction because of the non-implementation of the olive oil register and inadequacies of the computerised database. Member States had five years from 1998/99 to implement the GIS, which replaces the olive tree register and database. The Commission considers that the lack of effort to develop the GIS is a weakness in itself and that the improvements made do not compensate for its absence. Thus the 5 % flat-rate applied to expenditure incurred in 2000, relating mainly to 1998/99 marketing year, has been maintained. These checks are key controls and as they are not implemented, a 10 % correction would have been consistent with the Commission's normal scale of flat-rate corrections;

**Note:** Article 28(2) and (3) of Commission Regulation (EC) No 2366/98 (OJ L 293, 31.10.1998, p. 50) states that alternative checks are required as long as the GIS is not complete and operational.
THE COURT'S OBSERVATIONS

24 months rule

4.73. The Commission's ability to refuse financing of expenditure declared is limited to expenditure incurred in the 24 months preceding the date on which it notified the findings of its enquiry to the Member State (27). Thus, a weakness detected during an enquiry covering a period of three years can only lead to a correction of expenditure declared during two years. A proposal to increase the period to 36 months, made by the Commission in 2002 and endorsed by the Court, was rejected by the Council (28).

Time taken to make corrections

4.74. The average length of the clearance of accounts procedure, for corrections made in the three decisions taken in 2003, from the date of the mission in the Member State to the inclusion of the correction in a decision, is more than two and a half years (900 days). This is a reduction from the average length of the procedure in 2002 of three years (1 100 days). However, the average time taken from the date of the mission to the final letter notifying the correction continues to exceed significantly the standards defined internally by the Commission's services.

Clearance of accounts decisions in recent years

4.75. Clearance of accounts takes place over a period of years (see paragraphs 4.52 and 4.70). Table 4.6 shows the results of the Commission's clearance decisions for 1991 and subsequent years. Clearance is not yet complete for any year later than 1997. The total corrections represent the Commission's view, for the budget lines 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.

4.76. Graphs 4.6 and 4.7 set out the distribution of corrections in decisions taken by the Commission during the period 1999 to 2003 (29), by Member State and market sector. These decisions relate to items of expenditure from the Community budget years 1996 to 2002.

THE COMMISSION'S REPLIES

4.74. The Commission acknowledges that in some cases delays in the progress of accounts clearance persist. But, as the Court finds from year to year, major efforts have been made to reduce the average duration of the procedure. These will be continued.

4.75. In June 2004 only nine procedures remain open (three predating 1 January 2000) out of a total of 482 initiated between 1997 and the end of 2000.

The Commission has applied itself to reducing the backlog and the oldest cases still open were given particular attention when the 2004 work programme for auditing agricultural expenditure was drawn up.

(29) 1999 was the first year in which the Commission took conformity decisions under the revised procedure for clearance of accounts introduced in 1996.
Table 4.6 — Corrections in clearance of accounts decisions in respect of budget years 1991-2003

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<tr>
<td>Expenditure</td>
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<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>
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<td>Total amount of</td>
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<td>– 572.9</td>
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<td>– 481.4</td>
<td>– 328.3</td>
<td>– 248.4</td>
<td>– 305.0</td>
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<td>(a) Milk super</td>
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<td>(b) Corrections</td>
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<td>– 307.8</td>
<td>– 557.8</td>
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NB: Clearance is not yet complete for any year later than 1997.

Source: Commission’s ‘conformity’ decisions adjusted to take account of corrections cancelled as a result of European Court of Justice rulings.
Graph 4.6 — Corrections in conformity decisions (1999 to 2003) per Member State

Source: Commission’s ‘conformity’ decisions taken from 1999 to 2003.

Graph 4.7 — Corrections in conformity decisions (1999 to 2003) per market

Source: Commission’s ‘conformity’ decisions taken from 1999 to 2003.
THE COURT’S OBSERVATIONS

The Court’s conclusions

Financial clearance decision

4.77. Subject to the individual problems listed in paragraphs 4.54 to 4.57, the certification of paying agencies’ accounts worked satisfactorily.

4.78. There is however scope for:
(a) the Commission to evaluate the work performed by certifying bodies on the spot on a cyclical basis (see paragraph 4.58);
(b) the certifying bodies to follow more closely the Commission’s guidelines in respect of the treatment of CAP debts (see paragraphs 4.59 to 4.61).

4.79. The fact that no financial clearance decision has yet been taken for 43% of expenditure declared for 2003 nor for 21 paying agencies accounts for 2001 or 2002 is a cause for concern (see paragraphs 4.65 and 4.68).

Conformity decisions

4.80. Most of the corrections made in 2003 were calculated on the basis of the Commission’s normal scale of flat-rate corrections (see paragraph 4.71). In two cases, a higher rate of correction could have been applied (see paragraph 4.72).

FOLLOW-UP TO PREVIOUS OBSERVATIONS

Export refunds — destination and placing on the market

4.81. Export refunds are subsidies paid on the export of agricultural products to compensate exporters for the difference between EU prices and lower prices prevailing on the world market. Rates for the same product may vary according to the destination.

THE COMMISSION’S REPLIES

4.78. (a) Specific on the spot reviews of the certifying bodies’ activity will be considered, after examining all the priorities for the auditors of the Commission.
(b) The Commission will insist on the importance of proper reporting on debtors and increase the attention paid to this subject for the next accounts clearance decision.

4.79. It should be emphasised that the disjunction of accounts does not cause any financial consequences for the Member States concerned, nor does it prejudice any exclusion of expenditure of Community financing.

The postponement of the clearance allows the Member States to provide additional information and in some cases to perform certain tasks requested by the guidelines which were not finalised by the regulatory deadline of 30 April. Once these matters are addressed by the Member States the Commission should be in a position to clear the disjoined accounts.

The Commission continues to make efforts to clear the backlog of cases from the 2001 and 2002 exercises. It expects to clear the accounts for the four paying agencies disjoined for 2001, plus more than half of the paying agencies disjoined for 2002.

4.80. The Commission maintains that the rates of financial correction imposed in the following cases were justified.

4.81. The significance of export refunds as a policy instrument has steadily decreased due to the successive reforms of the Common Agricultural Policy designed to make Community produce more competitive by bringing EU prices closer to world market prices. 10 years ago expenditure on export refunds exceeded 10 billion euro; in 2003 it was down to 3.7 billion euro. This trend is expected to continue with the latest CAP reforms of 2003 and 2004.
THE COURT’S OBSERVATIONS

4.82. In its Special Report No 7/2001 (30) the Court recognised that it was preferable to apply one refund rate for each product to all destinations, although this was not immediately possible. It therefore made the following recommendations to simplify and improve the financial control of such transactions:

(a) proofs of arrival should not be required in every case, but only in cases of doubt, or for high risk destinations;

(b) transport documents and commercial invoices should be presented to CAP paying agencies for all claims exceeding the de minimis limit (31);

(c) a posteriori checks that products had been placed on the market intended (and not exported elsewhere) should be intensified; shipping and container movement databases should be consulted for the transactions selected for a posteriori checks (32).

4.83. The Court also put forward a series of detailed recommendations for improvements in financial control arrangements which should be applied if the requirement for the systematic presentation of proofs of arrival was maintained.

4.84. The Council and Parliament supported the Court’s recommendation for changes (33). In particular the Parliament invited the Commission to make a radical effort to simplify legislation and procedures for more transparency, before phasing out the export refund scheme.

4.85. The Commission has not taken action to simplify the scheme as recommended in paragraph 4.82.

THE COMMISSION’S REPLIES

4.82 and 4.85. The Commission has reacted appropriately to remedy the weaknesses identified in the special report. An action plan was defined and has been implemented. The Commission believes that with the measures taken, the management of the risks involved has significantly improved.

(a) Relaxing the requirements for proof of arrival could generate a potential risk for the Community budget through a loss of control over exports to countries for which an export refund is not fixed. It would also expose the Commission to fundamental criticism of the way the EU monitors and controls its subsidised trade with third countries, particularly taking into consideration its international undertakings to refrain from granting export refunds for specific markets.

(b) The Commission considers that generally speaking customs import declarations issued by official state authorities give greater assurance that goods have been imported in the third country for which the refund is paid than transport documents and commercial invoices issued by private operators. However, the Commission has decided to double the de minimis limit by which payment claims involving small amounts of refunds can be exempted from production of proof of import, but to maintain this requirement for differentiated export refunds above this limit.

(c) Given the decision to continue to require proof of import for differentiated export refunds, there is no need for a posteriori checks that products had been placed on the market intended to be intensified. Nevertheless, the Commission has encouraged Member State authorities to use the data held by transport companies as an additional element of check on the arrival of goods at their destination.

4.85. See reply to paragraph 4.82.

THE COURT'S OBSERVATIONS

4.86. On the other hand the Commission has responded positively to many of the Court's more detailed observations and recommendations:

(a) procedures for the approval of supervisory companies have been reinforced;

(b) provision now exists for sanctions against supervisory companies for the issue of false certificates;

(c) rules have been introduced governing the issue of certificates of unloading by Member States' embassies;

(d) the _de minimis_ limit to be applied for the purposes of checking export refund consignments has been doubled;

(e) provisions were made to prevent carousel traffic in milk products between the EU and the Baltic states by removing export refunds on milk products to those states;

(f) a procedure was set up in 2001 (34) for online exchange of information with Russian customs concerning falsified import declarations (although this is not used by all Member States);

(g) some improvements have been made in respect of exports of cattle: the higher refund rate for pure-bred breeding animals is now only payable for animals less than 30 months of age (35) (36);

(h) the Commission's Clearance-of-Accounts unit examined the system of proofs of arrival in 2001 and 2002 and has, as a result, initiated financial correction action against certain Member States.

4.87. However, on other detailed points raised by the Court, the Commission:

(a) has not taken over responsibility for approval of supervisory companies;

(b) has not followed the recommendation suggested by the Court in point a) whereas actions have been taken in relation to points b) and c).

THE COMMISSION'S REPLIES

4.87. Having examined the recommendations of the Court the Commission decided not to follow the recommendation suggested by the Court in point a) whereas actions have been taken in relation to points b) and c).

(a) Within the framework of shared management the responsibility for approval of supervisory companies lies within the Member States and the Commission has no intention to take it over. Member States are closer to events on the ground and are in a better position for managing the conditions for the approval and control of supervisory companies.

However, following the Court recommendation, procedures for approval of supervisory companies have been reinforced (see Commission Regulation (EC) No 1253/2002 (OJ L 183, 12.7.2002, p. 12)).

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(35) Refunds are still however calculated by weight, which is logical for animals for slaughter, and not by head, which is appropriate for breeding animals.
(36) Commission Regulation (EC) No 118/2003: preamble (4): ‘... As to live animals for reproduction, in order to prevent any abuse export refunds for pure-bred breeding animals should be limited to heifers and cows of no more than 30 months of age.'
THE COURT'S OBSERVATIONS

(b) has not yet provided Member States with a model file of acceptable proofs of arrival (customs documents and customs stamps used in various non-Member States);

(c) could have made more effective use of external audit firms to examine the system of differentiated export refunds.

4.88. OLAF has followed up some cases of concern identified by the Court, but has not taken or completed action in respect of a series of other cases involving illegal exports to Iraq, shortages in deliveries of cattle to Lebanon, carousel trade in milk products with the Baltic States, diversion of cheese from the United States of America to Canada and deliveries to North Korea of feta cheese which substantially exceeded its expiry date.

4.89. There has thus been only a partial follow-up to the Court’s recommendations (and the Council’s and Parliament’s conclusions). Destination-specific export refunds continue to account for a significant proportion (45 %) of expenditure on export refunds, (i.e. 1 882 million euro in 2003).

THE COMMISSION’S REPLIES

(b) The verification of the validity of proofs which are furnished by exporters in the payment application for differentiated refunds is the responsibility of Member States’ paying agencies. However, the Commission launched a tendering procedure, but this proved to be unsuccessful and had to be relaunched. Bearing in mind the time needed for the tender’s procedure and completion of the study, the results will not be available until the end of 2005. Meanwhile, in order to ensure a better coordination between paying agencies, Member States have been asked to exchange copies of the customs import documents, customs stamps and customs codes (entry for home use, entry for warehousing, entry for inward processing, etc.) that are available in their paying agencies concerning various third countries included in the study.

(c) The Commission contracted for the first time external audit firms for this task in 2001. With hindsight some aspects might have been perfectible and experience has already been, and will continue to be, taken into account in possible future engagements of external auditors.

4.88. The case ‘diversion of cheese from USA to Canada’ will be finalised shortly. Follow-up actions for all mentioned cases are still ongoing.

4.89. As the Court recognises in paragraph 4.87, the Commission has responded positively to many of the Court’s more detailed observations and recommendations. For the recommendations not accepted, due explanation is given in the reply to paragraphs 4.83, 4.86 and 4.88.

The Commission has reacted where appropriate to remedy the weaknesses identified in the Court’s special report. An action plan was defined and has been implemented. The Commission believes that with the measures taken, the management of the risks involved has significantly improved.

Support scheme for olive oil

4.90. In July 2000 the Court published a Special Report (37) on the results of its audit of the support scheme for olive oil. The audit was focused on the management of the scheme by the Commission and the operation of the controls in the Member States, in order to assess their contribution to the achievement of the main objectives of the scheme. The Council adopted on 29 April 2004 a reform of the common market organisation (CMO) for olive oil, which will enter into force on 1 November 2005 (38).

4.91. In its Special Report the Court observed in particular that:

(a) the system for the Commission's management and control was not sufficiently efficient and reliable;

(b) the CMO objectives set were not sufficiently clear;

(c) in creating and implementing the olive cultivation geographic information system (GIS) (39) in the Member States, the Commission should not allow repetition of the delays experienced with the initial olive cultivation register;

(d) any reform should maintain the principle of sound financial management set out in the Financial Regulation and the CMO objectives should be specified in such a way to make it possible to measure progress towards them;

(e) payment based on the number of trees rather than the quantity of production would pose fewer control problems but would reinforce further the need of the olive cultivation GIS.

4.92. The Council and the Parliament (40) supported the Court's recommendation relative to the need for sufficient and reliable management and control through a workable olive cultivation GIS and the integration of olive oil data in the IACS system. Because consumption aid was abolished by the 1998 reform and because of the insignificance of export refunds, the Court's follow-up concentrates on the production aid to olive oil producers.

4.93. The Court notes that, in the period before the 2004 reform, the Commission had already addressed a number of issues concerning notably overproduction and competitiveness of olive oil production. Despite the fact that every year the Commission has invited the Member States to accelerate their procedures, a discrepancy between the number of penalties recommended by the olive oil control agencies and the number of penalties effectively imposed by the Member States still persists.

4.93. The Commission closely monitors the quality of the Member States' monitoring of the work of the inspection bodies. Any inadequacies found are taken into account in the accounts clearance procedures for the olive oil production aid.

(39) Following the provisions of Article 2 of Council Regulation (EC) No 1638/98 the "Olive Cultivation GIS" shall be created using the data from the olive cultivation register, and information shall be geographically situated using computerised aerial photographs.

4.94. The 2004 reform, by setting clearer objectives and replacing the quantity based production aid by an area aid, abolished a number of measures in which the Court had found weaknesses, notably those concerning the controls in the Member States, the obligation to estimate production yields, and the decoupling of aid from production. However, the Commission did not quantify the reform objectives as required by the Financial Regulation. This hinders the measurement of progress in achieving them.

4.94. The reform of the olive oil sector is part of the reform of the common agricultural policy started in 2003 and aims at achieving the same objectives, which were presented in the explanatory memorandum of the proposal for a long term policy perspective for sustainable agriculture (COM(2003) 23 final, 21 January 2003), namely:

— to enhance the competitiveness of the EU agriculture,
— to promote a more market oriented, sustainable agriculture,
— to provide a better balance of support and strengthen rural development.

The achievement of the objectives is assessed by the Commission as part of the ongoing management and monitoring of the implementation of the CMO. Council Regulation (EC) No 864/2004 foresees that the Commission shall, before 31 December 2009, provide the Council with a report on the situation among others of this sector, accompanied, if appropriate, by proposals for amendments.

4.95. Under the new Council Regulation the aid will be based on the area planted with olive trees with a minimum amount of aid of 60% allocated to the single payment scheme. This part of the aid will be related neither to production of olive oil nor to the number of olive trees. The remaining 40% will be linked to the number of olive trees. However, until the olive cultivation GIS has been completed, the management and control of this 40% part of the aid, linked as it is to the number of olive trees, will continue to depend on insufficiently reliable statistical data. The absence of data and lack of reliability of the Commission’s statistical information was also confirmed by an external evaluation, requested by the latter, to evaluate the impact of the main market organisation measures of the olive oil sector (41).

4.95. The remaining funds (up to a maximum of 40%) would be retained by Member States for the granting of aid confined to olive groves already registered in a GIS. Producer Member States have informed the Commission as regards completion at various stages of the GIS. According to legislation in force, the GIS shall be fully operational for the payment of the aid from the marketing year 2003/04 onwards (advance payment fixed in September 2004, final payment to be fixed in June 2005) – see also reply to 4.97.

The purpose of this aid is to contribute to the maintenance of olive groves of environmental or social value. It will be granted per hectare of olive grove, whether or not in production. For the granting of this aid variations in the number of trees registered on 1 January 2005 in the olive groves should not exceed 10%.

4.96. Contrary to the Court’s recommendation the Commission proposed to the Council (42) a delay in the completion of the olive cultivation GIS by two years until 31 October 2003. The fact that this has not been fully completed to date will have a negative impact on the implementation of the reform.

4.96. The proposal to delay in the completion of the olive cultivation GIS was motivated by the limited progress achieved in 2001 by the Member States in the execution of the GIS and the aim of obtaining a reliable and trustworthy tool for the management of the sector. In cases where the GIS had not been completed, Member States were required to carry out reinforced on the spot controls (Regulation (EC) No 2366/98).

The proposal was accompanied by additional provisions stipulating that from November 1st 2003, olive trees and corresponding areas not attested by a GIS or olive oil produced therefrom are not eligible for aid to be paid to olive producers. According to the information provided by the producer Member States to the Commission, the GIS is largely operational to check the aid payments for the marketing year 2003/04, and its role in the practical implementation of the reform will be verified in due course in the framework of the clearance of accounts procedure.


4.97. The Commission has taken into account in the clearance of accounts procedure the Member States' failure to comply with CMO provisions concerning the olive oil register and the computerised files. However, in its Annual Report 2002 (**) and in the present Annual Report, the Court called on the Commission to be more rigorous in respect of applying its own instructions concerning corrections of olive oil expenditure (see paragraph 4.72 and Annual Report 2002, paragraph 4.61).

4.97. The Commission maintains that the rates of financial correction imposed in the concerned cases were justified. See the reply to point 4.72 and the 2002 Annual Report.

4.98. In view of the foregoing, the Commission should take immediate action to address the following outstanding issues:

(a) set appropriate and measurable indicators in order to monitor the implementation of the reform objectives and, in this way, to comply with the provisions of the Financial Regulation on sound financial management, and to improve the management of the CMO;

(b) insist that Member States dispose of a workable and reliable olive cultivation GIS and if this cannot be achieved, make appropriate financial corrections in accordance with the rules applicable.

(a) The reform of the olive oil sector is part of the reform of the Common Agricultural Policy started in 2003 and therefore aims at achieving the same objectives. The Commission will monitor the achievement of these objectives.

(b) As of November 1 2003, olive trees and corresponding areas not attested by a GIS or olive oil produced therefrom are not eligible for an aid to be paid to olive producers.

The Commission accepts the Court's recommendation and as in the past will continue to verify that checks are made correctly and uniformly.

PRINCIPAL OBSERVATIONS IN SPECIAL REPORTS

Evaluation of farm incomes by the Commission

4.99. According to Article 33(1) of the EC Treaty, one of the five objectives of the common agricultural policy (CAP) is to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture. This objective is proving to be a genuine guiding principle of the CAP.

4.100. The Commission has three systems for measuring farm incomes: the Farm Accountancy Data Network (FADN), which measures the incomes of agricultural undertakings on the basis of harmonised accounts, but is inadequate as far as the quality and comparability of the results are concerned, the Economic Accounts for Agriculture (EAA), which provide data that vary in quality according to the Member State concerned, and the Income of the Agricultural Household Sector (IAHS) containing non-homogeneous and obsolete statistics.

4.100. Improving the quality and especially the comparability of the statistical data from the FADN is a major concern of the departments responsible for these statistics and has been the subject of constant attention on the part of the Commission, the FADN Committee and the Member States. The latter have introduced a basic methodology designed to improve quality and harmonise the results from the FADN. It is true that the regional diversity of agriculture, in both socio-economic and structural terms, has meant the adoption of rules specific to some Member States. However, the impact of the methodological differences referred to by the Court is reduced as much as possible by the efforts made regarding sampling and weighting.

The economic accounts for agriculture are continuously and closely monitored for accuracy and comparability by the Working Party 'Agricultural accounts and prices' and more specific controls such as the inventories. This is why the quality of the income statistics produced under the EAA has always been considered satisfactory. In addition, although the choice of sources of data is left to the Member States depending on the specific structure of their agricultural sector and their statistical system, this has little impact on the quality of the EAA data.

(**) Report on the activities financed from the budget.
4.101. The European Community has never defined the concepts of 'agricultural population', 'fair standard of living' or 'income' that are set out in Article 33 of the EC Treaty. As a consequence, there are to this day no clear concepts and criteria that can be applied to the statistics that are supposed to measure these magnitudes.

4.102. The Court was able to establish that the nature of the information needed on the financial situation of farmers has evolved over the years. Whereas under the Mac Sharry reform of 1992 the aim was merely to make up for losses of revenue by means of direct payments, the Commission is now also interested in the sources of non-farm income and in the distribution of incomes within the agricultural sector. Information on the overall income of agricultural households is needed in order to examine these questions.

4.103. With the assistance of an expert, the Court endeavoured to clarify the various concepts set out in Article 33 EC. The conclusion of this study was that, where there are no other data, the overall disposable income for all the members of the household can be taken as an approximate indication of the standard of living. Furthermore, an agricultural household's standard of living can no longer be considered fair if the overall disposable income of all the members of the household falls below a certain threshold compared with other business households.

4.104. The Court examined the Commission’s three agricultural statistics systems from the point of view of their ‘relevance’ with regard to the requirements of the CAP. The purpose of all these systems is to measure incomes in the agricultural sector. However, the FADN gives only the figure for the profits of so-called professional farms, without taking account of either non-farm income or the incomes of other household members. As for the EAA, the main result it gives is the surplus remaining after the costs of all the agricultural products have been covered. These two systems do not therefore give any direct information on the standard of living of agricultural households. The IAHS project was conceived for this purpose, but it has never produced reliable and comparable results.

4.101 and 4.102. There are various different measures of income (inter alia, income by branch of activity and income of households at macroeconomic level, and income of holdings at microeconomic level). These have been extensively used and published by the Commission for the purposes of monitoring and analysing the levels of and changes in incomes in agriculture, as well as contributing to generating agricultural policy.
4.105. In conclusion, the Community statistical systems do not at present provide enough information on the net incomes of agricultural households and do not allow the standard of living of the agricultural population to be assessed. The Commission should therefore redefine precisely the Community’s needs in this area and reorientate the existing statistical systems accordingly.

4.105. Each of the statistical tools provides additional information in the decision-making process. Therefore, they should be seen as complementary parts in a very complex policy field.

The Commission’s Replies

The statistics of the EAA and of the FADN have for many years provided very useful, reliable and relevant information on the incomes generated by agricultural activity. This information has proved very important for the monitoring, evaluation and design of the common agricultural policy. So far these figures on income from agriculture could be regarded as relatively reliable estimates of farm households’ income to the extent that the latter draw the major part of their income from farming.

The socio-economic developments in the agricultural sector and recent changes in agricultural policy (in particular as regards rural development) may well require more detailed figures on farm income. Although reliable statistics on the income of agricultural households already exist in a considerable number of Member States, it would be worth making a study of the feasibility and cost of statistics that measure the standard of living of the farming population across all the Member States of the Union.

The financial situation and income levels of farming undertakings and in the agricultural sector generally will continue to be the subject of regular monitoring on the basis of FADN and EAA data, the harmonisation and consistency of which will need to be strengthened through increased collaboration among the various services concerned.

4.106. The need to complete the single market and promote trade in livestock in general made it essential for the Community to establish a common policy for preventing and controlling foot-and-mouth disease (FMD). As from 1992, therefore, it extended to all Member States the ban on preventive vaccination of livestock against the disease and introduced a complex system of prevention and control with the aim of both restricting the introduction of the virus and preventing it from spreading throughout the territory of the Community. In the event of an epidemic, contaminated animals were to be slaughtered, the carcasses destroyed, and premises and equipment disinfected. All the expenditure defrayed by Member States in this connection would then become partially reimbursable from an emergency veterinary fund set up within the EAGGF Guarantee Section.

4.107. Following the 2001 crisis Member States requested reimbursement of 1 616 million euro from the emergency veterinary fund. That cost, combined with the scale of the outbreak, was the motivation for the Court’s audit. The audit had three objectives: to ascertain, firstly, whether the method of analysis used by the Commission as the basis for the eradication strategy was up to date; secondly, whether the strategy had been implemented effectively;


While banning prophylactic vaccination for technical and economic reasons, the Directive introduced contingency planning for FMD and a system of antigen reserves to cater for the possibility of emergency vaccination, and modified other animal health legislation in order to prevent the spread of the disease.

Management and supervision by the Commission of control measures and expenditure relating to foot and mouth disease (44)

THE COURT’S OBSERVATIONS

and thirdly, whether the system for reimbursing to Member States expenditure on compensating farmers and slaughtering their animals was adequate, rapid and non-discriminatory. In as far as some of the lessons learned from previous epidemics might be relevant to the strategy for preventing and controlling FMD, the Court examined Commission action before, during and after the crisis.

4.108. The report emphasises that, before the 2001 crisis, the Commission had not revised its strategy in the light of changes in risk factors.

THE COMMISSION’S REPLIES

4.108. In 1990 the Commission defined the overall strategy of the Community as follows: 'Maintain the FMD- and infection-free status of the Community without practising prophylactic vaccination'.

This strategy has since been supported by Member States, the European Parliament and the relevant industries. It is science-based, operates on established international standards and balances the risk of virus introduction with the technical and economical possibilities to react to the occurrence of the disease.

Furthermore, the Commission feels that, although this strategy is not formally updated, it incorporates enough regular scientific information to be operational (1).

As far as an assessment of the Commission’s action before the crisis is concerned, the report of the British National Audit Office on FMD notes under 9c: 'if contingency plans were not sufficient to deal with an outbreak on this scale, it is unrealistic to expect that any could have coped with all the problems and difficulties that arose or that the authorities could have forecast the unprecedented nature of the 2001 outbreak'.

Whilst at the time of FMD crisis in 2001 not all measures in preparation were ready for implementation, due credit or acknowledgement as regards the progress which has been achieved by the Commission since the establishment of the single market in 1993 is not given in the present report.

(1) Following the outbreaks of FMD in Italy and Greece, to which the Court refers below, the Commission together with the Member States analysed in the Standing Veterinary Committee the epidemiological situation and the effects of the control measures applied; based on the output of working groups involving all Member States, a report was prepared in 1998 outlining the principles of a future FMD control policy. The Scientific Committee also prepared a report on emergency vaccination in 1999. Each year the Commission coordinates the position of Member States in the General Session of the OIE, including positions on the FMD chapter of the Animal Health Code. Member States, together with the Commission as observer, discuss biannually the FMD situation in the world and Europe within the framework of the European Commission for the Control of FMD at the FAO. Taking into account the experience of past crises Council Directive 2001/89/EC summarised the lessons to be learned from the classical swine fever epidemic in parts of the EC in 1996/97 and provided ample opportunity to discuss key strategies for the control and eradication of major infectious livestock diseases. More recently, and in the light of the 2001 outbreak, the Community strategy defined in 1990 was unanimously reconfirmed by the International Conference in December 2001, by the Resolution of the EP in December 2002, in the Commission proposal for a new Directive submitted to the Council in December 2002, and finally by the Council adopting Directive 2003/85/EC following an opinion of the European Parliament, the European Economic and Social Committee, and the Committee of the Regions.
THE COURT’S OBSERVATIONS

4.109. It also shows that in the absence of comprehensive evaluation and inspections by the Commission before 2001, some weaknesses in the prevention and control arrangements were not corrected in time, especially as regards protective measures at borders, animal feed, contingency plans, sheep identification, and the messaging system concerning livestock movements between Member States (ANIMO). Parliament criticised the Commission for failing to review Member States’ contingency plans before the crisis, but acknowledged that the Commission acted very positively during it (45). At the time of the crisis the Commission did, in fact, identify very quickly the weaknesses of the arrangements and their implementation in the Member States, as regards the number of veterinarians, disease notification and rapid culling, but it was too late to remedy them. More particularly, the Court observed that the effectiveness of the arrangements that had been introduced relied heavily on farmers notifying the disease immediately and complying with movement restrictions.

THE COMMISSION’S REPLIES

4.109. The Commission is constantly analysing the animal health situation in Member States and third countries and in particular has taken measures addressing the points raised by the Court as follows:

(a) The controls by the Commission in Member States

The Commission’s veterinary inspection services carried out missions in Member States in relation to the implementation of Community legislation with regard to control measures for major epidemic diseases.

(b) Provisions for the prevention and control of FMD

FMD is an exotic disease as regards the Community. In order to prevent the introduction of the virus, the Commission has established a system of import conditions and controls. In addition, the Commission in cooperation with international organisations supports neighbouring countries in their efforts to control and eradicate the disease.


(c) Protection of borders

There were strict rules in place before the 2001 outbreak. Some of these provisions were reinforced during or shortly after the 2001 crisis.

(d) Swill feeding

In 1980 feeding of swill to pigs was prohibited, unless such swill was collected, processed and provided under specific conditions authorised and controlled by the competent authorities.

(e) Contingency planning

The inspection of the implementation of the approved contingency plans had started before the crisis.

(f) Identification of small ruminants

Identification of small ruminants allowing the tracing of the holding of origin was already regulated by Directive 92/102/EEC.

(g) ANIMO system

The ANIMO system was very useful for the initial tracing of animals that had been dispatched from the UK to other Member States during a period of three weeks preceding the detection of the first outbreak. The problems encountered relate to primarily to the rapid movement and re-certification of fattening sheep.

(45) European Parliament resolution adopted on 17 December 2002, paragraph 54.
THE COURT'S OBSERVATIONS

(h) Compliance with movement restrictions

Movement restrictions imposed in accordance with Community and national legislation on disease control measures must be enforced by the Member State concerned.

The Commission's response and the decisions taken during the crisis were deemed to be prompt and appropriate.

The Commission invites the Court to consider the declarations of the Council during the crisis, as well as the conclusions of the International Conference on the prevention and control of FMD held on 12 and 13 December 2001 in Brussels.

Furthermore, the European Parliament's Resolution of 17 December 2002, which endorses the modified report mentioned in footnote (2), acknowledges in paragraph 53: The Commission responded to the crisis immediately and took the necessary decisions. In the course of the crisis, it promptly adapted and documented its decisions on the basis of the opinions of the standing committee in the light of the events. No shortcomings have been identified in the Commission's management of the crisis. The high quality of the Commission's work in controlling the crisis has also been expressly stressed by the national veterinary authorities of Member States concerned.

4.110. The audit showed that the Community financing system could be further improved. The compensation paid to farmers by Member States was not always adequately defined at Community level, even though it was reimbursed at a rate of 60 % of the amount accepted as eligible by the Commission. In the absence of a better-defined Community framework the Member States were able to introduce a variety of systems that gave rise to variations in the treatment of farmers within the Community.

4.110. The Commission does not have legal authority to harmonise at Community level the indemnification paid by Member States to their livestock farmers in the event of an epidemic.

However, the Commission took care to harmonise the conditions for Community reimbursement of Member States, under which the amounts presented by the Member States were reduced by EUR 583 million (of a total of 1 051 million).

4.111. Since then, the recent revision of the Community regulations has remedied many omissions. Nevertheless, the financial framework was not revised and the Community measures are still minimal in terms of the notification of the disease, supervision of farms and speed of culling. There is thus a risk that Member States' application of these measures could once again prove to be insufficient to contain a future epidemic, and yet still give rise to Community reimbursement.

4.111. Financial framework: since 2002, the Commission has been working on reviewing the arrangements for Community cofunding so that, inter alia, improper overstatement of the value of animals, to which farmers in the United Kingdom were particularly prone during the crisis, could be curbed and the burgeoning costs of eradicating diseases reined in. A proposal to this effect will be made soon.

From the veterinary point of view, it is important to note that:

First of all, there is no alternative to the system of notification of diseases. The EU standards comply with international standards.

Secondly, livestock holdings are under veterinary supervision and this supervision is being increased by stricter requirements for animal welfare, on-farm investigations to ensure compliance with public health requirements (food-chain approach) and in the context of disease eradication or control programmes.

Finally, the Commission has taken a number of measures to strengthen further controls on the movement of animals.

Community legislation on animal health in general and disease control measures in particular allows the Member States to implement the most appropriate measures for rapid eradication of the disease concerned. The measures laid down are minimum measures that may be or in other cases must be supplemented according to the epidemiological situation.

The Commission wishes to point out that a large part of the overall costs of an epidemic, including all indirect costs, is borne by the affected Member State.

4.112. With regard to the general control strategy for major infectious diseases there are no alternative strategies to the measures currently provided for in Community legislation. These measures aim at disease eradication while providing sufficient flexibility with regard to the instruments employed. The control measures for CSF in wild boar and for bluetongue are examples of this flexible approach.

By placing more emphasis on emergency vaccination in the event of major epidemic diseases (CSF, bluetongue, AHS, FMD) Community legislation provides for the instruments to limit the direct costs of disease control measures.

Decision 90/424/EEC provides a sensible incentive for producers to notify animals showing suspicious clinical signs at the earliest opportunity (see also 92). In addition, there are penal measures to be taken by Member States in cases of non-compliance with control measures.

In agreement with the request of the European Parliament, the Commission launched a study on existing compensation schemes in Member States and received the final report in October 2003. As a matter of follow-up and based on dedicated budget arrangements, a further study should provide exact expert estimates and calculations to carry out an impact assessment. These will be discussed with the Chief Veterinary Officers in September 2004 and will be presented to the International Conference on the prevention and control of infectious animal diseases in December 2004.

Guidelines on the nature and scale of eligible expenditure are currently being adopted in order to clarify the financial framework and reduce the risks for the Community budget.
4.113. Member States are obliged to notify the Commission when they detect irregular payments over 4,000 euro made under the common agricultural policy (CAP) and to attempt to recover such payments (46). Where recovery is not possible the sums concerned are written off and the losses are borne by the Community unless non-recovery is due to the negligence of the Member State concerned. There is provision for a ‘blacklist’ (47) to identify recipients of irregular payments in excess of 100,000 euro in any one year. Under separate arrangements (48) Member States report all debts to the Community arising from the CAP and the progress of recovery.

4.113. For the protection of its financial interests, Community legislation lays down reporting requirements as regards Community fields of activity (49). The Member States must send regular reports of irregularities which have been the subject of primary administrative or judicial findings of fact. Regulation (EEC) No 595/91 organises the system of communications of irregularities in the field of the expenditure by the EAGGF – Guarantee Section (European Agricultural Guidance and Guarantee Fund).

In order to facilitate exploitation of the information notified to the Commission, the Community legislation contains a detailed list of the information to be provided, in particular the provision which has been infringed, the amounts in question, the practices used to commit the irregularity, and the natural or legal persons involved (49).

Member States have the obligation to prevent and deal with irregularities and to recover amounts lost as a result of irregularities or negligence (50). Regulation (EEC) No 595/91 provides for the communication of all irregularities above EUR 4,000 to the Commission, meaning that all behaviour, intentional or not, that results in the infringement of a provision of Community law has to be communicated. The Commission has taken different initiatives in order to ensure that cases should be identified as a fraud or an irregularity.

The mutual notification and information system thus established is the concrete expression of the mutual duties of sincere cooperation arising from Article 10 of the EC Treaty (6), on which the Commission’s anti-fraud strategy, defined in July 2000 (7), rests. This partnership between the Commission and the Member States is also the guiding principle behind the provisions of secondary legislation.

As the Council has stressed on a number of occasions, it is essential that the information supplied be consistent and of high quality if the Commission is to make the best use of it in stepping up the fight against fraud and ensuring that cases are properly followed up (8), at both national and Community level.


(50) Except for Council Regulation (EC, Euratom) No 1150/2000 implementing Decision 94/728/EC, Euratom on the system of the Communities’ own resources (OJ L 130, 31.5.2000), where this information is optional only.
(8) Including the accounting and recovery aspects.
4.114. At the end of 2002 total irregular payments reported since 1971 totalled 3.1 billion euro. Of this sum 537 million euro had been recovered from beneficiaries and 252 million euro written off at the expense either of the Community or of the Member State concerned. The remaining 75 % of reported irregular payments were still 'pending', neither recovered nor written off. Most reported irregular payments relate to intervention in markets: expenditure in the fruit and vegetable sector and on export refunds accounts for over half of the total.

4.114. According to the Commission Report on the Protection of the Financial Interests of the Community and Fight Against Fraud — Annual Report 2002 hereafter 'Commission Report 2002 on the fight against fraud', the highest amounts affected by the irregularities were reported in the fruit and vegetable sector Member States were also informed of this trend in several meetings as Article 280 Working Group, Cocolaf and the Working Group 'Irregularities and Mutual Assistance — Agricultural Products'.

The electronic database storing the bulk of communications of irregularities transmitted by Member States has been subject to a thorough quality check in 2003 by the Commission with the participation of Member States, which resulted in an improved internal consistency of the data while at the same time the figures were updated. The updated figures (see paragraph 30) outstanding at 31 December 2002 should read as follows: the total irregular payments reported since 1971 represent EUR 2 983 million. Of this sum, 603 million (20 %) have been recovered and 297 million have been written off (10 %). The amount still pending represents EUR 2 083 million (70 %). These figures include also the updates which the Commission received in the year 2003 and the financial impact of Commission Decision 2003/481/EC (EUR 75 million).

4.115. The Court found that Member States provide information about irregularities as required but do so with varying delays. There are also inconsistencies in the data. There are discrepancies between the data supplied by Member States and the figures in the database drawn from them. The Commission's database on reported irregularities is not complete and accurate.

4.115. Some Member States do not fulfil their obligation to report within two months of the end of the quarter in which an irregularity was detected and/or new information concerning an irregularity has become known (Regulation (EEC) 595/91, Article 3 (1) and 5(1)). Among these Member States, Germany and Spain account for more than 50 % of the reported irregularities. The Commission has made Member States aware of this problem by reporting this in the Commission Report 2002 on the fight against fraud (paragraph 10.2.2) and discussing the problem in several meetings as Article 280 Working Group, Cocolaf and the Working Group 'Irregularities and Mutual Assistance — Agricultural Products'.

As regards inconsistencies, Member States have been informed of these and were asked to update these cases by sending digital updates. In meetings Article 280 Working group, Cocolaf and the Group 'Irregularities and Mutual Assistance — Agricultural Products' explanation and 'training' concerning ECR (Electronic Case Registry) database were given to Member States. In general it can be said that Member States have improved the reporting of irregularities, but not all obligations of Regulation (EEC) No 595/91 are completely complied with.

As regards discrepancies, the Commission will continue its efforts to oblige Member States to respect all provisions of Regulation (EEC) No 595/91 in order to receive within the delays foreseen, fully reliable data which contain homogeneous information from all Member States.
THE COURT’S OBSERVATIONS

4.116. The low rate of recovery of irregular payments (a cumulative recovery rate of only 17 % since 1971) is in part due to national administrative delays and practices (suspension of action to recover until related legal action concerning fraud has been completed, absence of preferred creditor status for CAP debts, no disincentive to frivolous appeals) and to the Commission’s reluctance to accept offers of partial settlement.

4.117. Only 10 % of reported irregular payments have been written off, partly because Member States have put forward few cases as irrecoverable, partly because the Commission has been slow to take action on long-standing irregular payments. The Commission had no adequate criteria for deciding whether sums written off should be charged to the Member States or borne by the Community and has inadequate information on whether write-off decisions are carried out correctly.

THE COMMISSION’S REPLIES

4.116. The updated rate of recovery was established at 20,2 % in May 2004 (see paragraph 30).

The Commission is fully aware of the fact that the recovery rate in Member States is not optimal and has undertaken to improve it, in particular with the creation of the task force recovery (see also answer to paragraph 4.118).

Paying agencies and administrative bodies in charge of the recovery process in some Member States (Italy, Greece) have always claimed that they had to wait for the outcome of judicial criminal procedures before proceeding with the recovery whereas the choice of a recovery process through a civil or administrative procedure is in some cases possible and does not preclude the launching of a parallel criminal judicial procedure.

Consequently the initial choice of the Member State (administrative procedure, civil procedure, criminal procedure) will have consequences on the recovery delay. For a limited number of Member States, administrative recovery procedures can be launched only after a final decision in the criminal judicial procedure if any, bearing in mind that the latter might take 15 years or more.

In Italy, for the pre-1995 cases, 46 % were subject to a criminal procedure whereas this percentage represented 18 % only for the cases posterior to 1995, which could be explained that the Member State decide to take the necessary administrative steps as early as possible and as soon as there was a notification of the irregularity.

In shared management, the Member State responsible is in direct contact with the debtors. The Commission is not in a position to write off debts. According to Regulation (EC) No 1258/1999 the Commission is legally obliged to exclude all expenditure from Community financing where that expenditure has not been executed in compliance with Community rules. Accepting compromise settlements and/or partial payments should be assessed on a case by case approach on the basis of national law and in conjunction with the criteria as laid down in Article 8 of Regulation (EC) No 1258/1999.

4.117. Following the Communication of the Commission entitled ‘Improving the recovery of Community entitlements arising from direct and shared management of Community expenditure’ of 3 December 2002 (COM(2002) 671 final), the Commission decided to set up a joint OLAF-Directorate-General for Agriculture task force Recovery in order to clear the burden of the past, i.e. all the irregularity cases prior to 1999 and still open in order to prepare a decision on whether the Community or the Member State bear the financial consequences.

As regards the Court’s observation on the absence of adequate criteria for deciding whether sums written off should be charged to the Member States or borne by the Community, the Commission wishes to point that it has developed throughout time and on account of the acquired experience applied four guiding principles and a number of procedural criteria documented in July 2002 (see also point 44).
THE COURT’S OBSERVATIONS

Since the creation of the Task Force Recovery in 2003, the Commission services have drawn up a list of detailed criteria with which all the cases are audited in order to have the amounts not recovered charged either to the Community or the Member State.

4.118. Responsibilities for the treatment of irregular CAP payments are shared between OLAF and the Directorate-General for Agriculture: formal and effective responsibilities differ; misunderstandings occur. The Commission does not make systematic use of the information it obtains about irregularities when managing and proposing changes in the CAP.

Following the allocation of responsibilities stated in Annex 2 of Commission Document SEC(95) 249 dated 10 February 1995, UCLAF/OLAF was to receive all communications notified by Member States under Council Regulation (EEC) No 595/91 and was responsible for the analysis and follow-up of the cases in question, including input of the data concerned into the irregularity-data base.

OLAF responsibility in matters of recovery action related to cases of fraud and irregularity includes the production of summary notes for each case containing a snapshot of the procedures performed and the reasoning behind the proposals for possible financial correction within the clearance of accounts procedure undertaken under the responsibility of the Directorate-General for Agriculture as Authorising Officer. The clearance procedure is conducted by the Directorate-General for Agriculture, but throughout its different steps, this DG is assisted by OLAF (see also point 4.121).

The Commission always draws the legal consequences on the fraud proofing and control capability of the existing CAP regulations, taking on board in particular the follow-up recommendations of the Office.

The Commission considers that the allocation of responsibilities between OLAF and the Directorate-General for Agriculture has been clearly defined: according to Annex 2 to the Communication of the Commission SEC(95) 249 of 10 February 1995 OLAF is responsible in matters of recovery on reported irregularities. Any decision to write off irrecoverable amounts has to be taken by the Commission via the EAGGF clearance of accounts procedure that is conducted by the Directorate-General for Agriculture, in which OLAF assists throughout its different steps.

4.119. The ‘blacklist’ does not work. Only six Member States have ever notified a company or individual under these arrangements (37 entities in total) because they fear that placing a company or individual on the blacklist may leave them open to legal redress and possible damages.

On account of new communications, the number of Member States making use of the blacklist has risen to seven. In total, an average of 44 notifications (the total number may fluctuate) were issued concerning 31 companies and 16 individuals.

Council Regulation (EC) No 1469/95 established, in the field of EAGGF Guarantee, a system for identifying economic operators who present a high risk for the Community Budget through a communication system via the Commission. After eight years of application of this Regulation, it appears that the number of communications is rather limited if not weak.

The Commission has extensively discussed the matter in the framework of the Irregularities and Mutual Assistance/Agriculture products group and is committed to presenting a Second Report to the European Parliament and to the Council containing comprehensive assessment of the blacklist Regulation and suggested options for action.

THE COMMISSION’S REPLIES

4.119. On account of new communications, the number of Member States making use of the blacklist has risen to seven. In total, an average of 44 notifications (the total number may fluctuate) were issued concerning 31 companies and 16 individuals.
THE COURT’S OBSERVATIONS

4.120. The separate arrangements by which Member States report all debts due to the Community in respect of the CAP have been improved in recent years but still have a number of weaknesses. It is not possible to reconcile the data produced with those for irregular payments.

4.121. The Court recommends the Commission to consider changes in the arrangements for the reporting, recovery and writing-off of irregular CAP payments to remedy the weaknesses set out above. The division of responsibilities between OLAF and the Directorate-General for Agriculture should be clearer. The Commission should consult with Member States on the future of the ‘blacklist’.

THE COMMISSION’S REPLIES

4.120. There is a difference between the amounts contained in table 105 (receivable which is certain and not subject to any condition, receivable of fixed amount expressed precisely in cash terms, receivable due and not subject to any payment time) for the EAGGF financial exercise and the amounts embodied in the ECR data base (amount of quarterly reported irregularities for one particular term, which can be at that stage mere estimates subject to subsequent refinements).

The Commission has asked the Member States to undertake a tentative reconciliation of the ECR database with the data of Table 105, bearing in mind that both sets of data will never coincide. Until now, first priority was to improve the quality of the data. The data of ECR database has reached now a level of reliability that it will be possible to compare the data.

4.121. Member States should shift in the near future to the electronic format for reporting of irregularities. The electronic format will increase the data quality, the on time reporting of irregularities and will avoid misunderstandings and misinterpretations.

The Commission is currently assisting Member States in this respect and is also considering an increase of the threshold from EUR 4 000 to 10 000 in order to reduce the dataflow and focus on the most important cases.

The Commission has undertaken to bring forward draft proposals to modify (EEC) Council Regulation No 595/91 and Council Regulation (EC) No 1258/1999 to seek to remedy the weaknesses in reporting, recovery and write off of irregular CAP payments.

The Commission considers that the allocation of responsibilities between OLAF and Directorate-General for Agriculture has been clearly defined: according to Annex 2 of the Communication of the Commission SEC(95) 249 of 10 February 1995 OLAF is responsible in matters of recovery on reported irregularities. Any decision to write off irrecoverable amounts has to be taken by the Commission via the EAGGF clearance of accounts procedure that is conducted by Directorate-General for Agriculture, in which OLAF assists throughout its different steps.

Finally, regarding the suggested abolition of the blacklist, the Commission while sharing the view of the Court that the system does not work well, thinks there is room for improvement of the scheme and would rather see the application of the tool by the Member States to be improved than simply abolished. There is certainly area for improvement, and the sheer existence of the regulation is designed to have a preventative impact which, admittedly, diminishes if not effectively applied. In this context, it is worth pointing out that clearance of accounts started to systematically include aspects regarding the application of the blacklist in its audits.
The introduction of a system of identification and registration of bovine animals (SIRB) in the European Union (49)

4.122. Identification and registration of bovine animals serve as the basis for tracing beef and veal and form part and parcel of the conditions to be met in order for the various premiums for bovine animals to be paid. These premiums amounted to over 7 000 million euro in 2002 and come to over 8 000 million euro in 2004.

4.123. The main objective of the audit was to evaluate the system of identification and registration of bovine animals (SIRB) at the level of the Commission (conception, monitoring of its introduction and follow-up) and of the Member States (operating system allowing animals actually to be traced from birth to slaughter and guaranteeing that all direct aid is paid correctly).

4.124. The SIRB that was introduced, which should have been operational by 31 December 1999 at the latest, still evidenced certain weaknesses when examined by the Court. The main finding is that the SIRB is unable to guarantee that bovine animals moved within or outside the Community can be traced, and yet around three million head of cattle are moved every year (some 4% of the livestock population).

4.124. The Commission takes note of the findings of the auditors during their missions carried out from October 2001 to June 2002 in the four Member States concerned. In 2002 FVO carried out missions on traceability to all Member States and provided recommendations to address the shortcomings found by the inspectors.

The Commission has noted the shortcomings in the management of passports for bovine animals which are traded within the Community. According to Article 6 of Regulation (EC) No 1760/2000 of the European Parliament and of the Council, Member States may issue a passport for animals from another Member State. In such cases, the passport accompanying the animal on its arrival shall be surrendered to the competent authority, which shall return it to the issuing Member State… In the case of death of an animal, the passport shall be returned by the keeper to the competent authority within seven days after the death of the animal. If the animal is sent to the slaughterhouse, the operator of the slaughterhouse shall be responsible for returning the passport to the competent authority.

The legislator, the Council and the European Parliament, laid down no detailed implementing rules on this issue. Since the adoption of the Regulation the Commission has provided clarification on this issue during discussions in several Commission working groups.

It is the responsibility of Member States to have in place a national database for bovine animals and to ensure that the requirements are met. The database must contain up-to-date information on all bovine animals and all movements whereby the traceability is ensured.

Furthermore with regard to the traceability of animals in intra-Community trade it should be noted that such animals must be accompanied by a health certificate in accordance with Council Directive 64/432/EEC, which includes information on the official individual identification of the animals concerned.

THE COURT’S OBSERVATIONS

4.125. The general framework of the system was laid down by the Parliament and the Council. The Commission was given the task of implementing certain components of the system but responsibility for implementing the system lies with the Member States. No procedure for exchanges of information between Member States regarding movements of animals was introduced into the rules, as such exchanges were compromised de facto because information formats vary from one Member State to another. All attempts to reconcile information from these different databases have failed. Member States interpreted certain elements of the Community regulations in different ways. The Commission has not been made responsible for taking application measures with regard to the databases and the monitoring of them, which partly explains the differences observed between Member States.

4.126. The control and penalty systems in place are not adapted to the holders of bovine animals, such as vendors, assembly centres or abattoirs. Moreover, the information contained in the databases such as late notifications or the rate of retagging is not used as a control tool. Control practices also differ greatly from one Member State to another.

4.127. As regards monitoring the implementation and follow-up of the SIRB, the Commission has interpreted its role narrowly and has not provided for any control over the setting-up of the databases. Not a single uniform management rule has been laid down, nor has any indicator of the quality of the way the data bases work been defined. The procedures for determining whether the data bases are operational are unsatisfactory and the Commission’s role has too often been confined to noting the technical existence of the database without evaluating how it actually works on the basis of precise management rules or predefined quality indicators.

4.128. The Commission should have sufficient means available to play a genuine role in controlling the system by establishing, inter alia, uniform management rules, quality indicators and a format for information exchange between national databases. Exchanges of information between Member States, or even with non-Member States, should be organised with a view to controlling intra- and extra-Community flows.

THE COMMISSION’S REPLIES

4.125. Responsibility for the implementation of Regulation (EC) No 1760/2000 lies with the Member States. Bovine animals must be identified within a period determined by the Member State as from the date of birth of the animal, at the latest at the age of 20 days and in any event before the animal leaves the holding of birth (Article 4); births, deaths and movements must be notified to the competent authority within a period fixed by the Member State of between three and seven days (Article 7); and passports must be returned to the competent authority by the last keeper (Article 6).

However, the Commission has acknowledged the need for precision of the deadline for notification by the keeper of births to the competent authority. To this effect a Regulation (EC) No 911/2004 — has been adopted which clarifies this issue.

4.126. The Commission takes note of the statement of the auditors that the current provisions for controls and penalties are not adapted to the activity of all categories of keepers. However, it should be noted that the detailed rules laid down concern the minimum level of controls and the minimum administrative penalties leaving the option open to Member States to go beyond these requirements. For controls it is specified that the minimum rate shall be increased immediately when it is established that Community legislation regarding identification has not been complied with.

According to the detailed rules for controls, which were laid down in 1997 and codified by Commission Regulation (EC) No 1082/2003, the criteria for selecting holdings for on-the-spot inspections must include proper communication of the data to the competent authority.

4.127. The legislation places a clear obligation on the Member States to put in place a national database for bovine animals, which should be fully operational by 31 December 1999 and must be able to supply, at any time, the identification number of all animals present on a holding and a list of all movements to and from the holding. It is the responsibility of Member States to ensure that such requirements are met. The limited role of the Commission’s recognition of the fully operational character of the national databases as laid down in Article 6(3) of Regulation (EC) No 1760/2000 lies with the Member States.

Bovine animals must be identified within a period determined by the Member State as from the date of birth (Article 4); births, deaths and movements must be notified to the competent authority within a period fixed by the Member State of between three and seven days (Article 7); and passports must be returned to the competent authority by the last keeper (Article 6).

The limited role of the Commission’s recognition of the fully operational character of the national databases as laid down in Article 6(3) of Regulation (EC) No 1760/2000 is in line with the political choice made by the legislator of having separate national databases in the different Member States instead of a single Community database. It is also clear that harmonisation of the characteristics of the national databases has not been considered a desirable objective by the legislator, which has left the Member States free to design their own databases. Attempts made by the Commission to establish, if not harmonise, interoperability between the national databases have been rejected by the Council of Ministers, as acknowledged by the auditors.

4.128. With regard to the national databases, the Commission acknowledges the need for established transparent criteria and benchmarks based on shared standards. Despite the legal vacuum, the Commission services are pursuing the review and consolidation of the criteria and benchmarks currently used.
THE COURT'S OBSERVATIONS

4.129. The administrative controls in force in the various Member States should also be compared and the cross-checks that are to be carried out between the SIRB and IACS databases before the various premiums are paid should be defined. The on-the-spot control system should also be reviewed, including the penalty systems, and a specific approach should be laid down for each type of holder of bovine animals, and finally an approach that is entirely integrated into the IACS should be made obligatory.

4.130. The EU produces about 5% of the world’s raw tobacco making it the fifth largest producer. It exports more than half its own production however, because the aroma and taste of most of the tobacco cultivated is not in demand within the EU. This production is predominantly of Virginia and Burley varieties of neutral aroma and taste used as the main cigarette filler. Smaller quantities of oriental varieties are also grown which have the required aroma and taste in demand. Consequently, it imports from outside the EU the tobacco which meets the aroma/taste requirements and takes 9% of the world’s production making it the biggest importer. The major EU producers are Italy, Greece and Spain who together account for 87% of total production. Production is characterised by a large number of growers dedicating small individual areas to its cultivation. Mechanisation is limited and production cost high. EU growers cannot make a reasonable living without the EU aid as the premium represents around 75% of producers’ income from tobacco production. Were EU tobacco production to cease, this would not affect manufacturers of tobacco products who would obtain supplies through increased imports.

THE COMMISSION’S REPLIES

4.129. The Commission considers that to integrate the identification system with IACS would, given the systems’ different objectives, jeopardise the smooth operation of the animal premiums system and could be open to legal challenges. The IACS concerns itself, inter alia, with animals for which CAP premium has been claimed; therefore the only relevant ‘reconciliation control’ to be made is to ensure that such animals appear in the SIRB.

In drafting IACS legislation and interpretations thereof, due care has been taken to ensure that aid reductions or exclusions are applied in proportion to the offence and only where appropriate. The Commission believes that regulatory controls should be as practical and efficient as possible, whilst providing the necessary financial safeguards.

4.130. The Commission welcomes the report of the Court of Auditors, but has difficulty in endorsing a number of the Court’s conclusions.

4.131. The EU has been supporting its tobacco cultivation through a common market organisation (CMO) since 1970 and the annual budget is some 1 000 million euro. The market has been reformed substantially, first in 1992, 1998 and again in 2004, in efforts to provide appropriate income support within budgetary limits, improve the response to market requirements and thus the value of production. It was hoped that growers would become less dependent on aid. Other measures are targeted towards facilitating voluntary departure from the sector and alternative cultivation.

Sound financial management audit of the common organisation of the market in raw tobacco (50)

(50) Special Report No 7/2004 (in the process of being published).
THE COURT’S OBSERVATIONS

4.132. The Court has reported on the operation of the CMO on three previous occasions. It concluded, in its last report in 1997, that the measures adopted in 1992 had achieved no measurable effect on the high level of subvention in relation to the value of production, the areas planted, the level of employment or the EU’s market situation.

4.133. The objective of this audit was to assess whether the reforms introduced in 1998 were soundly based and well managed by Member States. It also examined how the Commission had monitored and evaluated implementation and whether the objectives of the reformed CMO had been achieved.

4.134. As a result of its examination the Court concluded that the process by which the Commission elaborated its proposals for the 1998 reform was based on unreliable data and its analysis of the market was inadequate. Because of these failings the measures adopted were largely inappropriate from the outset and proved to be ineffective in many areas. There is no evidence that the CMO has influenced EU production so as to reduce the mismatch of supply and demand. The Court also found that the measures introduced did not achieve significant improvements in the income from tobacco cultivation or the market balance anticipated. The value of production was also put at risk by anti-competitive behaviour, in the form of price agreements, in the three largest producer states.

4.135. There were numerous failings in Member States to apply the checks required by the regulations and the verification of key controls and the pursuit of corrections through the clearance-of-accounts process should have been extended. No clearance of accounts decision has been taken as at June 2004.

THE COMMISSION’S REPLIES

4.134. The Commission’s proposal for the 1998 reform was based on a report presented in 1996. This report was based on the most reliable data available at that time, which suffered from some limitations. The Commission does not consider that its market analysis was affected by this lack of data. The reform did significantly reduce the production of the two lowest quality groups of tobacco, thereby addressing the problem that the qualities grown were not suited for the market demand. The alleged anti-competitive behaviour within the tobacco sector is being followed up by the Commission (see also point 4.139).

4.135. The Commission’s clearance of accounts departments were not inactive as regards tobacco. Based on their own risk analysis, and taking into account certain preliminary remarks of the Court of Auditors, they launched an investigation into tobacco in 2001 (audits in Greece, Italy, France and Germany) plus another three audits in 2003 (Greece, Italy and Spain). The procedures following the 2001 audits have been finalised for Germany and France. For some of the other Member States, however, the Commission is aware of some delays and will attempt to finalise its investigations as soon as possible.

The Commission notes the extended list of key controls now proposed by the Court. However, the Commission defined the key controls to be carried out in the tobacco sector in 2001 and is of the opinion that they cover the essential controls laid down in the Regulation.
4.136. The Commission’s monitoring was unsatisfactory and the evaluation of the CMO was delayed. The findings of the evaluation carried out by external consultants were made public in a report in October 2003 and are, on common issues, very similar to those of the Court.

4.136. The Commission is of the opinion that its monitoring proved satisfactory.


In the meantime, the Commission had employed an external evaluator to examine the CMO. This evaluation (10) was available in October 2003. Furthermore, in preparation for a reform of the raw tobacco sector, the Commission carried out an extended impact assessment (11) which was completed on 23 September 2003.

4.137. In July 2002 the Commission published its mid-term review of the common agricultural policy and proposed a new strategy for sustainable development across the agriculture sector which would be based on decoupling aid from production and providing support to farmers through a single farm payment scheme. The audit also examined how this might affect the tobacco CMO.

4.137. In July 2002 the Council of Agriculture Ministers decided to fundamentally reform the support for the tobacco sector. The 2004 Reform provides that, from 2010 onwards, tobacco aid will be completely decoupled from production. Half of the aid will be transferred to the single farm payment and the remaining half will be used for restructuring tobacco-producing regions under the rural development policy. In a four-year transition period, between 2006 and 2009, at least 40% of the aid will be decoupled and integrated in the single farm payment. Member States may decide to retain up to 60% as a coupled payment. The coupled payment has to be granted in such a way as to ensure equal treatment between farmers and/or according to objective criteria such as for tobacco producers situated in Objective I regions or for tobacco farmers producing varieties of a certain quality. Further criteria may be considered in the future. The 2004 reform should in principle resolve all of the present difficulties.

4.138. The reform adopted by the Council in April 2004 (11) envisages phased decoupling of the aid from production. Future support for tobacco producers will be included in the single farm payment scheme. There will also be a specific financial envelope for the restructuring of tobacco-producing areas.

4.138. On 22 April 2004 the Council of Agriculture Ministers decided to fundamentally reform the support for the tobacco sector. The 2004 Reform provides that, from 2010 onwards, tobacco aid will be completely decoupled from production. Half of the aid will be transferred to the single farm payment and the remaining half will be used for restructuring tobacco-producing regions under the rural development policy. In a four-year transition period, between 2006 and 2009, at least 40% of the aid will be decoupled and integrated in the single farm payment. Member States may decide to retain up to 60% as a coupled payment. The coupled payment has to be granted in such a way as to ensure equal treatment between farmers and/or according to objective criteria such as for tobacco producers situated in Objective I regions or for tobacco farmers producing varieties of a certain quality. Further criteria may be considered in the future. The 2004 reform should in principle resolve all of the present difficulties.

THE COURT’S OBSERVATIONS

4.139. The Court welcomes the present reform, which should go some way to addressing many of the weaknesses identified by the audit, although this will take some time. The Court recommends that the Commission pursue their investigations of the anti-competitive behaviour in Member States and, if it is confirmed, take appropriate action. The Member States’ failures to apply the checks required by the regulations should also be pursued and corrections applied where possible.

THE COMMISSION’S REPLIES

4.139. The Commission has issued Statements of objections concerning alleged cartels in the raw tobacco markets in Spain and Italy (in December 2003 and February 2004 respectively). These statements of objections contain the preliminary conclusions of the Commission’s investigations on alleged anti-competitive behaviour by producer groups and processors in the two Member States which started in October 2001 and January 2002 respectively. Issuing a statement of objections is a preliminary step in the procedure that may lead to the adoption of a prohibition decision imposing fines on the companies concerned.

As regards possible financial corrections the Commission refers to the ongoing clearance of accounts procedure following the 2001 and 2003 audits.
## ANNEX 1

### Evolution of key observations — Agriculture

<table>
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<th>2002</th>
<th>2003</th>
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<tr>
<td><strong>Observations</strong></td>
<td><strong>Replies of the Commission</strong></td>
</tr>
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</table>
| **Area aid schemes** | Member States were not consistent in providing a breakdown of their results, which affects the comparability of results between Member States and between the results of risk-based and random testing. IACS statistics should provide more detailed information about the categories of transactions tested. The Commission should investigate the reasons why tests performed on a random basis show a higher rate of error than those selected on the basis of a risk analysis. | The Court correctly points out the variable nature of statistics supplied by some of the Member States, and this is difficult to overcome in the short term. However, the great majority of Member States did provide adequate breakdowns for 2001, and both they and the Commission continued to improve reporting techniques in 2002 and 2003. The Commission is aware of several reasons for the situation outlined by the Court no least being the generally weak design and evaluation of Member States risk analysis that, although legally valid and often providing maximum coverage, do not always identify the greatest risks. | **The Commission should:**  
- seek to identify the reason for poor-quality checks of CAP spending (in particular for post-payment checks) and ways in which they could be improved;  
- improve the format of reporting of the results for all supervisory systems, at a minimum providing a breakdown of the number and value of payments checked and of errors found by budgetary chapters;  
- use the information so provided to compare the results provided by the different Member States in order to:  
  1. identify subsidies which are particularly subject to fraud and error;  
  2. evaluate the relative performance of the different Member States and  
  3. propose changes to regulations and to systems aimed at eliminating these areas of risk and reducing the rate of error. |
| **Animal premium schemes** | Overall the percentage of animals found by IACS inspections to be missing or ineligible shows considerable variation from year to year and from member State to Member State. Both the results of IACS testing and the direct work of the Court indicate that there is significant risk in this area. IACS statistics should provide more detailed information about the categories of transactions tested. | Generally any error rates notified by the Member States are naturally examined in the light of the Commission agricultural audit service’s own findings established after documentary audit and re-performance of on-the-spot checks, which have indeed often cast doubt on the veracity of some figures presented. | 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. The Court considers these statistics to be less reliable than the equivalent statistics for area aid applications. |
| **Other expenditure** | The Commission has identified weaknesses in the checks carried out under Regulations (EEC) No 4043/89 and (EEC) No 386/90. For export refunds and subsidies paid to intermediaries the Commission should ensure that statistics on physical, documentary and a posteriori checks are available on a timely and consistent basis, and show the value of transactions subject to checks and the value and incidence of irregularities detected. | The deficiencies mentioned by the Court were found by the Commission in a series of follow-up audits carried out in 2000 in those Member States where serious weaknesses had been found in previous audits and financial corrections imposed. In each of the Member States mentioned, major improvements had occurred. The Commission services made recommendations for further improvements. Annual statistics on physical controls (comprising information as mentioned in paragraph 4.4.9) are made available to the Commission by Member States by 1 May each year. These statistics are closely monitored by the responsible services. | The Court continues to find serious errors in this area of spending, and examined two relevant control systems:  
- post-payment checks were found to be of a low standard in terms of both the performance of inspections (one in five proving wholly unreliable) and the reporting of errors (the Commission has no information on the type of expenditure most at risk);  
- physical and documentary checks on goods at the time of export cover at least 5% of subsidised exports (*). The results do not indicate the amount of subsidy claims rejected, nor the type of export refunds most affected. |
| **Rural development** | Schemes of this kind have eligibility conditions which are more complex and difficult to verify than payments to farmers for arable crops or animal premium. Frequent conditions include adherence to ‘good farming practices’ and minimum standards for environmental impact, hygiene and animal welfare. The criterion of good agricultural practice should be clarified or replaced by a more robust criterion. | The Commission, together with the Member States, has developed a practical approach when good farming practices and minimum standards were introduced in 2000. The Commission is carefully and continuously following up the implementation of this approach by the Member States. | The Court considers that a summary of the results of supervisory checks should be included in the annual activity report of the Director-General for Agriculture. |

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*In the light of the Court’s figures for 2002 and 2003, and the comments made by the Commission in the reply to last year’s report, the Court recommends that the Commission investigate the reasons why IACS checks on areas, tests performed on a random basis continue to show a higher rate of error than those selected on the basis of an analysis of risk.

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*The deficiencies mentioned by the Court were found by the Commission in a series of follow-up audits carried out in 2000 in those Member States where serious weaknesses had been found in previous audits and financial corrections imposed. In each of the Member States mentioned, major improvements had occurred. The Commission services made recommendations for further improvements. Annual statistics on physical controls (comprising information as mentioned in paragraph 4.4.9) are made available to the Commission by Member States by 1 May each year. These statistics are closely monitored by the responsible services.*

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*The Court continues to find serious errors in this area of spending, and examined two relevant control systems:  
- post-payment checks were found to be of a low standard in terms of both the performance of inspections (one in five proving wholly unreliable) and the reporting of errors (the Commission has no information on the type of expenditure most at risk);  
- physical and documentary checks on goods at the time of export cover at least 5% of subsidised exports (*). The results do not indicate the amount of subsidy claims rejected, nor the type of export refunds most affected.*
<table>
<thead>
<tr>
<th>Observations</th>
<th>2002</th>
<th>Replies of the Commission</th>
<th>Observations</th>
<th>2003</th>
<th>Recommendations</th>
</tr>
</thead>
</table>
| Subsidies paid on the basis of quantities produced | Two risks are apparent here:  
— producers often have an incentive to understate the area cultivated with these crops, and to overstate the area with crops paid on an area aid basis;  
— the system relies on intermediaries (olive pressing mills, ginning mills, etc.) providing accurate figures for the quantities produced, this figure is not directly verifiable at a later date. | Each of the schemes referred to by the Court became compulsory IACS compatible as from 1 January 2003, from which time the Commission expects that control mechanisms will be significantly enhanced. Results on inspections of the olive oil agencies are always presented in the Annual Financial Report of EAGGF, in addition, statistics on inspections and the results of supervisory checks are classified in statistical comparative tables following yearly communications by the agencies or the Member States concerned. | In Greece, IACS is not fully implemented, and staff in regional offices do not always have access to the IACS database, which means the cross-checks on cotton, olive oil and tobacco producers cannot be made. Neither Spain nor Greece had a functioning GIS for the period relevant to payments made in 2003. A key part of the olive oil control agencies’ work relates to checks on olive mills (producers are paid on the basis of quantities weighted and processed at the mill. 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. | The Commission should take appropriate action through clearance of accounts decisions. |

(*) Regulation (EEC) No 386/90.
### ANNEX 2

**IACS monitoring elements — Follow-up 2002 paying agencies**

<table>
<thead>
<tr>
<th>Member State</th>
<th>PAYING AGENCY</th>
<th>Assessment year (1)</th>
<th>Area aid</th>
<th>Animal premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td>DE (1)</td>
<td>BAYERN L.</td>
<td>2002</td>
<td>A</td>
<td>A</td>
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<td></td>
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<td>2003</td>
<td>A</td>
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<td></td>
<td>2004</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>FR (2)</td>
<td>OFIVAL (3)</td>
<td>2002</td>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2003</td>
<td>B</td>
<td>B</td>
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<tr>
<td></td>
<td></td>
<td>2004</td>
<td>B</td>
<td>B</td>
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<td>ONIC (4)</td>
<td></td>
<td>2002</td>
<td>B</td>
<td>B</td>
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<td>2003</td>
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<td>2004</td>
<td>B</td>
<td>B</td>
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<tr>
<td>IT (5)</td>
<td>AGEA</td>
<td>2002</td>
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<td>2003</td>
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<td>2004</td>
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<td>NL (5)</td>
<td>LASER</td>
<td>2002</td>
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<td>2003</td>
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<td></td>
<td></td>
<td>2004</td>
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### Notes:

- **A** Works well, few or minor improvements required
- **B** Works, but improvements are necessary
- **C** Does not work as intended

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(1) The EAGGF payment year runs from 16 October to 15 October. For area aid, it covers subsidies paid for claims (applications) made in the preceding campaign year, which would also have been inspected in that campaign year. For example, the payment year 2002, ending 15 October 2002, would cover aid applications made in the preceding campaign year 2001. For animal premiums, subsidies are inspected and paid in the year of application.

(2) Many of the paying agencies reviewed for the payment year ending 15 October 2002, which covers payments made with reference to claims and inspections made in the 2001 campaign, were unable to take corrective action in time for the 2002 campaign, thus affecting payment year ending 15 October 2003. In many cases, corrective action could only be taken in time for the 2003 campaign, which affects payments in the EAGGF payment year ending 15 October 2004.

(3) France — OFIVAL is the paying agency for animal premiums, the schemes are administered and inspected by local services of the Minister of Agriculture.

(4) France — ONIC is the paying agency for area aid, and performs the inspections. The scheme is administered by local services of the Minister of Agriculture, which also select the inspections.

(5) Source: Court of Auditors review of paying agency IACS systems.
## ANNEX 3

### IACS monitoring elements 2003

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<th>Member State</th>
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<th>Risk analysis and selection procedures for inspections</th>
<th>Inspection methodology and reporting of individual results</th>
<th>Preparation and reliability of statistics on inspections and results</th>
<th>Administrative procedures and controls to ensure correct payment</th>
<th>Risk analysis and selection procedures for inspections</th>
<th>Inspection methodology and reporting of individual results</th>
<th>Preparation and reliability of statistics on inspections and results</th>
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<tr>
<td>DE</td>
<td>Niedersachsen</td>
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<td>ES</td>
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<tr>
<td>LU</td>
<td>Luxembourg</td>
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<tr>
<td>AT</td>
<td>AMA</td>
<td>2</td>
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<tr>
<td>FI</td>
<td>Finland</td>
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<tr>
<td>UK</td>
<td>RPA England</td>
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<tr>
<td>UK</td>
<td>DARD N. Irl.</td>
<td>3</td>
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<tr>
<td>Commission review over MS paying agencies</td>
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1. Land register is not up to date, resulting in a high number of anomalies when cross checks are carried out.
3. Re-inspection shows serious doubts about original inspection, and quality control procedures are not adequate.
4. Significant differences between data submitted to the Commission and the underlying data provided to the auditors.
5. No checks on slaughter premium retention period, an estimated 10-20% of slaughter premiums are paid to the incorrect beneficiaries. Very poor audit trail on calculation and application of sanctions.
6. No penalties applied for extensification premiums when basic premiums were sanctioned, some sanctions calculated incorrectly and no recoveries made for sums paid unduly in previous years.
7. Aid applications can be withdrawn after inspections have been announced and sanctions are not applied for animals without ear tags.
8. No inspection quality assurance procedures for animal inspections, which have been outsourced.
9. Excessive notice of inspections and applications can be withdrawn after announcement of inspection. Inspections do not cover claims in previous 12 months, nor are there checks to underlying documents. Quality control is limited to documentary review of serious errors only.
10. No statistics submitted to the Commission, information on inspections not available.

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

Structural measures

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Scope of the Special Report and the main recommendations

The International Fund for Ireland

Assessment of financial needs

Appropriate evaluation criteria for project applications consistently applied and adhered to

Routine monitoring of the Community contribution in IFI projects and evaluation of the projects’ merits

Special Support Programme for Peace and Reconciliation in Northern Ireland and the border counties of Ireland (1995 to 1999)

Further assistance to the implementing bodies ensuring consistent selection criteria for local community projects and social groups as well as guidance and resources ensuring assistance to the same projects and groups

Assessment of financial needs based on projected activity

Review of non-governmental bodies’ work

Documented project appraisals according to specific, written criteria

Introduction of appropriate control mechanisms

Assessment of synergy and coordination between IFI and Structural Funds

Principal observations in special report No 4/2004 on programming of Interreg III
5.1. Structural measures support the economic and social development of the European Union. The measures are financed by the Cohesion Fund and 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). The Structural Funds co-finance socio-economic development programmes in the Member States and the Cohesion Fund co-finances projects to improve the environment and develop transport infrastructure in Member States whose per capita GNP is less than 90 % of the Union average (1).

5.2. For the 2000-2006 period, the total budgeted expenditure is 230 177 million euro (2). Graphs 5.1 and 5.2 give a breakdown of the expenditure committed and paid in 2003. Most of the expenditure is directed towards three priority policy objectives:

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

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

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

Community Initiatives account for just over 5 % of Structural measures expenditure in 2003. These are programmes of Community interest carried out in and by the Member States at the initiative of the Commission to supplement actions implemented under the main programmes.

(1) In 2003: Greece, Spain, Ireland and Portugal.
(2) 210 579 million euro for the Structural Funds and 19 598 million euro for the Cohesion Fund (at 2003 prices).
Graph 5.1 — Breakdown of commitments by budgetary area in 2003

Total commitments: 33 987 million euro

NB: For more detailed information see Diagrams III and IV of Annex I.
Source: 2003 annual accounts.

Graph 5.2 — Breakdown of payments by budgetary area in 2003

Total payments: 28 528 million euro

NB: For more detailed information see Diagrams III and IV of Annex I.
Source: 2003 annual accounts.
5.3. Structural Funds assistance takes the form of ‘operational programmes’ which are made up of large numbers of operations or projects, whereas Cohesion Fund assistance is based on contributions to individual projects (3). The measures are implemented through the co-financing of national and regional programmes and individual projects (4). 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 Member State’s contribution. 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 470 Structural Funds programmes and 450 Cohesion Fund projects (5).

5.4. For the 1994 to 1999 and previous programme periods, contributions for structural measures were paid in the form of advances and final payments, the latter constituting the ‘closure’ of the programmes or projects. Community financing in the 2000 to 2006 programme period takes the form of a single initial advance payment of 7% of the total contribution to the programme or project, followed by the periodic reimbursement of expenditure declared by the Member States and final payments. These reimbursements are called ‘interim payments’. For the Structural Funds, each payment by the Commission concerns a given Fund and a given programme.

5.5. Structural measures are subject to the principle of ‘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 and the Member States and the latter are required to cooperate with the Commission to ensure that expenditure is made in accordance with the principles of sound financial management (6). Four Directorates-General of the Commission are concerned; the Directorate-General for Regional Policy (DG REGIO) for the ERDF and the Cohesion Fund, the Directorate-General for Employment and Social Affairs (DG EMPL) for the ESF, the Directorate-General for Agriculture (DG AGRI) for EAGGF-Guidance and the Directorate-General for Fisheries (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.

(3) The Commission may also carry out direct innovatory and technical assistance actions, up to a budgetary limit of 0.65%.

(4) For ease of reference, the single term ‘programme’ is used throughout the text to refer generally to Structural Funds assistance. A programme may receive assistance from more than one Fund.

(5) These are the figures before the approval of programmes and projects for the new Member States from 2004.

(6) Article 274 of the Treaty establishing the European Community.
Objective and scope of the audit

5.6. 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 audit examined in particular the operation of the supervisory and control systems at the Commission and in the Member States, and assessed 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 (1994-1999) and current (2000-2006) programme periods, the Court performed tests of underlying transactions as an independent check and in order to obtain further evidence on the operation of the funds. The audit focused on:

— the internal control environment at the Commission;
— the management of the 1994-1999 programme period;
— the management of the 2000-2006 programme period;
— the Annual Activity Reports and declarations of the Directors-General;
— a follow-up to previous observations in recent Statements of Assurance.

The internal control environment at the Commission

5.7. In the context of the ongoing reform of the financial and operational management and control systems of the Commission, the audit examined the operation of internal controls at the Commission, in particular the management of risks and the implementation of the internal control standards (see paragraphs 1.87-1.91).
THE COURT'S OBSERVATIONS

Risk analyses carried out by the Commission: Member States' management and control systems do not yet provide sufficient assurance of the legality and regularity of expenditure

5.8. The main risks which may be identified to the legality and regularity of expenditure for Structural measures arise from the shared management by the Commission and the Member States, the multiplicity of bodies and authorities — with different control structures and practices — 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 from weaknesses which may occur in the management and control systems. Similarly to last year, the Court's examination of the risk analyses carried out by the Directorates-General responsible for managing structural measures did not give rise to any observations. The Commission again recognises the risk that it is unable to obtain adequate assurance that operations carried out in the Member States for the programme period 2000 to 2006 are legal and regular as the management and control systems in the Member States do not in all cases provide sufficient assurance of the legality and regularity of expenditure. In 2003, the Commission continued to make improvements to its internal control systems and to analyse the systems descriptions submitted by Member States. The Commission's desk reviews and on-the-spot checks in the Member States of the management and control systems have identified a number of weaknesses, although the on-the-spot visits have covered only a limited number of those systems (see paragraphs 5.42-5.46).

5.8. The Commission considers that the supervision and control it exercises over the Member States are an adequate response to the risk of irregularity in the underlying transactions. In a given year the Commission can cover by its own audit work a limited number of Member States' systems, particularly having regard to other risks, such as the closure of the previous programme period, to which the Court refers. The Commission has a multiannual audit strategy for its own audit work aimed at achieving a reasonable assurance on the functioning of the systems during the programme period.

Implementation of the internal control standards: generally satisfactory progress by the structural measures Directorates-General

5.9. The Court's examination focused on 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 (7). The Synthesis of the 2002 Annual Activity Reports required the implementation of all the standards before the end of 2003.

5.10. For DG REGIO and DG EMPL, the implementation of the standards was generally found to be good. DG FISH had not fully implemented two (8) of the standards and DG AGRI had yet to fully implement one of them (see also paragraph 4.23). As regards Standard 17 'Supervision', both DGs are developing or formalising procedures to complete its implementation.


(8) Standards 17 ‘Supervision’ and 22 ‘Internal audit capability’.
Follow-up to the Action Plan

5.11. The Court examined the follow-up given by the structural measures Directorates-General to the action plan introduced by the Commission to remedy weaknesses identified (two of the actions concern aspects of shared management). These actions were contained in the 2001 Synthesis Report, with a deadline for completion in 2004, and are still being implemented (see also paragraphs 1.84-1.86).

Substantial progress has been made in the implementation of the two actions concerning shared management. By September 2004 the Commission had adopted communications on the legal responsibilities under shared management (COM(2004) 580) and on the alignment of audit methodology in this area (COM(2004) 3115); in December 2003 the Commission also published revised audit manuals for the Structural and Cohesion Funds. In the draft legislation for the Structural Funds in the 2007-13 period the Commission has also taken up the idea of annual declarations by an independent audit body which was also mentioned in action 17.

Management of the 1994-1999 programme period

Improvements made to the financial control framework, although late in the programme period

5.12. Commission Regulation (EC) No 2064/97 (\(^{(*)}\)), which entered into force in November 1997, was an important step in the development of the management and control arrangements for the Structural Funds. It introduced a set of common minimum requirements for the Member States’ management and control systems. The principal elements are:

- the requirement for the Member States to put in place management and control systems which provide satisfactory certification of the validity of claims for payments;

- a sufficient audit trail, permitting the reconciliation of declarations made to the Commission and the accounting records in the Member States, as well as the identification of the allocation of the Community funding;

- a minimum level of independent checks (at least a 5% sample), additional to the day-to-day management 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; and

— the requirement (under Article 8) for Member States to present to the Commission, at the closure of each programme, 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.

5.13. The Member States had to develop their control structures in response to all these requirements. However, the Regulation did not enter into force until November 1997 and there were delays in providing appropriate guidance. As the Court has previously noted (10), this was too late to influence the way in which management and control systems were originally set up; earlier implementation could have helped to avoid some weaknesses in Member States’ systems

Management and control systems in the Member States: failures to respect regulatory requirements

5.14. As part of the work towards the specific assessment of structural measures expenditure, the Court examined the operation of the management and control systems in the Member States on the basis of a random sample of seven final payments made by the Commission (in Germany, Spain, France, Ireland, Italy and Portugal (11).

5.15. For one of the programmes examined by the Court, a large part of the independent checks on projects were carried out by the same department responsible for proposing payments (12) and in two other cases, some projects were checked by persons performing management checks or involved in the final declaration process (13). This contravenes the fundamental control principle of the separation of functions.

5.15. The Commission has been aware of the issue of independence of bodies carrying out checks under Article 3 of Regulation (EC) No 2064/97 from its own systems audits carried out in 2001/2002. Guidance was given to the independent bodies as to how to treat the matter in the closure guidelines of the Commission.

For the cases concerned, based on the information on this point provided by the independent body, the Commission considered that sufficient checks had been carried out to meet the requirements of the Regulation.


(11) 3 ERDF, 2 ESF, 1 EAGGF-Guidance and 1 Cohesion Fund.

(12) Ireland EAGGF-Guidance Objective 1 94IR16006.

(13) France (Pays de la Loire) ERDF Objective 2 970313015; Germany (Thuringen) ERDF Objective 1 940209005.
THE COURT'S OBSERVATIONS

Weaknesses in the management checks of operations

5.16. In one programme, where the organisation in charge of a project had subcontracted the implementation of most of the project to another body, the management checks were limited to an examination of the invoices received by the organisation from the subcontractor (14). The Court has previously highlighted the particular risks that subcontracted costs represent (15).

5.16. As regards subcontracting, the Commission would refer to its reply to paragraphs 5.20 and 5.23 of this report and to its reply to paragraph 3.66 of the 1999 annual report.

Weaknesses in the independent checks

5.17. The sampling basis used for the independent (5 % sample) checks to verify the effectiveness of the management and control systems and the expenditure declarations was not always clear. For two programmes, risk factors were mentioned, but it was not clear how they were applied (16). For another programme, a set of homogeneous measures were identified from which a random sample could be drawn, but there were no specific risk factors associated with these measures (17). In another case, no risk analysis was made (18).

5.17. In its guidance on closure statements the Commission made it clear that the body issuing the statement must satisfy itself that the sampling basis was adequate. The Commission checked the information given on this aspect in its analysis of the statements.

For the Azores programme the statement indicated that the sample was balanced across the measures of the programme and took account of the level of financing involved.

For Ireland (EAGGF Guidance Section), based on the information available, and especially the confirmations of the independent body, the Commission considered that sufficient independent checks had been carried out to meet the requirements of the Regulation.

5.18. For the programmes examined by the Court, the Member State checks generally covered the whole period required by the Regulation. However, the process of carrying out independent checks under the Regulation did not start until 2000 or 2001 in certain Member States (19).

5.18. For the programmes examined by the Court, the Member State checks generally covered the whole period required by the Regulation. However, the process of carrying out independent checks under the Regulation did not start until 2000 or 2001 in certain Member States (19).

(14) Italy (Emilia-Romagna) ESF Objective 3 94000913.
(16) Portugal (Azores) ERDF Objective 1 941209013; France (Pays de la Loire) ERDF Objective 2 970313015.
(17) Germany (Thuringen) ERDF Objective 1 940209005.
(18) Ireland EAGGF-Guidance Objective 1 94IR16006.
(19) Court of Auditors, Special Report No 10/2001 concerning the financial control of the Structural Funds, paragraph 33.
5.19. The Regulation indicates what the checks should cover, such as the practical application and effectiveness of the management and control systems, the correspondence of accounting records with supporting documents, respect of Community requirements and the provision of appropriate national co-financing. For three programmes, the checks failed in some cases to include specific aspects related to the eligibility of expenditure co-financed by the Structural Funds (20).

5.19. The Commission is examining the Court’s findings in the light of the replies of the authorities of the Member States concerned. It will take account of the results for its closure audits. The Commission considers that the instructions provided in Portugal on the content of the checks were comprehensive.

5.20. In two cases, the Member State checks were not carried out at the projects. In one case, on the grounds that projects had been systematically subject to management control visits, the Member State — referring to specific correspondence with the Commission — carried out the independent checks entirely on documentation without any visits to projects, in contradiction to the Commission’s general guidance (21). In another case, a subcontractor, acting without a formal contract, could not produce evidence for the amount he had charged to the project promoter (22). In two other cases, the checks were limited to the organisation managing the aid, with few checks of invoices (23).

5.20. The Commission is examining the Court’s findings in the light of the replies of the authorities of the Member States concerned. It will take account of the results for its closure audits. Where the Commission has found cases where Member States had not checked supporting documentation held by the final recipients of aid, it has required them to quantify the expenditure affected and carry out further audit work if necessary.

For Ireland (EAGGF Guidance Section), based on the information available, and especially the confirmations of the independent body, the Commission considered that sufficient checks had been carried out to meet the requirements of the 1994-1999 Regulations.

Concerning the ESF case in Italy (Emilia Romagna) referred to in footnote 21, the guidance note sent by the Commission to the Italian authorities states that the independent body may also base its work on duly documented checks already carried out on the spot, but those checks must of course comply with certain conditions to be verified by the independent body; in particular, they must have been carried out using appropriate methods and with a sufficient degree of independence and reliability. The Commission, which has complied with its own guidance notes, did not therefore specify that the checks could not be carried out on the spot.

As regards the ESF subcontracting case in Portugal (Madeira) referred to in footnote 22, the Commission is particularly vigilant on the question of fictitious or unnecessary subcontracting whose aim is essentially to increase the costs declared. The Commission has therefore introduced the rule on eligibility sheet No 4, whereby subcontracting which is unjustified or does not add value is not admissible.

(20) Ireland EAGGF-Guidance Objective 1 94IR16006; Germany (Thuringen) ERDF Objective 1 941209005; Portugal (Azores) ERDF Objective 1 941209013.

(21) Italy (Emilia-Romagna) ESF Objective 3 94000913.

(22) Portugal (Madeira) ESF Objective 1 947000P1.

(23) France (Pays de la Loire) ERDF Objective 2 970313015; Ireland EAGGF-Guidance Objective 1 94IR16006.
5.21. The checks did not in general cover projects in their entirety. In some cases Member States included project costs in their calculations of the 5 % requirement which had not been audited on an appropriate sampling basis (24). In one programme, projects not audited were included in the calculation of the percentage coverage of the checks, on the grounds that a systems audit had been carried out and that the systemic error discovered in the audit of a single project had been corrected for all the projects concerned. This significantly inflated the percentage coverage reported (25). For another programme, the checks had covered 28 % of the total expenditure. However, the Court’s audit showed that only a part of them had actually been carried out at projects by persons independent of the managing department, and that these checks had mostly been concentrated on one of the three managing bodies (26).

5.22. For part of the sample of payments examined by the Court, the expenditure declarations and accompanying statements provided by the Member States at the closure of programmes — attesting the legality and regularity of the expenditure — contained significant levels of error (see paragraphs 5.23-5.27). The closure statements made by these Member States by contrast generally indicate minimal levels of error (less than 1 %). This is due to the poor quality and limited coverage of the checks performed, and because for the cases examined the Member States have not attempted to draw appropriate conclusions from the checks for the programme as a whole (27).

(24) Germany (Thüringen) ERDF Objective 1 940209005; Portugal (Azores) ERDF Objective 1 9412090013; France (Pays de la Loire) ERDF Objective 2 970313015.

(25) Portugal (Madeira) ESF Objective 1 947000P1.

(26) Ireland EAGGF-Guidance Objective 1 94IR16006.

(27) Portugal (Madeira) ESF Objective 1 947000P1; France (Pays de la Loire) ERDF Objective 2 970313015; Germany (Thüringen) ERDF Objective 1 940209005.
The Court’s substantive testing of transactions: final expenditure declarations contain significant levels of error

5.23. A total of 139 projects from seven programmes (see paragraph 5.14) were selected for substantive testing in the Member States. This revealed a significant number of failures to respect the regulatory provisions: ineligible expenditure and projects (28), expenditure without supporting documents (29), incorrect calculation of the Community contribution (30) and other failures (31).

5.23. The Commission is examining the Court’s findings in these cases in the light of the replies of the authorities of the Member States concerned and any additional information obtained where necessary. Once it has completed this examination it will take whatever action is necessary.

The Commission also confirms that, in the case of contractual relations, once the services have been provided the subcontractor does not have to justify its invoicing provided that it complies with the terms of the contract. Provided the subcontracting/provision of services adds value and that market prices are charged, the profit is recognised and legitimate.

5.24. For the sub-programmes of the three ERDF programmes (32) audited in the Member States, the Court found irregularities indicating significant overpayments.

5.24. The precise level of overpayments resulting from the errors identified by the Court will be determined in the Commission’s follow up of the cases, taking full account of the arguments presented by the Member States.

(28) Ineligible expenditure and projects:
The declaration of projects which do not fit into the programme criteria: Germany (Thüringen) ERDF Objective 1 940209005.
Declaration of expenditure incurred outside the eligible area or outside the eligible period: France (Pays de la Loire) ERDF Objective 2 970313015; Portugal (Madeira) ESF Objective 1 947000P1.
Declaring expenditure twice: Portugal (Azores) ERDF Objective 1 941209013; Ireland EAGGF-Guidance Objective 1 94IR16006; Germany (Thüringen) ERDF Objective 1 940209005.
Failure to respect job creation criteria: Germany (Thüringen) ERDF Objective 1 940209005.
Declaration of ineligible expenditure relating to the day-to-day management tasks of the claimant public administration: Ireland EAGGF-Guidance Objective 1 94IR16006.
Other ineligible expenditure: Ireland EAGGF-Guidance Objective 1 94IR16006.

(29) Expenditure without supporting documents:
Expenditure without adequate supporting documents: Ireland EAGGF-Guidance Objective 1 94IR16006; France (Pays de la Loire) ERDF Objective 2 970313015; Portugal (Madeira) ESF Objective 1 947000P1.
Declaration of estimated rather than actual expenditure: France (Pays de la Loire) ERDF Objective 2 970313015; Portugal (Madeira) ESF Objective 1 947000P1.
Failure to maintain a separate accounting system or adequate accounting codes to enable identification of the Community funding: France (Pays de la Loire) ERDF Objective 2 970313015.
The allocation of a proportion of overhead costs to projects without any underlying calculation supporting the amount attributed: Portugal (Madeira) ESF Objective 1 947000P1.

(30) Incorrect calculation of the Community contribution:
Failure to take account of potential generation of revenue or other income when calculating the rate of Community contribution to projects: Portugal (Azores) ERDF Objective 1 941209013.
Exceeding the maximum public subsidy limit: Germany (Thüringen) ERDF Objective 1 940209005.

(31) Other failures: Failure to provide information and publicity measures for the participation of the Structural Funds: France (Pays de la Loire) ERDF Objective 2 970313015; Germany (Thüringen) ERDF Objective 1 940209005; Portugal (Azores) ERDF Objective 1 941209013; Portugal (Madeira) ESF Objective 1 947000P1.

(32) Germany (Thüringen) ERDF Objective 1 940209005; France (Pays de la Loire) ERDF Objective 2 970313015; Portugal (Azores) ERDF Objective 1 941209013.
5.25. For one of the ESF programmes, the independent checks by the Member State had covered a sample of transactions from 1998 and 1999, leading to a correction in the declared expenditure, based on an extrapolation of the results of the checks. The Court found a higher level of error in the same sample (33). The differences stem to a large extent from a different treatment of inconsistencies in the national regulations and in their application.

5.26. The Court’s audit of the EAGGF measures within a multi-fund programme (34) revealed a significant level of irregular expenditure. The audit tests were carried out on transactions throughout the period of the programme and indicate that there were systemic weaknesses. An indication of these weaknesses was already given in the documentation submitted by the Member State with the request for final payment.

5.27. For none of the programmes examined did the management and control systems fully satisfy the requirements of Regulation No 2064/97. The Regulation does not contain specific requirements for day-to-day management checks and it is clear that the additional independent 5% sample checks alone cannot compensate for any deficits in the management checks. The findings resulting from the Court’s audit of projects confirms that this affects the legality and regularity of expenditure. The overall frequency and impact of errors is similar to that found by the Court in previous years.

5.28. The original regulatory deadline for the submission by Member States of final payment claims for programmes of the 1994-1999 period was 30 June 2002 (35). Member States did not in general meet this deadline. Council Regulation No 1260/1999 (June 1999), laying down general provisions on the Structural Funds, stipulated that sums for programmes of the 1994-1999 period for which no request for final payment had been received by 31 March 2003 would be decommitted. This last date was interpreted as the de facto final deadline — after which funds would be lost — but still caused problems for the Member States. In order to respect this deadline, in many cases Member States submitted incomplete documentation. This necessitated supplementary requests for information by the Commission and led to delays in the processing of the claims.

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(33) Portugal (Madeira) ESF Objective 1 947000P1.
(34) Ireland EAGGF-Guidance Objective 1 94IR16006.
... and problems for the Commission’s examination of files...

5.29. The Commission’s closure process consists mainly of obtaining assurance as to the eligibility and regularity of expenditure claimed by the Member States for payment. The Commission verifies in particular the adequacy of the Article 8 statement (36), the completeness of the final report and the correspondence of the final declaration of expenditure to the final report and Article 8 statement. This includes whether all known irregularities have been satisfactorily treated (including appropriate recovery procedures) in respect of:

a) the statement accompanying the request for final payment as specified in Article 8 of Commission Regulation (EC) No 2064/97 (the 5 % checks included);

b) the irregularities reported by the Member States (37) to the Community anti-fraud office or detected by the office;

c) audits by other national bodies, by the Commission or by the Court.

5.30. For the ERDF, for the 858 programmes of the 1994-1999 period 317 (almost 40 %) of the Article 8 statements required further enquiries by the Commission. In such cases, the Commission needs to seek more information or requests the Member State to carry out additional audits. Up to 31 March 2004 such additional audits were done for 51 programmes. Where appropriate, the Commission may propose the reduction or cancellation of the payments claimed by the Member State. The Commission had already decided or proposed such action in 127 cases (almost 15 % of all ERDF programmes of the 1994 to 1999 period) up to the same date.

5.31. The Court examined the processing by the Commission of Member States’ requests for final payments, taking a sample of 77 files out of 2 170 claims received by the Commission (38).


(37) As required by Regulation (EC) No 1681/94.

(38) 33 ERDF (of which 2 closed), 27 ESF (of which 5 closed), 13 EAGGF-Guidance (of which 5 closed), 4 FIFG (of which none closed).
5.32. For 33 ERDF programme files examined by the Court, delays or interruption in the payment procedure were linked to the Article 8 statement in 29 cases. The Commission had found that the statements contained a number of reservations which were not considered in the final expenditure declaration or the request for payment:

a) irregularities, ineligible expenditure and other problems not cleared (39);

b) differences between the irregularities notified by Member States to the anti-fraud office and those shown in the Article 8 statement and/or final declaration of expenditure (40);

c) unsatisfactory implementation of projects, in particular regarding cost overruns, problems with tender procedures, non-respect of environmental criteria, inconsistencies in construction works (41);

d) uncertainties concerning the independent 5% checks carried out or failure to make checks at the final recipients (42); the statements did not always provide details on the risk analysis underlying the sampling of projects for the 5% checks (43). In one case examined, the confirmation requested by the Commission of the work carried out by the independent body — including whether the 5% checks took place at projects — was left to the authority managing the programme (44); and

e) need for clarification as to whether sums subject to recovery were included in the final declaration (45).


(45) Brandenburg 940209002, Sachsen-Anhalt 940209003, Sachsen 940209004, Sachsen Objective 1 DG V, Corsica 940313024, Reunion 940313028, Hainaut 941013001.

5.32. In its guidance to Member States on closure issued in May 2003, the Commission indicated that reservations by the Article 8 body should be quantified and taken into account. The guidelines also covered the treatment of irregularities and the implementation of the sample checks.
5.33. The examination at DG EMPL showed that, concerning the 
check of the independence of the bodies in the Member States drawing 
up the Article 8 statements, the list of the certifying agencies 
held by the Commission for this purpose was not exhaustive. For a 
number of files, the Commission suspended the closure procedure 
and requested clarification and further information from the Mem-
ber State regarding the independence of the body providing the 
Article 8 statement or the content of the final expenditure declara-
tion. In two cases, the statements and final reports contained no 
information on the control examinations carried out by the Mem-
ber State during the programmes, but the Commission did not ask 
for any clarification (46). In five programmes examined, the 5 % 
checks had not taken place at projects (47). In two cases, the Com-
mission took over eight months to request further information from 
the Member State (48).

5.33. Concerning the list of independent bodies, the Commission pos-
sessed additional information which enabled the body’s independent char-
acter to be assessed. The independence of the services concerned was also 
checked in audits for the implementation of Regulation (EC) 
No 2064/97, the findings of which were taken into account when exam-
ining the files for the 1994-1999 closure. As regards footnote 46, the 
verification of the Article 8 declaration had not been started at the time of 
the Court’s audit, because the final reports which were analysed in the first 
instance had not been accepted for either of the programmes.

Regarding footnote 47, the Commission refers to its reply to paragraph 
5.20.

With regard to footnote 48, it took eight months to deal with those cases 
because of consulting other departments in order to ensure that irregulari-
ties were handled correctly.

5.34. The audit of files at DG AGRI revealed that the documents 
submitted by the Member States were of variable quality and, for 
those cases examined, were insufficient to allow the programmes to 
be closed (49). For example: there was no information on the period 
covered by the checks (50); the sample of projects to be checked was 
not made using risk analysis (51); there was insufficient indepen-
dence of the body making the 5 % checks and the checks were not 
always made at the project and were made before the final pay-
ments to the projects (52).

5.34. The closure statements were of variable quality, despite the Com-
mission guidelines in that respect and the reminders to Member States to 
follow the guidelines for the preparation of the closure statements.

In the cases where Agriculture Directorate-General considered that prob-
lems bearing a risk for EAGGF-Guidance existed, requests for 
clarifications/further information were addressed to Member States before 
the closure.

5.35. For five EAGGF-Guidance programmes examined by the 
Court, the Member States failed to properly assess the financial 
impact of control weaknesses found in the systems audits or in the 
audit of projects (53). In other cases, the Commission withheld pay-
ment but failed to officially inform the Member State of the suspen-
sion of the procedure: in two of the programmes examined, the 
Commission addressed an initial request for information only in 
May 2004 (54).

(46) Germany 941001D1, Germany 943001D3.
(47) Italy 9400191I, 94001312, 94001213, 9400221I, 9400171I.
(48) Spain 940112ES1, 970234ES2.
(49) Spain 94ES06016, Italy 94IT06045, Portugal 94PT16004, Spain Inter-
reg Z1 97EU16002, United Kingdom 94UK06016 5a, Irelan-
d 94IR06009, France (Brittany) 94FR06016 5b, France (Guadeloupe) 
Objective 1 94FR16002SPD, Sicily 94IT16033, Spain 94ES06032, Ger-
many 94DE06007, Italy 94IT06056, Austria 95AT06016.
(50) Spain 94ES06016.
(51) Spain 94ES06032, Italy 94IT16033.
(52) Ireland 94IR06009, United Kingdom 94UK06016.
(53) Spain (Andalusia) 94ES06016, Italy 94IT06045, France (Guadeloupe) 
Objective 1 94FR16002SPD, Portugal 94PT16004, United Kingdom 
94UK06016 5a.
(54) United Kingdom 94UK06016, Spain 94ES06016.
5.36. The FIFG likewise contributes towards achieving the objectives of the common fisheries policy, including as regards compliance with the multiannual guidance programmes (MAGPs) for the fleet. It should therefore be verified that the aid was granted in accordance with those requirements.

The Directorate-General for Fisheries decided to carry out on-the-spot checks prior to the programmes’ financial closure, after which additional information/checks were requested from the authorities concerned.

The Commission requested the Member State to extend the sample and to audit more projects in order to fulfil the requirements of Regulation (EC) No 2064/97.

The Commission considers that the checks carried out meet the requirements of Article 3 of Regulation (EC) No 2064/97.

5.37. The variable quality of the documentation submitted by the Member States complicates their examination by the Commission and makes further queries necessary. This increases the risk that the final declarations contain ineligible expenditure.

5.38. Table 5.1 shows the closed programmes for each of the Structural Funds as at 31 December 2003 and at 31 March 2004. The table shows that less than 10% of the programmes had been closed before 2003. Although the Commission had initially planned to close the bulk of the remaining programmes during 2003, only 331 out of 1 090 of the main programmes and 251 out of 1 080 Community Initiative programmes were closed by the end of 2003.

5.38. The inability of the Commission to meet its original target is because the bulk of final payment claims from Member States was received shortly before the deadline of 31 March 2003. Because of the variable quality of the closure documentation, in many cases additional enquiries had to be made before the claims could be processed.
### Table 5.1a — Structural measures: European Regional Development Fund programmes 1994-1999 closed at 31 December 2003 and 31 March 2004

<table>
<thead>
<tr>
<th>Budgetary area (1)</th>
<th>Total</th>
<th>Closed before 2003</th>
<th>Number of closure requests received by 31 March 2003</th>
<th>Closed during 2003</th>
<th>Closed at 31 March 2004</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>
<td>Number of programmes</td>
</tr>
<tr>
<td>Objective 1</td>
<td>181</td>
<td>57 571 255 951</td>
<td>5</td>
<td>1 630 221 360</td>
<td>181</td>
</tr>
<tr>
<td>Objective 2 94-96</td>
<td>84</td>
<td>5 165 903 927</td>
<td>62</td>
<td>2 963 694 368</td>
<td>84</td>
</tr>
<tr>
<td>Objective 2 97-99</td>
<td>73</td>
<td>7 157 716 211</td>
<td>0</td>
<td>0</td>
<td>73</td>
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<tr>
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<td>0</td>
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<td>0</td>
<td>0</td>
<td>0</td>
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<td>Objective 4</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Objective 5 (a)</td>
<td>0</td>
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<td>0</td>
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<td>0</td>
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<tr>
<td>Objective 5 (b)</td>
<td>84</td>
<td>3 302 548 791</td>
<td>0</td>
<td>0</td>
<td>84</td>
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<tr>
<td>Objective 6</td>
<td>2</td>
<td>355 453 472</td>
<td>0</td>
<td>0</td>
<td>2</td>
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<tr>
<td>Community Initiatives</td>
<td>520</td>
<td>9 223 064 769</td>
<td>58</td>
<td>245 322 179</td>
<td>520</td>
</tr>
<tr>
<td>Total</td>
<td>944</td>
<td>82 775 943 121</td>
<td>105</td>
<td>4 839 238 107</td>
<td>944</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 5.1b — Structural measures: European Social Fund programmes 1994-1999 closed at 31 December 2003 and 31 March 2004

<table>
<thead>
<tr>
<th>Budgetary area (1)</th>
<th>Total</th>
<th>Closed before 2003</th>
<th>Number of closure requests received by 31 March 2003</th>
<th>Closed during 2003</th>
<th>Closed at 31 March 2004 (2)</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>
<td>Number of programmes</td>
</tr>
<tr>
<td>Objective 1</td>
<td>102</td>
<td>22 806 888 948</td>
<td>0</td>
<td>0</td>
<td>102</td>
</tr>
<tr>
<td>Objective 2 94-96</td>
<td>82</td>
<td>1 397 251 132</td>
<td>70</td>
<td>1 225 350 076</td>
<td>82</td>
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<tr>
<td>Objective 2 97-99</td>
<td>72</td>
<td>2 112 708 834</td>
<td>1</td>
<td>6 262 842</td>
<td>72</td>
</tr>
<tr>
<td>Objective 3</td>
<td>56</td>
<td>13 221 222 835</td>
<td>1</td>
<td>53 748 169</td>
<td>56</td>
</tr>
<tr>
<td>Objective 4</td>
<td>16</td>
<td>2 614 128 525</td>
<td>0</td>
<td>0</td>
<td>16</td>
</tr>
<tr>
<td>Objective 5 (a)</td>
<td>0</td>
<td>0</td>
<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>0</td>
<td>0</td>
<td>83</td>
</tr>
<tr>
<td>Objective 6</td>
<td>2</td>
<td>177 902 801</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Community Initiatives</td>
<td>373</td>
<td>4 664 895 421</td>
<td>2</td>
<td>41 705 618</td>
<td>373</td>
</tr>
<tr>
<td>Total</td>
<td>786</td>
<td>48 252 482 256</td>
<td>74</td>
<td>1 327 066 705</td>
<td>786</td>
</tr>
</tbody>
</table>

(1) Structural measures objectives have since been regrouped for the 2000 to 2006 programme period.

(2) Figures available are as at 15 April 2004.

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 2003 and 31 March 2004

<table>
<thead>
<tr>
<th>Budgetary area (1)</th>
<th>Total</th>
<th>Closed before 2003</th>
<th>Number of closure requests received by 31 March 2003</th>
<th>Closed during 2003</th>
<th>Closed at 31 March 2004</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>
<td>Number of programmes</td>
</tr>
<tr>
<td>Objective 1</td>
<td>69</td>
<td>14 301 716 000</td>
<td>0</td>
<td>0</td>
<td>69</td>
</tr>
<tr>
<td>Objective 2 94-96</td>
<td>0</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>
<td>0</td>
</tr>
<tr>
<td>Objective 3</td>
<td>0</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>
<td>0</td>
</tr>
<tr>
<td>Objective 5 (a)</td>
<td>66</td>
<td>5 544 906 000</td>
<td>8</td>
<td>17 989 829</td>
<td>66</td>
</tr>
<tr>
<td>Objective 5 (b)</td>
<td>84</td>
<td>3 163 701 000</td>
<td>0</td>
<td>0</td>
<td>84</td>
</tr>
<tr>
<td>Objective 6</td>
<td>2</td>
<td>288 794 000</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Community Initiatives</td>
<td>167</td>
<td>1 156 618 000</td>
<td>2</td>
<td>6 659 147</td>
<td>167</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>388</td>
<td>24 455 735 000</td>
<td>10</td>
<td>24 648 976</td>
<td>388</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 2003 and 31 March 2004 — FIFG

<table>
<thead>
<tr>
<th>Budgetary area (1)</th>
<th>Total</th>
<th>Closed before 2003</th>
<th>Number of closure requests received by 31 March 2003</th>
<th>Closed during 2003</th>
<th>Closed at 31 March 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of programmes</td>
<td>Planned Community contribution in Commission Decisions (EUR)</td>
<td>Number of programmes</td>
<td>Total Community contribution paid (EUR)</td>
<td>Number of programmes</td>
</tr>
<tr>
<td>Objective 1</td>
<td>18</td>
<td>1 797 039 031</td>
<td>0</td>
<td>0</td>
<td>18</td>
</tr>
<tr>
<td>Objective 2 94-96</td>
<td>0</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>
<td>0</td>
</tr>
<tr>
<td>Objective 3</td>
<td>0</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>
<td>0</td>
</tr>
<tr>
<td>Objective 5a</td>
<td>12</td>
<td>850 431 000</td>
<td>1</td>
<td>2 060 003</td>
<td>12</td>
</tr>
<tr>
<td>Objective 5 (b)</td>
<td>0</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>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Community Initiatives</td>
<td>20</td>
<td>127 103 242</td>
<td>0</td>
<td>0</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>52</td>
<td>2 782 833 273</td>
<td>1</td>
<td>2 060 003</td>
<td>52</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.
5.39. The figures for Objective 2 include 15 programmes covering the period 1994 to 1996 with outstanding commitments of 35,15 million euro which remained to be closed at 31 December 2003, five years after the end of the programmes.

Limited extent of Commission’s closure audits

5.40. As already indicated in the Annual Report 2002 (paragraph 5.21), in most cases audits on underlying expenditure are carried out by the Commission only after the final payments have been made. DG REGIO had carried out ex-post audits on 17 programmes by the end of 2003. DG EMPL has postponed most of its ex-post audits to 2005. DG AGRI began its ex-post audits only in mid-2004. DG FISH has elected to carry out audits (of which it has done 15), including on individual projects, before closing programmes, as part of its analysis of closure documents. The number of errors found by both the Court's and the Commission's audits underlines the importance of in-depth verifications in the Member States of the declarations made at the closure of programmes. In each case, the results of these verifications should be extended to the whole programme audited.

Management of the 2000 to 2006 programming period

Further financial control requirements introduced into the regulatory framework

5.41. Commission Regulations (EC) Nos 438/2001 (59) and 448/2001 (60) lay down detailed rules for the implementation of Council Regulation (EC) No 1260/1999 (61) and stipulate the management and control systems required for Structural Funds programmes for the 2000 to 2006 period. The Regulations are based on the same principles as Regulation No 2064/97. They develop the control framework and further specify certain requirements, in particular:

1. the elements of the management and control systems to be put in place, especially concerning

- the definition, allocation and separation of functions, and

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ii) the differentiation between the controls carried out during the implementation of programmes ('the day-to-day management checks') and the sample checks to verify the effectiveness of the systems and the accuracy of expenditure declarations ('the independent 5% sample checks');

b) the declarations of interim and final expenditure which have to be accompanied by a certificate drawn up by a person or department functionally independent of any services that approve claims;

c) the provision by the Member State of a certificate at the closure of each programme, drawn up by a different person or department independent of the managing authority, giving an opinion on the checks carried out during the course of the programme and on the legality and regularity of the expenditure;

d) the responsibility of the Member States in the first instance to make any necessary financial corrections.

The Commission’s supervision of the Member States’ systems: limited assurance on the legality and regularity of expenditure

5.42. In 2003 DG REGIO continued its checks on the management and control systems. The assessment of the management and control systems was concluded for most of the Member States (62). By the end of 2002, the Directorate-General had carried out audits of systems for ERDF in all Member States. Visits were made in 2003 to seven Member States for the ERDF and to all four Cohesion Fund Member States, but as each programme may represent a different system, it has achieved a limited coverage. The checks on ERDF rarely included tests of projects.

5.43. The systems audits in the Member States by DG EMPL have, by the end of 2003, covered 46% of the total budgeted amount for the ESF for the 2000 to 2006 period. This has led the Directorate-General to express a reservation withholding assurance on the shared management of the ESF, because this coverage is considered insufficient and because of weaknesses found for part of the systems audited in the Member States.

5.42. Some Member States have systems with common elements which are applicable across many programmes, while in others the systems are relatively different for different programmes. The figures for programmes audited on the spot underestimate the percentage of systems that have been checked by the Commission given the overlaps which exist across programmes. In the first phase of ERDF system audits carried out in 2001-2003 it was not possible to carry out tests of projects because little expenditure had been incurred. In the second system audit enquiry starting in the second half of 2004 such tests will be carried out. By the end of 2003 the Regional Policy Directorate-General had audited 27% of programmes involving the ERDF. In 2003 it carried out a total of ten audits of the management systems for the Cohesion Fund and six project audits.

5.43. The 46% of the 2000-2006 programming period budget audited made it possible to cover all the Member States and a broad sample of the different systems set up.

The audit strategy for the 2000-2006 period, based on the concept of a single audit through mutual exchange of audit results (see reply to paragraph 5.68), is designed to obtain at the end of 2004 reasonable assurance regarding a significant number of management and control systems with a view to covering around 70% of the total 2000-2006 ESF budget for the 15 Member States.

(62) The assessment was not completed for the Community Initiatives and a final conclusion on the systems could not be reached for Greece, Spain, United Kingdom (Northern Ireland) and for one programme in Portugal.
5.44. For EAGGF-Guidance, DG AGRI has examined the management and control systems for all 141 programmes, and carried out audits covering 38 programmes. It has concluded its assessment of the systems for 25 programmes. For the remaining 116 programmes, it is seeking further clarifications. By the end of 2003, the assessment of the management and control systems was concluded for programmes covering 7% of the total budgeted amount for 2000 to 2006.

5.45. As concerns the FIFG, DG REGIO (for multifund programmes) and DG FISH have examined the management and control systems for all 50 programmes. DG FISH has carried out audits of the 16 programmes (in 13 Member States) for which it has lead responsibility. By the end of March 2004 the Commission had concluded its assessment of the management and control systems for programmes covering 24% of the total budgeted amount for 2000 to 2006.

5.46. Although the financial control framework has been reinforced since the previous programme period, these weaknesses in the Commission’s assurance on the reliability of the management and control systems in the Member States — and thus on expenditure declarations and the legality and regularity of the expenditure which it cofinances — still pose a problem.

5.46. The Commission is continuing its efforts through guidance, dissemination of good practices, audit work and financial corrections where appropriate to increase its assurance of the reliability of Member States’ systems and thus of the legality and regularity of expenditure declared.

The operation of the management and control systems in the Member States: failure to respect regulatory requirements still to be found in the current programme period

5.47. Similarly to its work on the previous programme period (paragraph 5.14 above), the Court examined the operation of the management and control systems in the Member States using a random sample of 11 payments made by the Commission on the basis of interim expenditure declarations by the Member States (in Belgium (2), Germany, Greece, Spain (3), Italy (2), Netherlands and the United Kingdom) (63). Annex 1 provides an overview of the results of the Court’s examination.

5.47. The Commission is examining the Court’s findings in the light of the replies from the Member States concerned. It will make any necessary recommendations to improve the systems.

(63) 5 ERDF, 4 ESF, 1 EAGGF-Guidance and 1 FIFG.
THE COURT’S OBSERVATIONS

Unclear definition, allocation and separation of functions

5.48. A lack of separation of functions was noted in several cases:

— for one programme, the body carrying out part of the checks on the functioning of the systems also had competence temporarily for authorising payments and the body responsible for issuing the closure statement was also involved in the checks underlying the certification of statements of interim expenditure; the certifying body is thus not independent with regard to the drawing up of those certificates (64);

— for one part of a programme, there was no separation between the managing and the paying authorities (65);

— for two programmes, organisations with managing responsibilities for the programme were also beneficiaries of Community funds under the programme (66).

THE COMMISSION’S REPLIES

5.48. The body responsible for issuing the closure statement is functionally independent but had some conflicting tasks within the framework of Regulation (EC) No 438/2001. The Member State has improved the segregation of duties by designating another body to carry out the work underlying the Article 9 certification.

Concerning the Belgian non-Objective 1 FIFG programme, the Member State has announced that the requisite measures will be adopted in order to ensure separation between the managing authority and the paying authority.

With reference to the Apulia programme, it may be legitimate for the same body like a local authority to be a beneficiary and at the same time to have management functions, provided it performs the latter functions independently.

Weaknesses in day-to-day management checks

5.49. The management and control systems should include procedures to verify the delivery of the products and services cofinanced and the reality of expenditure claimed and to ensure compliance with the relevant rules. The Court identified a number of weaknesses in the Member States’ systems, similar to those which it found in previous years. In three cases, the weaknesses are serious: failure to check compliance with rules on the eligibility of expenditure for support from the Structural Funds and late introduction of the controls so that limited numbers of projects have been checked (67). In one case, the procedures in place were insufficient to ensure that the projects carried out complied with the terms of the programme and with the applicable national and Community rules. For the same programme, there were insufficient checks that projects may receive a financial contribution from more than one fund at a time, which is excluded by the Regulations, or that projects may receive public funding above the permitted limit (68).

5.49. As regards footnote 69, for the ESF Dutch case, it is inherent to the declaration system implemented via Regulation (EC) No 1260/1999 that for the interim declarations of expenditure, all the control and verification activities have not been finalised. It is then also not exceptional that corrections to initially declared expenditure are made in a next interim claim.

As regards the EAGGF Guidance Section (footnotes 68 and 70), an audit mission on the Agriculture Directorate-General on the same programme, which took place in early 2004, detected similar problems which are now under discussion with the national authorities.

As far as the ERDF Spanish case is concerned, at the beginning of 2004 the Commission agreed with the Spanish authorities an action plan for improvements in their management and control systems for ERDF, with particular reference to management checks. The recommended improvements are being implemented in Galicia.

(64) Netherlands ESF Objective 3 1999NL053DO001.
(65) Belgium FIFG Outside Objective 1 2000BE14DO001.
(66) Italy (Puglia) ERDF Objective 1 1999IT161PO009; Spain (Galicia) ERDF Objective 1 2000ES161PO011.
(67) Spain (Galicia) ERDF Objective 1 2000ES161PO011; Italy (Piemonte) ERDF Objective 2 2000IT162DO0007; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004.
(68) Spain (Andalusia) EAGGF-Guidance Objective 1 2000ES161PO003.
For two other programmes, failure to properly check amounts declared for projects led to unreliable amounts being declared to the Commission, necessitating subsequent corrections and cancellations \(^{(69)}\). In two cases, checks performed were not documented \(^{(70)}\). In a final case, the checks were largely confined to compliance with national rules and the content of the checks was unclear \(^{(71)}\).

Weaknesses in the independent checks of management and control systems and expenditure declarations

5.50. The Regulation requires Member States to organise independent checks on projects, which, as for the previous programme period, should cover at least 5% of the total eligible expenditure and be based on a representative sample of the projects approved and on risk analysis.

5.51. In many cases, the efforts put into the closing of 1994-1999 programmes led to delays in the Member States in organising the systems for independent checks for the 2000-2006 programme period. The independent checks on the 2000-2006 management and control systems and the legality and regularity of the expenditure often did not begin until 2003 or even 2004, again reducing the preventive effect of the checks. In some cases, the checks had either not yet been started or were not very much advanced \(^{(72)}\), although the Regulation requires Member States to seek to spread the implementation of the checks evenly over the programme period.

5.52. For some programmes, the Member State failed to apply an appropriate sampling basis for the checks of projects \(^{(73)}\) or did not set out sampling criteria \(^{(74)}\).

\(^{(69)}\) Germany (Thüringen) ESF Objective 1 1999DE161PO002; Netherlands ESF Objective 3 1999NL053DO001.
\(^{(70)}\) Netherlands ESF Objective 3 1999NL053DO001 (operational centre of The Hague); Spain (Andalusia) EAGGF-Guidance Objective 1 2000ES161PO003.
\(^{(71)}\) Italy (Puglia) ERDF Objective 1 1999IT161PO009.
\(^{(72)}\) Belgium (Hainault) ERDF Objective 1 1999BE161DO001; Spain ESF Objective 1 2000ES053PO311; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004.
\(^{(73)}\) Spain (Galicia) ERDF Objective 1 2000ES161PO011; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004; Italy (Puglia) ERDF Objective 1 1999IT161PO009.
\(^{(74)}\) Spain (Andalusia) EAGGF-Guidance Objective 1 2000ES161PO003.
THE COURT’S OBSERVATIONS

5.53. For several programmes, it was not possible to assess the content of the independent checks as they had only just started. In other cases, improvements are necessary in the quality of the audits and reports, for example in the method of selection of items to be checked during visits to projects (75). In a final case the checks carried out before the Court’s audit visit were insufficient as there had been practically no visits to projects (76).

5.53. Guidance on the requirements for independent checks is given in Appendix 2 of the Structural Funds audit manual.

As regards footnote 76, for the ESF German (Thuringia) case, the Member State has taken prompt corrective action and the final report on independent checks indicates the completion of on-site audit visits for the year 2003 as well as a good coverage of Article 10(2) audits.

5.54. The Court’s audit revealed one case where there was no audit trail (77). For this case, the amount considered by the Commission as national contribution to a project combatting early school leaving is based on the assumption that under the lump sum financing system, the national contribution equals the Community contribution by definition. The amount really contained for this purpose in each lump sum amount, however, is neither identified nor separately accounted for, so the real national co-financing rate cannot be verified. On the expenditure side, the amounts declared concern projects that do not correspond to the description of the action in the ESF programme and notably include the full cost of special curricula rather than the additional cost as the programme description specifies. Costs of actions that do correspond to the description are neither identified as such nor separately accounted for. In addition, there were two other programmes where the audit trail was incomplete (78).

5.54. For the ESF Dutch case referred to under footnote 77, the schools can decide autonomously on the allocation of the annual budget in line with the national legislation which specifies the objectives and funding mechanisms of the schools. The Regulation also states that the institution needs to carefully account for the funding and expenditure and make sure that these are identifiable in the ledgers (separate accounting obligation). The Commission control work showed that this was the case in the sites it visited. The Community contribution is not included in the lump-sum but the national budget is used as matching funding for the ESF projects. Since the national matching funding for the ESF projects have been identified both in the school budget as well as in the application for ESF funding, signed by the director of the centres, the part-financing and the audit trail are clear.

Finally, the budget which is allocated annually to the various schools is based on the headcount of n-2. Therefore, there is no link between the headcount of n-2 and the schools’ actual expenditure in year n. This also confirms that the national budget can be used autonomously.

As regards, the Belgium FIFG case, the Member State has reported that it has taken the measures needed to ensure a full audit trail.

Footnotes:
(75) Italy (Puglia) ERDF Objective 1 1999IT161PO009; Italy (Piemonte) ERDF Objective 2 2000IT162DO007; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004.
(76) Germany (Thüringen) ESF Objective 1 1999DE161PO002.
(77) Netherlands ESF Objective 3 1999NL033DO001.
(78) Belgium FIFG Outside Objective 1 2000BE14FDO001; Italy (Piemonte) ERDF Objective 2 2000IT162DO007.
5.55. A total of 109 projects from 11 programmes (see paragraph 5.47) were selected for substantive testing in order to obtain further evidence on the operation of the funds. This revealed a significant number of failures to respect the regulatory provisions: ineligible expenditure and projects (79), expenditure without supporting documents (80), incorrect calculation of the Community contribution (81) and other failures (82). Similar types of errors were found in the 1994–1999 programmes examined.

(79) Ineligible expenditure and projects:
Declaration of costs unrelated to the programmes or projects concerned: Netherlands ESF Objective 3 1999NL053DO001; Belgium FIFG Outside Objective 1 2000BE14FDO001; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004; Belgium (Hainault) ERDF Objective 1 1999BE161DO001; Italy (Puglia) ERDF Objective 1 1999IT161PO009; Spain (Andalusia) EAGGF-Guidance Objective 1 2000ES161PO003.

Declaration of expenditure incurred outside the eligible period: Netherlands ESF Objective 3 1999NL053DO001; Spain (Andalusia) EAGGF-Guidance Objective 1 2000ES161PO003; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004; Spain (Galicia) ERDF Objective 1 2000ES161PO011.

Declaration of recoverable value added tax: Belgium (Hainault) ERDF Objective 1 1999BE161DO001.

The declaration of expenditure although funds had not been paid out to projects by the final beneficiaries: Netherlands ESF Objective 3 1999NL053DO001.

(80) Expenditure without supporting documents:
Declaration of estimated rather than actual expenditure: Germany (Thuringen) ESF Objective 1 1999DE161PO002; Spain ESF Objective 1 2000ES053PO311.

Expenditure without adequate supporting documents: Netherlands ESF Objective 3 1999NL053DO001; Germany (Thuringen) ESF Objective 1 1999DE161PO002; Spain ESF Objective 1 2000ES053PO311; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004; Belgium (Hainault) ERDF Objective 1 1999BE161DO001; Spain (Galicia) ERDF Objective 1 2000ES161PO011.

The allocation of a proportion of overhead costs to projects without any underlying calculation supporting the amount attributed: Netherlands ESF Objective 3 1999NL053DO001; Germany (Thuringen) ESF Objective 1 1999DE161PO002; Spain ESF Objective 1 2000ES053PO311; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004; Spain (Galicia) ERDF Objective 1 2000ES161PO011.

Failure to maintain a separate accounting system or adequate accounting code to enable identification of the Community funding: Netherlands ESF Objective 3 1999NL053DO001.

(81) Incorrect calculation of the Community contribution:
Failure to take account of potential generation of revenue or other income when calculating the rate of Community contribution to projects: Spain (Andalusia) EAGGF-Guidance Objective 1 2000ES161PO003; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004; Spain (Galicia) ERDF Objective 1 2000ES161PO011; Italy (Puglia) ERDF Objective 1 1999IT161PO009.

(82) Other failures:
Failure to check that the appropriate national cofinancing was in fact made available: Germany (Thuringen) ESF Objective 1 1999DE161PO002.

Failure to carry out an environmental impact assessment: Italy (Puglia) ERDF Objective 1 1999IT161PO009.

Failure to provide information and publicity measures for the participation of the Structural Funds: Netherlands ESF Objective 3 1999NL053DO001; Spain (Galicia) ERDF Objective 1 2000ES161PO011.

Failure to respect Community rules on the award of public contracts: Belgium FIFG Outside Objective 1 2000BE14FDO001; United Kingdom (East Midlands) ERDF Objective 2 2000GB162DO004; Belgium (Hainault) ERDF Objective 1 1999BE161DO001; Spain (Galicia) ERDF Objective 1 2000ES161PO011; Italy (Puglia) ERDF Objective 1 1999IT161PO009.

Failure to notify substantial modifications to a project: Germany (Thuringen) ESF Objective 1 1999DE161PO002.
5.56. The results of the substantive testing corroborated the weaknesses in the management and control systems in the Member States described in paragraphs 5.48 to 5.54. There was no marked difference in the errors found in comparison to previous years. This confirms the previous observation of the Court (83) that the Commission should continue its checks in the Member States; and should apply, where appropriate, the regulatory provisions permitting it to suspend interim payments in cases of serious irregularities (84), or when serious failings in the management or control systems are found which could lead to systemic irregularities (85).

5.56. The Commission is continuing to devote a large proportion of its audit resources to checking Member States’ systems for the current period. It refers to its replies under points 5.8. and 5.40. It has already made and will continue to make use of its powers where necessary to suspend payments to programmes whose systems show serious weaknesses which place Community funds at risk.

Annual activity reports and declarations of the Directors-General

Overall positive assurance on the legality and regularity of expenditure limited by serious reservations on the operation of the Member States’ management and control systems

5.57. The annual activity reports and declarations by the Directors-General are key elements of the Commission reform. The Directors-General for structural measures reaffirm that they have reasonable assurance that the systems in their Directorates-General guarantee the legality and regularity of the underlying transactions. Nevertheless, the Directors-General express a number of justified reservations concerning the operation of the management and control systems in the Member States.

5.58. The reservations of the Director-General for Regional Policy arise mainly from the results of desk controls and audits in the Member States (based on the systems descriptions provided by the Member States) carried out by his department, although limited compliance checks or substantive tests have so far been performed for the current period for the ERDF. The bulk of the reservations contained in the 2003 declaration — which all concern the 2000-2006 programme period — were also made in 2002. Thus, a reservation is again expressed on the management systems of two Member States (86) for the ERDF. Similarly, there is a reservation on the operation of the control systems for the Cohesion Fund in three Member States (87). A general reservation is maintained for the ERDF Community Initiatives (URBAN and Interreg), as the analysis of documentation received from the Member States has not yet been completed. No reservation is made regarding previous programme periods, for which 2 397 million euro were paid in 2003. None of the reservations is quantified and no indication of materiality is given.

5.58. For the previous programme periods the payments relate to the closure process for which the procedures applied were considered sufficient to provide reasonable assurance. Given the nature of the reservations it was not considered that quantification was appropriate.

(86) Greece and Spain.
(87) Greece, Spain and Portugal.
THE COURT’S OBSERVATIONS

5.59. For the ESF, the declaration of the Director-General for Employment and Social Affairs contains a contradiction between the global positive assurance on the legality and regularity of the underlying transactions and the reservation made concerning shared management and the operation of the systems in the Member States. The Director-General notes that her department has not yet been able to verify the modifications to the management and control systems made by the Member States following the Commission’s checks which covered systems relating to 46 % of planned expenditure for the 2000 to 2006 period (see paragraph 5.43). No mention is made as regards the assurance concerning the ESF for the 1994-1999 period, for which 768 million euro were paid in 2003. The planned ex post checks of the payments will not take place until the end of 2004 or in 2005.

5.60. The Director-General for Agriculture had a reservation for all EAGGF-Guidance payments made in 2003 to programmes for the 2000-2006 period. The reservation was based on outstanding queries raised by his department on the Member States’ systems descriptions examined and on the preliminary findings of systems audits in the Member States. No estimation was provided on the impact of the weaknesses revealed by the audits.

5.61. The Director-General for Fisheries also had a reservation concerning shared management and the operation of the systems in the Member States due to the fact that, following preliminary findings of system audits in the Member States, bilateral contacts are still underway with nine of them. The reservation is not quantified and no indication of materiality is given.

5.62. Although the Directors-General do not make any reservations for the period 1994 to 1999, the Court’s audit shows that significant problems of legality and regularity persist in the closed programmes. The systems put in place in the Member States for the current period also contain important weaknesses. Three structural measures DGs have made general reservations on the systems. DG REGIO has restricted its reservation to two Member States.

THE COMMISSION’S REPLIES

5.59. Concerning the 2000-2006 programming period, the reservation expressed relates to Member States’ systems in respect of which serious weaknesses have been detected and corrective measures will have to be taken. The Commission also refers to its reply to paragraph 5.43. regarding the action plan for attaining the systems coverage objective.

For the 1994-1999 programming period, the Director-General did not express a reservation regarding the ESF because the paid amount referred to by the Court concerns cases regarded as non-problematic since they were found to be satisfactory on the basis of in-depth document checking procedures.

In addition to expenditure audits, before 2003 the Directorate-General for Employment carried out system audits on the application of Regulation (EC) No 2064/97, the results of which were taken into account when closing the 1994-1999 programming period.

5.62. The absence of reservations on 1994-1999 programmes is justified given the rigorous procedures in place in the Directorates-General and the closure audits which are being carried out to verify the reliability of the closure statements. The scope of the assurance given by the Directorates General for the 2000-2006 period in 2003 was in general wider. Each Directorate-General took account of the level of audit work completed on the systems for the 2000-2006 period and its own audit strategy in determining the scope of its reservations. The Regional Policy Directorate-General took account in particular of its positive conclusions for most Member States resulting from its assessment of the system descriptions.

Follow-up of observations from previous Statements of Assurance

5.63. The previous audits of the Court concerning the management and control systems for Structural measures have revealed weaknesses both in the Commission and the Member States, which have contributed to the declaration of ineligible expenditure and the making of undue payments. Annex 2 summarises developments in the main issues arising from the Court’s recent audits affecting the legality and regularity of operations.
5.64. The Court reviewed the action taken by the Commission concerning observations made under recent Statements of Assurance. For the ESF, EAGGF-Guidance and FIFG the review did not give rise to particular observations.

5.65. Concerning the ERDF cases, DG REGIO had followed up the Court’s observations, although with delays in some cases in taking a position and launching any appropriate recovery procedures. There are, however, cases where no recovery procedures have been initiated (88) or the recoveries made do not fully take account of the Court’s observations (89).

Financial correction procedures are underway in both the North Rhine-Westphalia and the Piedmont cases. The Commission also intends to close the airport infrastructure case in 2004, without a recovery in the light of arguments presented by the Italian authorities and the results of a legal analysis. The second Italian and UK cases were dealt with at the closure of the programmes and the Commission considers the corrections made appropriate.

Conclusions and recommendations

5.66. The reform begun in 2001 has reinforced the internal control environment of the Commission. However, the declarations of the Directors-General do not yet enable the Court to take assurance from them.

5.66. Through its work to improve the content and widen the scope of declarations and its monitoring of compliance with the standards on which the declarations are based, the Commission is endeavouring to make the annual declarations into a reliable indicator of its performance and its strategy for dealing with the risks identified, in order that the Court can use them as a basis for its assurance.

5.67. Progress in closing programmes from the 1994 to 1999 programme period remains limited, largely due to the submission by Member States of incomplete and inadequate documentation with the claims for final payments and to the difficulties for the Commission in processing the files. In the cases examined, the Member States’ management and control systems did not fully respect the regulatory requirements. Their checks of expenditure were insufficient and the reliability of the statements provided with requests for final payments is questionable. The Court found similar problems to those which it has already reported for the closure of previous periods (90).

5.67. Based on the audit work carried out by the Commission in preparation for the closure, the examination of the closure documents presented for the 1,104 programmes to be closed, and the results of closure audits carried out, the Commission considers that the Member States have generally made serious efforts to comply with the requirements of Regulation (EC) No 2064/97 and that the level of checks carried out by Member States prior to closures is significantly higher than for the closure of previous periods.

The strategy adopted by the Commission for closing 1994-1999 programmes has reduced the risk that final payments are made for irregular expenditure. In particular, as a result of its scrutiny of Article 8 declarations it has asked Member States to clarify matters concerning the closure process or to undertake further audit work where necessary. It has launched financial correction procedures in a number of cases based on its examination of Article 8 declarations and will do so in further cases on the basis of its closure audits. The Commission will take account of the Court’s observations in its own audits and will follow up the Court’s findings of irregular expenditure in the programmes it audited and make appropriate corrections.


5.68. The regulatory requirements for the management and control systems were reinforced for the 2000 to 2006 period, but the Court’s audit showed that the systems are affected by serious weaknesses. The testing performed by the Court revealed the existence of the same type errors as found for the 1994 to 1999 period. Unless significant improvements are made to the systems, repetition of the problems encountered at the closure of the 1994 to 1999 period will be unavoidable.

5.68. The Commission is following a multiannual strategy to address these issues which in addition to including a level of audit work on the current period commensurate with the risks, taking account of other priorities, also involves applying the ‘single audit’ approach in order to maximise the effect of its own and Member States’ audit work. This involves improved exchange of control results with Member States within the present regulatory framework and coordination of audit work in order to avoid duplication and ensure a good coverage of systems considered as most at risk by both Commission and national auditors. In addition, the Commission disseminates guidance and good practice to Member States.

5.69. For structural measures, as an area of shared management between the Commission and the Member States, the key supervisory and control systems governing the legality and regularity of expenditure are in the Member States. However, the Commission is responsible for the implementation of the budget. Given the numerous weaknesses in these systems (see for example Annex 1), the Commission should require improvements from the Member States. The possibility to suspend payments should be used by the Commission in cases of serious systems weaknesses. In the context of the enlargement of the Community and the approach of the next programme period, the Commission, in cooperation with the Member States, should seek to further reinforce and rationalise the financial control framework for structural measures. This should include a clear and comprehensive audit and control strategy, as recommended by the Court in its recent opinion on the single audit model (91).

5.69. The standards of management and control required of Member States are laid down in the regulations and the Commission seeks to ensure that they are complied with. As part of the normal auditing procedures and standards, the Commission addresses detailed recommendations to the Member States whenever deficiencies are identified and follows up the improvements requested. It uses its powers to suspend payments and apply financial corrections to programmes where necessary when it concludes that the weaknesses in their systems involve a serious risk to Community funds. The Commission is closely examining the management and control systems in the new Member States for the current programme period. It has already proposed a management and control framework for the next period, which builds on the experience of the past by further reinforcing and clarifying the control responsibilities of the Member States whilst respecting the requirements of proportionality.


Scope of the Special Report and the main recommendations

5.70. The Special Report focused on the legality and regularity of the Community funding for the two programmes and, by means of a broad sample of measures and projects, examined the efficiency and effectiveness of procedures for the disbursement of funds.

5.71. The main recommendations for the International Fund for Ireland (IFI) (92) and for the Special Support Programme for Peace and Reconciliation (PEACE Programme) (93) are discussed below.

(91) Court Opinion No 2/2004
(92) Paragraphs 70 a), 70 c) and 70 d) of the Special Report.
(93) Paragraphs 71 a), 71 b), 71 c), 71 d), 71 e) and 71 f) of the Special Report.
The International Fund for Ireland

Assessment of financial needs

5.72. Council Regulation (EC) No 2236/2002 of December 2002, covering the Community contributions for 2003 and 2004, requires an assessment of the Fund's financial needs prior to each payment to the IFI. The specific content of this assessment has been agreed by the Commission and the IFI. It has also been agreed that payments would be made by the Commission whenever the cash balance falls to a level equivalent to or below two years' payments (to projects). While this represents a large reduction in the cash held by the IFI compared with current levels, there still remains an unduly large amount of cash available.

5.73. The requirement for an assessment prior to payment was not introduced by Council Regulation (EC) No 214/2000 of 24 January 2000. The Commission opted instead for a change in the system of advance payments from a single payment of 80% of the annual contribution to two payments of 40%.

Appropriate evaluation criteria for project applications consistently applied and adhered to

5.74. The Commission has not issued any guidelines or instructions, although it has made recommendations during its audits. Subsequent to these, the IFI has issued a Grant Procedures Manual in early 2004 which deals with the evaluation of project applications.

5.75. While this manual gives some guidance as to which areas to assess and where to find other potential funders’ opinions, the IFI has not decided what its detailed evaluation criteria should be for the achievement of its own objectives. The general guidance contained in the manual does not adequately cover all types of projects funded by the IFI.

Routine monitoring of the Community contribution in IFI projects and evaluation of the projects’ merits

5.76. The IFI regularly monitors the financial implementation of projects, but does not undertake any regular monitoring of non-financial information, precluding any evaluation of the merits of the funded projects.

5.77. Although a legal requirement to assess the Fund’s financial needs prior to payment was only introduced in the 2002 Regulation on the basis of the Court’s recommendations in the Special Report and an audit by the Commission in late 2000, the Commission had begun to adjust Community payments to the current target in cooperation with the Fund’s Board as early as 2000 under the previous regulation. The Commission acknowledges that cash balances currently held in the IFI’s bank accounts exceed its immediate needs. It will shortly be reassessing the Fund’s financial situation and expects the cash balance to decrease to the target level of two years of payments to projects by the end of 2004. The interest on the cash balances is used for the activities of the Fund.

5.77. At the time of the preparation of the 2000 regulation, the Commission had not yet received the formal recommendation made in the Special Report. When it did so, it proposed the new requirement in the 2002 regulation. However, since 2000 at the Commission’s request the Chairman of the Board has signed a statement for every payment that if the financial situation of the Fund is such that utilisation of the new funds is not guaranteed or existing funds remain unused, the Fund will repay the funds to the Commission.

5.77. The Commission points out that the Fund is an independent legal entity operating under funding rules based on an international agreement between two Member States and other donor governments. The Commission is an observer on the Fund’s board and can influence but not determine its policy.

5.77. The Commission has encouraged the IFI to develop its criteria and procedures for evaluating project applications and continues to do so. A strategic review now under way should allow further progress to be made.

5.77. The Commission agrees that the IFI’s monitoring of the impact of its activities could be improved. An assessment by outside consultants is planned in 2004 to assist with the ongoing strategic review.
THE COURT’S OBSERVATIONS

Special Support Programme for Peace and Reconciliation in Northern Ireland and the border counties of Ireland (1995 to 1999)

Further assistance to the implementing bodies ensuring consistent selection criteria for local community projects and social groups as well as guidance and resources ensuring assistance to the same projects and groups

5.77. The Programme identifies local community projects and social groups and contains selection criteria, which are further developed in the Programme complement (**). The managing authority issued further guidance in early 2003 and at the end of 2003 and in early 2004. While this is in line with the recommendation of the Court, much of the guidance has appeared rather late in the life of the Programme.

5.78. The resources allocated to technical assistance have been increased from 18.8 to 50.5 million euro in December 2003.

Assessment of financial needs based on projected activity

5.79. The financial allocation to the PEACE II Programme was decided in March 1999 by the European Council and amounted to 500 million euro. However, the allocation was based on a simple projection of the financial allocation made to the PEACE I Programme.

Review of non-governmental bodies’ work

5.80. The Local Strategy Partnerships, the Intermediary Funding Bodies and the County Council-Led Task Forces were formally established in April 2002, at the end of 2001 and in mid-2002 respectively. Later, the managing authority carried out an assessment (published in August 2003) concerning the examination of whether the PEACE II Programme is being administered by each Implementing Body in accordance with both the applicable guidance notes and the contract entered into with the managing authority.

5.81. The recommendation has been followed, but this review has been undertaken late in the life of the programme. Moreover, the authorities responsible for the implementation of the programme should undertake a follow-up of the situation at regular intervals.

Documented project appraisals according to specific, written criteria

5.82. Project appraisal criteria form part of the Programme and the Programme complement and have been developed further in guidance notes issued by the managing authority. Checklists have also been introduced.

THE COMMISSION’S REPLIES

5.77. The guidance was delayed by the setting up of the new administrative arrangements.

5.78. The Commission encouraged the increase. Technical assistance is essential for delivering the programme with the maximum involvement of the local community and NGOs.

5.79. The PEACE I programme had taken up 98% of its financial allocation and the same allocation was agreed for PEACE II.

5.81. The implementing bodies had to be given time to settle down before the review started. The managing authority intends to follow up the lessons throughout the lifetime of the programme.

(**) The Programme complement is an additional document, providing further details on the implementation of the Programme.
Introduction of appropriate control mechanisms

5.83. Both Member States have submitted to the Commission descriptions of their management and control systems for the PEACE II programme in accordance with Commission Regulation (EC) No 438/2001, although neither respected the deadline. The Commission has satisfied itself that for Ireland the systems descriptions meet the standards set out. However, this is not yet the case for the United Kingdom. Furthermore, in December 2003 the Commission performed a compliance audit in Ireland and Northern Ireland of the systems put in place as notified in the descriptions. The audit revealed certain weaknesses and that the structures have been put in place late.

5.84. The managing authority has subsequently issued a guidance note on financial controls and checklists for the checks required by the Regulation. Moreover, training seminars have been held for all implementing bodies in 2004 concerning management and control systems checks, verifications and other relevant management issues.

Assessment of synergy and coordination between IFI and Structural Funds

5.85. The presence of the IFI as an observer on the Monitoring Committee of the PEACE II Programme and of the Commission as an observer on the IFI Board is the only element of coordination. The managing authority is still not a member of the IFI Board. No operational contacts ensuring regular and concrete coordination between the IFI and the PEACE II Programme’s managing authority or paying authority exist. Therefore, it is not possible to obtain any intentional synergy effects between IFI and PEACE II Programme activities.

5.86. In relation to the issue of projects with multiple funding sources, a formal arrangement or procedure assessing which of the funding bodies is best placed to ensure the attribution of the funding and management of the project does not exist and is not envisaged in the near future.

PRINCIPAL OBSERVATIONS IN SPECIAL REPORT No 4/2004 ON PROGRAMMING OF INTERREG III (95)

5.87. The Interreg Community Initiative was launched in 1990 in an attempt to tackle the isolation of border areas. By proposing cooperation between partners in different Member States, it contributes to the opening of borders. It was renewed for the periods 1994-1999 (Interreg II) and 2000-2006 (Interreg III). With commitment appropriations of 4 875 million euro, Interreg III is the most substantial Community Initiative.

5.88. The Court’s audit of Interreg III covered the period from the preparation of the Commission guidelines to the first decisions to adopt beneficiaries’ projects. The objective was to answer the following questions:

a) Do the guidelines make it easier to attain the Initiative’s objectives?

b) Did the Commission use a suitable procedure for examining programme proposals, and were decisions taken within the agreed deadlines?

c) Did the various partners cooperate as provided by the guidelines?

d) Was the initial analysis for each region consistent with the priorities and measures of the corresponding programme, as required by the guidelines?

e) Will it be possible to measure progress ex post?

5.89. The Interreg III guidelines focus on the procedures for implementing programmes that seek to enhance cooperation. However, they were not made available until preparation of the programme proposals had been underway for at least a year. The proposed objectives are not targeted and cannot be measured or quantified. There are no indicators with which to assess how much overall progress has been made.

5.90. Procedures by which the Commission could examine programme proposals had been devised and put in place. However, the assessment criteria were under-prepared and insufficient improvements had been made in response to the significant shortcomings identified in the proposals. The adoption of the programmes was delayed, with the result that the process of cooperation between eligible regions was interrupted and the available appropriations were underutilised.

5.91. As advocated by the guidelines, the programmes were prepared in the context of a consultation process. The partners from the various Member States generally contribute to implementation in a spirit of cooperation. However, there remain some obstacles to setting up programme implementation structures that are genuinely shared and to allocating the financial resources of the ERDF.

5.89. In view of the large number of cross-border programmes, the many different types of area concerned and the priority objective of developing cross-border economic and social centres, the Commission opted in its guidelines for a bottom-up approach. This is why the guidelines for strands A and C refer to priority areas in relatively broad and non-exhaustive terms. The added value is to be found in the development of cross-border cooperation and in catalyst effect this produces. The indicators should measure progress made in this field. However, the intangible nature of a great many operations made it difficult to devise targeted indicators.

The main actors were familiar with the general points of the guidelines, and the Commission had been in regular contact with them well before the guidelines were published.

5.90. Even though improvements are always possible, the Commission believes that the procedural stages were adequately prepared and that the main shortcomings had been corrected, as far as was possible given that there had to be some negotiation. The delays were largely due to the time taken to remedy these shortcomings given the need to secure the agreement of all the Member States concerned. The delays had little impact on the start-up of the programmes.

5.91. The creation of genuine joint management structures with their own legal personality would facilitate implementation of cooperation programmes. The Commission has proposed a new legal instrument in the package of draft regulations for the new period.
THE COURT’S OBSERVATIONS

5.92. From the point of view of consistency, the Strand A and B programmes incorporate numerous analyses. However, these are of little use. This is because the priorities and measures were established on the basis of other concerns which are not elucidated in the programmes. Neither were decisions made concerning the resolution of problems caused by the presence of a border, and the analyses do not help to fix the starting points in terms of which progress is to be measured. The first projects to be approved were prepared and will be implemented in the context of cooperation between the different partners concerned. However, because some projects are limited to the sharing of experience, they do not always contribute significantly to the resolution of problems specific to border areas.

5.93. The indicators are inadequate to the task of ex post evaluation of the progress made. They do not correspond closely enough to the objectives. Moreover, some indicators need to be clarified and the information sources used to constitute them should be more precise. In most of the cases examined the computer application had still not been introduced.

5.94. For the current period, the Court recommends that the systems of indicators applied to each programme be simplified and improved in order to give a more valid measure of impact. The project selection criteria should be strengthened so as to enhance the added value of projects, i.e., the degree to which they contribute to the resolution of border-related problems.

5.95. If the Initiative is renewed after 2006, the Commission should launch a study to ascertain which problems are caused by the existence of a border. Whatever the approach adopted, the study would help in the setting of concrete objectives to be given priority status in the Initiative and which give the Initiative itself added value. Indicators therefore need to be defined for each strand. Subsequently, setting detailed criteria for the Commission’s assessment of programme proposals, would make it possible to adopt a proactive approach towards the Member States. The analyses requested at the level of each programme should be used to set specific objectives and measure progress at that level.

THE COMMISSION’S REPLIES

5.92. The bottom-up approach brings out concerns not identified by expert analysis but expressed by regional and local authorities which feed into the strategy and choice of priorities. As the overall objective of the cross-border CIPs is to contribute to the development of cross-border economic and social centres, any project which facilitates cooperation on this point can participate in the objective.

5.93. The Commission recognises that there is a difficulty in finding suitable indicators due to the fact that the added value of the Interreg Initiative takes a variety of forms. The sets of indicators in individual Interreg III programmes are, however, a promising start in this direction.

5.94. After the mid-term assessments, the Commission urged many programme management authorities to improve the systems of indicators. As part of the simplification drive, the Commission called on Member States to simplify and reduce the number of their impact indicators.

5.95. The Commission considers that added value is greater if CIPs contribute to creating cross-border economic centres rather than simply resolving problems still existing at borders. The choice of this approach affects the possibility of laying down standard indicators, even if improvements are possible in this field.

5.96. The guidelines and methodology documents should be made available before work starts on preparing programmes, and the ex ante assessor’s role and the content of the programme complement need to be clarified.
5.97. Finally, in order to encourage cooperation the financial resources allocated to the Initiative should no longer be assigned by Member State, and the work begun on legal cooperation instruments should be completed and the recommendations put into effect.

5.97. The Commission will examine the Court’s recommendation when preparing the next programming period. The Commission has proposed a new legal instrument in the package of draft regulations for the new period.
## ANNEX 1

### Structural measures

#### Management and control systems

Assessment by the Court of implementation of Commission Regulation (EC) No 438/01 for the management and control systems in the Member States visited.

<table>
<thead>
<tr>
<th>Key Audit Areas</th>
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<tbody>
<tr>
<td>Member State/Region/Fund</td>
<td>Clear definition, allocation and separation of functions (Article 3)</td>
<td>Satisfactory day-to-day procedures to verify legality and regularity of co-financed operations (Article 4)</td>
<td>Sufficient audit trail (Article 7)</td>
<td>Adequate recovery procedures (Article 8)</td>
<td>Assurance of reliability of certificates of expenditure (Article 9)</td>
<td>Progress of checks to cover at least 5% of total eligible expenditure (Article 10)</td>
<td>Adequate organisation of 5% checks (Articles 10-12)</td>
<td>Independence and auditing standards of body issuing declaration at closure of programme (Article 15)</td>
<td>Examination of management and control systems in preparation for providing declaration at closure of programme (Article 16)</td>
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<td>Thüringen (Germany) ESF</td>
<td>Works well, few or minor improvements required</td>
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<td>Netherlands ESF</td>
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<td>Spain ESF</td>
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<td>Greece ESF</td>
<td>Works, but improvements necessary</td>
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<td>Galicia (Spain) ERDF</td>
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<td>Piemonte (Italy) ERDF</td>
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<td>Hainault (Belgium) ERDF</td>
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<td>Puglia (Italy) ERDF</td>
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<td>Andalusia (Spain) EAGGF Guidance</td>
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<td>Belgium FIFG Outside Objective 1</td>
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</table>

(a) Works well, few or minor improvements required
(b) Works, but improvements necessary
(c) Does not work

For details see paragraphs 5.47-5.54

(1) Procedures not tested as they have not had to operate.
(n/t) Not tested.
### ANNEX 2

#### Follow-up of key observations

<table>
<thead>
<tr>
<th>Observation</th>
<th>Action taken</th>
<th>Comment(s)</th>
<th>The Commission’s reply</th>
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<tr>
<td>Weaknesses in supervisory systems and controls, persistent errors in payments</td>
<td>The Commission has only documentary evidence for a large number of the Member States' management and control systems. It has undertaken to increase the number of audits including the verification of expenditure underlying Member States' requests for payment. The coverage of the audits is still limited in comparison to the audit domain but they highlight failures by the Member States to respect the regulations.</td>
<td>Although efforts have been made by the Commission to increase its assurance, no guarantee can be given as to the legality and regularity of the transactions underlying Community payments. The Commission remains therefore unable to give any guarantee as to the practical effectiveness of the systems and controls.</td>
<td>The Commission has made significant progress in auditing Member States' management and control systems for the 2000-06 period. Whenever they were found not to comply with the regulations or to operate ineffectively the Commission has recommended improvements and in some cases agreed comprehensive action plans with the Member States and is following up their implementation. In addition to its own audit work, the Commission monitors that of the Member States' authorities, discusses the systems with them and provides guidance. In cases of serious doubt that systems do not guarantee that the expenditure declared is regular, the Commission suspends payments to the programmes concerned. The result of this work is that in 2003 the assurance the Commission had obtained on national systems was in general broader than in 2002. Concerning 1994-99 programmes, the Commission considers that the thorough checking of closure documentation, its closure audits of a risk-based sample of programmes and the application of financial corrections for inadequate audit work or individual errors provide a sound basis for obtaining reasonable assurance on the expenditure cofinanced.</td>
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<td>Limitations in the Commission's assurance on the operation of the management and control systems</td>
<td>A limited number of audits have been carried out in the Member States. Also, the declarations are based on the assumption that the Member States will fulfill their control and management obligations in line with the relevant regulations. Therefore, concerning the information about the systems in place in the Member States and possible reliance upon them, the declarations are limited to a negative appraisal in some cases.</td>
<td>Although efforts have been made to improve the quality of the declarations, their coverage remains largely limited to the internal control systems at the Commission. They do not provide a global indication, even indirect, on the legality and regularity of the expenditure managed by the systems in the Member States.</td>
<td>The scope of the declarations has become broader as the Directorates General have completed their assessment of the systems and carried out further audit work in the Member States. Nevertheless, the declarations are necessarily focused on the assurance with regard to the expenditure effected by the DG and with regard to its own activities and systems for ensuring the legality of expenditure managed by the Member States.</td>
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<td>Delays and weaknesses in closing 1994-1999 programmes</td>
<td>The Commission has a programme of ex post audits.</td>
<td>The bulk of the audits will only take place in late 2004 or in 2005.</td>
<td>Despite the late submission and variable quality of the closure documentation provided by Member States, the Commission made good progress in 2003 in examining the final claims for 1994-99 programmes. The Commission began closure audits in 2002 and for some funds had completed the bulk of them by mid-2004.</td>
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<tr>
<td>Limited follow-up by the Commission of audit findings</td>
<td>The Commission's follow-up action has improved, although delays persist.</td>
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CHAPTER 6

Internal policies, including research

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INTRODUCTION

6.1. The European Union’s internal policies focus on the implementation and development of the single market and cover four complete subsections of the budget (in addition to small parts of other subsections (1)):

— education, vocational training and youth (subsection B3);

— energy, Euratom nuclear safeguards and the environment (subsection B4);

— consumer protection, the internal market, industry and Trans-European Networks (subsection B5); and

— research and technological development (subsection B6).

Graphs 6.1 and 6.2 show how the appropriations were spent in 2003.

6.2. Within the Commission, the responsibility for implementing internal policies and managing the corresponding budget is spread across 14 Directorates-General (2). The principal ones — in terms of the funds managed — are the Directorates-General for Research, for Energy and Transport, for Information Society, for Education and Culture and the Joint Research Centre.

(1) Other agricultural operations, other regional operations, transport as well as other measures concerning fisheries and the sea (Titles B2-5 to B2-9 of subsection B2), and public awareness of the common agricultural policy (Article B1-382).

(2) Directorates-General for Research (RTD), Information Society (INFSO), Energy and Transport (TREN), Enterprise (ENTR), Fisheries (FISH), Justice and Home Affairs (JHA), Education and Culture (EAC), Environment (ENV), Health and Consumer Protection (SANCO), Competition (COMP), Internal Market (MARKT), Economic and Financial Affairs (ECFIN), EUROSTAT and the Commission’s Joint Research Centre (JRC).
Graph 6.1 — Breakdown of commitments by budgetary area in 2003

Total commitments: 7 173 million euro

- Energy, Euratom and the environment: 4%
- Training, youth and social operations: 15%
- Consumers, internal market industry and networks: 18%
- Other structural operations: 4%
- Research and technological development: 59%

NB: For more detailed information see Diagrams III and IV of Annex I.
Source: 2003 annual accounts.

Graph 6.2 — Breakdown of payments by budgetary area in 2003

Total payments: 5 672 million euro

- Energy, Euratom and the environment: 3%
- Training, youth and social operations: 17%
- Consumers, internal market industry and networks: 19%
- Other structural operations: 7%
- Research and technological development: 57%

NB: For more detailed information see Diagrams III and IV of Annex I.
Source: 2003 annual accounts.
6.3. 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 internal policies area as a whole. For that purpose, the audit examined in particular the operation of selected supervisory systems and controls and assessed to what extent the Commission’s internal controls give assurance on the legality and regularity of the underlying transactions. The audit focused on:

— the Commission’s internal control environment for four out of the fourteen Directorates-General in the internal policies area, namely those for Research, for Information Society, for Justice and Home Affairs and for Education and Culture;

— the management and control systems for the 6th Framework Programme (FP6) for Research and Technological Development (RTD) and for the European Refugee Fund (ERF) in the area of freedom, security and justice;

— tests of a sample of commitments and payments authorised in 2003;

— the reports for the Commission’s financial audits; and

— the Annual Activity Reports and Declarations by the Directors-General for the four Commission departments mentioned above (3).

THE COURT’S OBSERVATIONS

Assessment of the Commission’s supervisory systems and controls

Implementation of the Internal Control Standards

Scope of the review of the implementation of the Commission’s internal control standards

6.4. The Court reviewed the implementation of eight out of the twenty-four Internal Control Standards in the Directorates-General for Research, for Information Society, for Education and Culture and for Justice and Home Affairs, all of which should have been implemented by the end of 2003, and assessed whether the Commission’s self-assessment is accurate (see Chapter 1, paragraphs 1.80 to 1.84) (5).

Court does not share the Commission’s self-assessment in several areas

6.5. The Court’s verification work confirmed that the four Directorates-General generally complied with the requirements set out in the Commission’s Internal Control Standards in the course of 2003, with the following exceptions:

— At Directorate-General for Research Standards 20 ‘Recording and correction of internal control weaknesses’ and 21 ‘Audit reports’ were found to be sufficiently implemented, although the adequate follow-up of the corrective actions drawn in relation to these standards (which had been decentralised to directorate level) was not fully assured as of the end of 2003 (6). The analysis also confirmed previous observations made by the Court with regard to the insufficient compliance with Standard 12 ‘Adequate management information’ (7).

6.5. Setting up the Unit ‘Coordination and integration of the internal control systems’ in DG RTD in February 2004 should help to improve the follow-up of the corrective actions.

The Commission intends to complete the implementation of control standard 12 in the course of 2004.


(6) This was corrected in February 2004 by the creation of a central unit to monitor the implementation of corrective actions.

(7) Special Report No 1/2004 on the management of indirect RTD actions under the 5th Framework Programme (FP5) for Research and Technological Development (1998 to 2002), together with the Commission’s replies, paragraph 110.
THE COURT’S OBSERVATIONS

— For Directorate-General for Information Society, the Court considers that the baseline requirements are partially implemented in two cases. As regards Standard 12 ‘Adequate Management Information’, this is due to the non-systematic use of the planning tool IRMS (‘Integrated Resources Management System’). As for Standard 20 ‘Recording and correction of internal control weaknesses’, the new procedures are of a formal nature, not clearly explained and therefore risk being not sufficiently effective.

— DG INFSO considers that the baseline requirements are adequately met but agrees with the Court that there is scope for improvement as regards the effectiveness of the procedures related to standard 20 (Identification and correction of internal control weaknesses).

— Similarly, in the case of Directorate-General for Education and Culture, the Court’s verification work revealed that the system used to monitor budgetary implementation was not fully reliable, potentially leading to incorrect information being processed.

— The Commission proposes to eliminate the risk of errors in encoding data relating to monthly budgetary implementation through more extensive automation of data extraction.

— At Directorate-General for Justice and Home Affairs, although reports were made as set out in the requirements, the financial information regarding payment delays in the reports was not reliable.

— DG JAI had already noted the inadequate quality of the data of the DWH (Data WareHouse) used for the establishment of the statistics on payment delays and this point raised by the Court was commented on by the Director-General of DG JAI in his 2003 annual report. Measures have already been taken by the Commission in the context of the implementation of the new integrated accounting system.

As a result, in the Court’s view, Standard 12 ‘Adequate management information’ has not been complied with in 2003 by all four Commission departments examined by the Court.

For the reasons explained above, the Commission is of the opinion that Standard 12 has been adequately complied with.

Preliminary assessment of the management and control system for FP6

Scope of the preliminary analysis

6.6. 2003 was the first year of implementation of the 6th RTD framework programme (FP6). With an initial budget (prior to enlargement) of 17 500 million euro, it covers the period 2002 to 2006 (8). FP6 is implemented through specific instruments to

(8) The FP6 budget comprises 16 270 million for the European Community (EC) section and 1 230 million euro for the Euratom section. This budget will be increased with the contributions from third countries signing a cooperation agreement with the Community to participate in FP6. This budget includes 760 million euro and 290 million euro from the EC and the Euratom sections respectively, intended to cover the direct research activities carried out by the Directorate-General Joint Research Centre.
address targeted scientific areas and to support the development and coordination of national research policies in the European Union (9). Like the previous framework programme, indirect RTD actions under FP6 are jointly managed by five Directorates-General (i.e. Directorates-General for Research, for Information Society, for Energy and Transport, for Enterprise and for Fisheries). Payments for FP6 indirect RTD actions, mostly advances, amounted to 551,5 million euro (i.e. 9.7 % of 2003 payment appropriations for Internal policies).

Regulatory framework adopted in time, but model contract finalized late

6.7. For FP6, Regulation (EC) No 2321/2002 concerning the rules for the participation of undertakings, research centres and universities and for the dissemination of research results was adopted on 16 December 2002 by the European Parliament and the Council, completing the regulatory framework significantly earlier in the framework programme cycle as compared to FP5 (10).

6.8. The Commission aimed to simplify the management of FP6 indirect RTD actions through the use of a single model contract, covering all types of actions (with the exception of Marie-Curie fellowships) (11). However, since the new contractual arrangements provide for a large number of special clauses and specific annexes

(9) In 2003, the five Directorates-General signed 507 contracts for FP6 indirect RTD actions (i.e. Networks of excellence, Integrated projects, Specific targeted projects, Article 169 actions, Specific research projects for SMEs, Actions to promote and develop human resources and mobility, Specific Actions to promote Research Infrastructure, Coordination actions, Specific support actions, Integrated infrastructure initiatives) for a total Community contribution of 1 945.7 million euro. This compares to 846 contracts for FP5 indirect RTD actions, covering a total Community contribution of 961.0 million euro, signed in 1999, the first year of the previous RTD framework programme (see Special Report No 1/2004 on the management of indirect RTD actions under the 5th Framework Programme (FP5) for Research and Technological Development (1998 to 2002), together with the Commission’s replies: paragraphs 59, 60, 132 and annex 3a and 3b).

(10) FP6 was adopted on 27 June 2002 by Decision No 1513/2002/EC of the European Parliament and of the Council. The specific programmes ‘Integrating and strengthening the European Research Area’ and ‘Structuring the European Research Area’ were adopted on 30 September 2002 by Council Decisions No 834 and No 835 respectively (see Special Report No 1/2004 on the management of indirect RTD actions under the 5th Framework Programme (FP5) for Research and Technological Development (1998 to 2002), together with the Commission’s replies, paragraphs 11 to 15).

(11) Special Report No 1/2004 on the management of indirect RTD actions under the 5th Framework Programme (FP5) for Research and Technological Development (1998 to 2002), together with the Commission’s replies: paragraph 15.
for the different instruments, no real simplification was achieved. Moreover, the complete version of the FP6 model contract for indirect RTD actions was not available before December 2003.(12). Furthermore, the financial guidelines, which clarify the eligibility criteria for costs to be declared by the final beneficiaries, were formally adopted only in January and subsequently modified in April 2004(13). In the Court’s view, this late adoption created an unnecessary uncertainty (in particular for the negotiation of contracts for FP6 indirect RTD actions) and thus created a risk for the legal and regular implementation of FP6.

Late deployment of a common IT system for FP6, which is not being used by all Commission departments

6.9. The Commission aimed to increase the effectiveness of its internal controls in FP6 through the introduction of a common IT system for the management of proposals, contracts and projects, thereby addressing a previous recommendation by the Court.(14). However, this IT system will not be operated by all Commission departments since Directorate-General for Energy and Transport continues to use its own IT system for specific functions. Furthermore, during 2003 — the first year of the FP6 programme period — some of the modules of the common IT system were not yet operational. This reduced the effectiveness of internal controls across FP6, in particular when assessing the legal and financial viability of participants and evaluating and negotiating proposals. It also diminished the reliability of the Commission’s management information.

The Commission shares the Court’s view on the need for a common IT system to manage the RTD framework programmes. The Directorates-General operating these programmes collaborated in setting-up a joint IT Management Office which became operational in 2004. DG TREN has participated in the design of the common FP6 IT system and decided to use all of its modules except the contract module. At the same time an interface has been set up to enable data exchange with the common system.

The implementation of a common IT system represents major progress in the set-up of the Commission’s systems for the management of the European RTD framework programmes.
6.10. In the Court's view, the mandatory requirement that financial statements for FP6 indirect RTD actions must be certified should in the long run significantly strengthen the Commission's control over expenditure for RTD framework programmes. These audit certificates are given by an independent external auditor or, in the case of public bodies, by a competent public officer. However, the Commission has not yet provided the necessary clarification to contractors and external auditors on the audit scope, the external auditor's reporting obligations and the Commission's role in verifying the adequacy of audit certificates for FP6 indirect RTD actions (15). In the Court's view, the main limitation of the FP6 certification system is that the external auditors are not required to confirm whether the costs incurred were necessary.

6.10. The audit scope is sufficiently defined in the wording of the model audit certificate attached to the Financial Guidelines for FP6. The auditors have to certify that the costs claimed are in compliance with the eligibility criteria as defined in the legal base, except for their necessity. The assessment of necessity is subject to the scientific monitoring assured by the Commission's services with the assistance of external experts.

6.11. In line with the Commission's administrative reform, ex-post financial audits have become one of the most important elements of the Commission's control procedures for assessing the legality and regularity of payments for FP6 indirect RTD actions. A common audit approach for FP6, taking into account the modifications in the control environment in FP6 compared to the previous framework programme, was proposed by Directorate-General for Research, but has not yet been agreed by all five Directorates-General (16). In addition, this proposal does not set clear and measurable targets for the audit coverage of FP6 (such as the objective of auditing 10% of all contractors during FP5), despite the recommendation of the Court (15).

FP6 audit approach not agreed by all Commission departments

6.11. The Directorates-General operating RTD framework programmes agreed in May 2004 the main principles of a common audit strategy for FP6 and will put in place the mechanism for the implementation of the common audit approach. They continue to collaborate intensively in order to define more detailed principles and to exchange the results of their audits.

The Commission confirms the target of auditing 10% of all contractors during FP5. For FP6, the situation is entirely different as the introduction of audit certificates is generalised and the Commission's audit strategy will focus on the qualitative assessment of the system based on audit certificates.


(16) This approach provided for three types of audits to be carried out by (or on behalf of) the Commission: ex-post financial audits to verify the reliability of audit certificates accompanying financial statements for FP6 indirect RTD actions, compliance audits (so-called 'management audits') to provide assurance on the effective operation of the new instruments (i.e. 'Networks of Excellence' and 'Integrated projects'); and — ex-post financial audits for those instruments for which an audit certificate is not required, intended to confirm the eligibility of the costs declared (see Directorate-General for Research, L4/RH/ER D (2003), Common Audit Policy of the DG's for FP6, dated 5 December 2003).

Preliminary assessment of the management and control systems for the European Refugee Fund in the area of freedom, security and justice

Scope of the preliminary assessment

6.12. The Directorate-General for Justice and Home Affairs carries out programmes and activities in the area of freedom, security and justice. In 2003 appropriations of 138.7 million euro were committed against budget title B5-8 and payments amounted to 101.8 million euro.

6.13. The ‘European Refugee Fund’ (ERF) (2000 to 2004), which supports Member States in receiving and bearing the consequences of receiving refugees and displaced persons, represented 28 % of the total payments in this area in 2003 (18). It comprises three different measures, namely reception, integration and voluntary repatriation. The allocation of funds among the 14 Member States participating in the ERF (19) comprises an annual fixed amount and a variable amount in proportion to the number of refugees and displaced persons received over the previous three years. In the period 2000 to 2002, the number of asylum applicants varied widely among Member States. Given this fact and the different funding choices made by the Member States for the three measures, there were large differences in the Community contribution per applicant and per Member State.

6.14. The Court examined the management and control procedures of the ERF and tested a sample of payments authorised in 2003 at the Commission, extending the verification to the final beneficiary where appropriate.

(19) Denmark is not participating in the ERF programme (Recital 23 of Council Decision 2000/596/EC)
THE COURT’S OBSERVATIONS

Operational procedures not yet documented at Directorate-General for Justice and Home Affairs

6.15. Internal Control Standard 15 ‘Documentation of procedures’ states that all Commission departments should have fully documented their financial procedures and produced up to date operational manuals by 31 December 2002 (20). Contrary to what was requested, a comprehensive manual for operational procedures did not exist for any of the programmes managed by Directorate-General for Justice and Home Affairs as at the end of 2003 (21).

6.15. The staff in charge of the management of the financial intervention programmes has at its disposal the Vade-mecum of financial procedures of the Directorate-General which contains numerous references concerning operational provisions.

Discussions are already in progress to bring together in the manuals of operational procedures for the programmes the various standard documents already accessible in the common information technology repertories of each programme.

Weaknesses in the ERF’s control system at different levels

6.16. The following weaknesses were identified by the Court’s audit of the ERF at Commission, Member State and final beneficiary level:

— late adoption of implementing rules: Member States are responsible for ensuring an adequate financial control environment (22). Although the ERF was set up in September 2000, the Commission only defined the rules on eligibility of expenditure in March 2001 and on management and controls in Member States in December 2001. This left the national intermediate managing bodies without clear instructions during the starting phase of the programme (23);

— The Commission is aware that a delay has occurred in the adoption of the various decisions concerning the implementing procedures, in particular as a result of the consultations needed with the Member States.

This is already the subject of measures by the Commission in the context of the second phase of the European Refugee Fund.

6.16. In addition to guidelines prepared at technical level, which were not formally approved by the hierarchy, the only manuals at Directorate-General for Justice and Home Affairs were on financial procedures and interdepartmental consultation (in particular ‘Vademecum des Circuits financiers’, Unit C1, Human resources, budget, informatics, security; ’Vademecum sur les procédures institutionelles’, July 2003, DG JAI01).


(21) In addition to guidelines prepared at technical level, which were not formally approved by the hierarchy, the only manuals at Directorate-General for Justice and Home Affairs were on financial procedures and interdepartmental consultation (in particular ‘Vademecum des Circuits financiers’, Unit C1, Human resources, budget, informatics, security; ’Vademecum sur les procédures institutionelles’, July 2003, DG JAI01).

(22) Article 7 in combination with Article 18 of Council Decision 2000/596/EC.

THE COURT’S OBSERVATIONS

— non-respect of eligibility criteria: the ERF supports measures for the reception, integration and repatriation of refugees. According to the Council decision establishing the ERF, repatriation shall be funded provided that the refugees concerned have not acquired a new nationality and have not left the territory of the Member State (24). The Court found that in Germany the latter condition was not complied with;

— weak control environment in the Member States: since 2002 the Commission has undertaken visits to all the Member States concerned, in order to monitor the national management and control systems for the ERF. Several monitoring reports point to weaknesses in the Member States’ control environment, such as management and control procedures which could not be verified, inadequate documentation of the evaluation and selection of projects, non-compliance with the Community regulation with regard to the eligibility of projects, an insufficient verification of eligibility of costs by the intermediate bodies and absence of the required sample checks. These shortcomings show a need for increased additional ex-post financial audits by the Commission in this field, in addition to the strengthening of Member States’ control environment (25);

— specific requirements on supporting documentation not respected by the Member States: Member States’ management and control systems are required to provide for an adequate audit trail. This must allow the reconciliation of the ‘summary accounts’ (i.e. the cost declarations by intermediate bodies to the Commission) with the individual expenditure records and supporting documents kept at the various administrative levels and by the final beneficiaries (26). The audit found that this was not always possible (27);

— advance payments incorrectly declared as expenditure: when submitting ‘summary accounts’ to the Commission, intermediate bodies have to confirm that the costs declared were actually incurred, were eligible and were recorded in the accounts or the tax ledger of the final beneficiary. The Court’s audit showed that advances granted by intermediate bodies to final beneficiaries were declared to the Commission as costs incurred.

THE COMMISSION’S REPLIES

— On the basis of information provided by the Court, the Commission has contacted the Member State about the project concerned and financial adjustments will be made if necessary.

— The Commission organised in 2002 and 2003 monitoring visits in all the Member States and verifications of project expenditure.

The monitoring visits showed that improvements were possible, and the weaknesses were taken into account in the programming of the ex-post audits.

— The Court’s findings have been sent to the Member State concerned and, where appropriate, rectifications will be made. The Commission will inform the Court once replies have been provided by the Member State

— In 2002 the Commission specified the implementing procedures, in particular as regards the definition of expenditure incurred.

The Court’s findings have been sent to the Member State concerned and, where appropriate, rectifications will be made. The Commission will take appropriate measures to remind the Member States about the provisions contained in the implementing rules concerning the ERF.

In addition, the definition of the concept of ‘eligible expenditure’ has been included in the Commission proposal for the second phase of the European Refugee Fund (COM (2004)102 of 12 February 2004, Articles 20 and 23.

(27) For one transaudited by the Court the interim report prepared by a final beneficiary and forwarded to the national authority did not contain sufficient information to justify the declared expenditure. Nevertheless the amount was fully accepted and certified to the Commission on which basis the Commission authorised the payment. Another final report included amounts paid by a local office of the beneficiary in Kosovo without any adequate supporting documentation in the file.
Results of the tests of underlying transactions authorised during the financial year

Scope of the testing

6.17. The Court's audit assessed the legality and regularity of the underlying transactions in the field of internal policies based on a random sample at Commission level of ninety-three payments and nine commitments. This sample included pre-financing, interim, final and single payments, concerning actions implemented through Commission decisions, grant agreements and procurement contracts. Within this sample, fifteen payments based on declarations of costs incurred were also tested at the final beneficiary.

6.18. This sample included eight payments and two commitments for FP6 indirect RTD actions, and it was supplemented with seventeen payments of budget title B5-8 'Area of freedom, security and justice', of which four were checked at the final beneficiary.

Weaknesses observed in the functioning of the Commission's internal controls

6.19. In a number of cases the scope and rigour of the controls carried out by the Commission were insufficient. Examples include the award of grants for which Commission decisions could not be furnished, or improper contract management (including contract amendments) and non-compliance with the financial procedures applicable to the authorisation of payments. The Court notes that the documentation of the controls operated was still inadequate in a number of cases.

6.20. In some cases the Commission also failed to respect award and commitment procedures. In two other cases explicit reservations made by the Commission's own internal control units on the regularity of the selection of contractors and on the management of service contracts did not lead to the appropriate corrective action.

6.21. When verifying the eligibility and accuracy of costs claimed by the final beneficiary (or national authorities acting as an intermediate body) and processing cost-claim based payments, inadequate or ineffective controls often led to overpayments by the Commission.
6.22. As in previous years, payments by the Commission were often made late. This finding is confirmed by the information contained in the Annual Activity Reports 2003 of a number of Directorates-General (28).

6.22. The Commission is closely monitoring the payment times indicator and has made further progress. In a number of cases payment delays are due to deferred availability of appropriations at the beginning of the financial year, additional controls or requests for new substantiating documents, which are not always correctly recorded as giving rise to an interruption in the reference period for making the payment in question.

Concerns as to over declarations of costs by beneficiaries for indirect RTD actions

6.23. In budget subsection B6 'Research and technological development', payments for FP6 indirect RTD actions made in 2003 were predominantly advances following the contract signature. These transactions were not audited at the final beneficiary by the Court. For cases related to previous RTD framework programmes, several cost declarations stated rates of Community funding which were not in line with those in the contract, without being detected by the Commission's internal controls. The Court reiterates its concerns as to the legality and regularity of cost-claim based payments authorised by the Commission for FP5 as a whole, given the frequency and impact of errors in this area (29).

6.23. To address the problem of erroneous cost statements submitted by beneficiaries, the Commission has adopted a number of corrective measures. For FP5, the number of financial audits at beneficiary level has been significantly increased. Moreover the Commission has made a concerted effort to ensure consistency and uniformity of legal interpretations and applications by means of the Action Plan established further to the Commission’s synthesis of the 2001 Annual Activity Reports (Communication from the Commission to the European Parliament and the Council. Synthesis of the Annual Activity Reports and Declarations of the Directors-General and Heads of Service. COM (2002) 426 final, Brussels, 24.7.2002). For FP6 the measures taken include a simplification of rules, the use of audit certificates and the introduction of sanctions.

Previous observations for TEN-T confirmed by this year’s audit findings

6.24. Similarly, for Trans-European Transport Networks (TEN-T) in budget title B5-7, this year’s audit confirmed the observations reported previously by the Court (30). In particular the audit found that interim and final payments were often authorised by the Commission without the specific preconditions stipulated in the financial implementing provisions being satisfied.

6.24. The Commission considers, as already indicated in its reply to the ECA’s Annual Report 2002 (paragraphs 6.35 and 6.36) that the preconditions for interim and final payments were met. The difference in the interpretation of activities eligible for funding as studies will be addressed by a revised definition of studies and works to be integrated into the TEN-T handbook for beneficiaries.

Control weaknesses identified in the ‘Area of freedom, security and justice’

6.25. Concerning the budget title B5-8 ‘Area of freedom, security and justice’, the Community regulation was applied incorrectly by the intermediate bodies in the Member States. Requests for funding submitted after the official deadline were accepted.

6.25. The Commission will remind the Member States of the provisions of Decision 2000/596/EC.

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(28) The Annual Activity Report 2003 for DG RTD, for example, states that the time limits for the Commission are not respected in more than 60 % of cases.
(29) Special Report No 1/2004 on the management of indirect RTD actions under the 5th Framework Programme (FP5) for Research and Technological Development (1998 to 2002), together with the Commission’s replies, paragraphs 90 to 100 and 129.
THE COURT’S OBSERVATIONS

Non-compliance with contractual requirements at final beneficiary level

6.26. The errors detected at final beneficiaries related mainly to non-compliance with the contractual requirements. As in previous years, the audit found that beneficiaries were overcharging costs, mainly due to an incorrect calculation of the costs incurred for the funded activity, or declaring ineligible costs, costs not actually incurred or costs related to ineligible activities.

6.26. The type of errors identified by the Court’s audits at beneficiary level is very similar to the errors found by the Commission’s own audits of beneficiaries. For research the errors are mainly linked to the wrong application of average rates for personnel costs and to calculation errors for indirect costs. Certain contractual requirements, which have caused problems of interpretation in the past, have been simplified in the FP6 contracts.

Analysis of the Commission’s ex-post financial audits

Slight increase in audit activities

6.27. In internal policies, the Commission increasingly relies on ex-post financial audits, as recommended in the Court’s opinion on ‘Single audit’ (31), which are to a large extent carried out by external auditors on its behalf. As in previous years, the Court reviewed the reports for the Commission’s ex-post financial audits in the internal policies area which were completed during the financial year. Overall the number of completed audits increased from 511 in 2002 to 579 in 2003 in internal policies (see Table 6.1). Similarly, the total number of contracts audited increased from 800 to 944. Nevertheless, six out of the fourteen Directorates-General showed a decrease both in audits carried out and the number of contracts audited. For the first time since its creation in 1999, the Directorate-General for Justice and Home Affairs carried out a limited number of ex-post financial audits.

6.27. Overall, audit activities for research actions were intensified. For 2002 and 2003, the audits reported were only related to research. In order to reach the 10 % target established for FP5 contracts, DG TREN estimates that on average 40 to 50 audits need to be performed each year, representing 80 to 100 contracts. For the period 2002-2004, the average targeted number of audits (40 to 50) and audited contracts (80 to 100) for DG TREN will be reached.

During 2003 the JAI’s audit plan started to be implemented but, on account of limited human resources, only a limited number of audits could take place.

6.28. All audits carried out by Directorate-General for Health and Consumer Protection in 2003 related to veterinary actions. These audits led to financial adjustments in favour of the Commission of some 95.5 million euro. Directorate-General for the Internal Market carried out no inspections or financial audits during 2003.

### Table 6.1 — Internal policies area — Audits by (or on behalf of) the Commission completed in 2003 (1) (2)

<table>
<thead>
<tr>
<th>Directorate-General</th>
<th>Number of audits completed 2002</th>
<th>Number of contracts audited 2002</th>
<th>Number of open contracts 2002</th>
<th>Value of audited contracts (million euro) 2002</th>
<th>Value of open contracts (million euro) 2002</th>
<th>Amounts recoverable or reduced payments as a result of the audits (million euro) 2002</th>
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<tr>
<td>AGRI — Agriculture</td>
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<td>12</td>
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<td>21</td>
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<td>EAC — Education and Culture</td>
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<td>47</td>
<td>173</td>
<td>28 063</td>
<td>19 424</td>
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<td>EMPL — Employment and Social Affairs</td>
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<td>17</td>
<td>39</td>
<td>19</td>
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<td>1 559</td>
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<tr>
<td>TREN — Energy and Transport</td>
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<td>111</td>
<td>37</td>
<td>2 133</td>
<td>1 630</td>
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<td>ENTR — Enterprise</td>
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<td>ENV — Environment</td>
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<td>1 711</td>
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<td>14 981</td>
<td>8 229</td>
</tr>
<tr>
<td>TAXUD — Taxation and Customs Union</td>
<td>4</td>
<td>3</td>
<td>12</td>
<td>24</td>
<td>191</td>
<td>98</td>
</tr>
</tbody>
</table>

| TOTAL | 511 | 579 | 800 | 944 | 54 840 | 38 366 | 2 015.6 | 1 277.6 | 10 256.5 | 10 568.5 | 532.6 | 12 | 108.2 | 8 |

(1) The figures for 2002 have been modified, as compared to the Court's Annual Report 2002, taking into account additional information made available by the Commission.

(2) Definitions used in this table:

— Number of audits completed: number of financial audits where a final audit report was issued during the year.

— 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. The word 'contract' denoted 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). A 'completed contract' is a 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.

— Value of audited contracts: the value of only the contractor's share of the contract audited on the spot.

— Amount recoverable: amounts calculated in the on-the-spot audits as recoverable and evidenced in the audit reports.

(3) Veterinary and phytosanitary actions. Value of audited contracts means here the maximum contribution to be EU funded.

(4) Fishery control measures. Contract means here programme of a Member State; value of audited contracts means here value of audited items within a programme; value of open contracts means here the total value of the pluriannual measures for all Member States.

(5) The figures for 2002 include exclusively research related audits.

(6) This amount includes a suspended 2 million euro payment to the Netherlands under the project 'Idea' (identification of animals).

(7) The number of audits includes two audits of 'Idea' (identification of animals) in the Netherlands and Spain of budget line B1-3 6 0.

Source: European Commission.
6.29. 373 ex post financial audits relating to 589 contracts for indirect RTD actions were closed during 2003 by the five Directorates-General operating the RTD framework programmes (see Table 6.2). As in previous years, Directorate-General for Research performed most of the audits. The majority of the audits carried out by (or on behalf of) the Commission during 2003 concerned FP5 indirect RTD actions (320 of a total of 373 audits).

### Table 6.2 — Directorates-General operating the RTD framework programmes — Summary table of audits closed in 2002 and 2003

<table>
<thead>
<tr>
<th>Directorate-General in charge</th>
<th>RTD-related audits closed in 2002 and 2003 (1)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total number of audits closed</td>
<td>Total number of contracts audited</td>
</tr>
<tr>
<td>DG RTD Internal</td>
<td>23</td>
<td>11,1%</td>
</tr>
<tr>
<td>External</td>
<td>185</td>
<td>88,9%</td>
</tr>
<tr>
<td>Total DG</td>
<td>208</td>
<td>100,0%</td>
</tr>
<tr>
<td>DG INFSO Internal</td>
<td>5</td>
<td>6,8%</td>
</tr>
<tr>
<td>External</td>
<td>69</td>
<td>93,2%</td>
</tr>
<tr>
<td>Total DG</td>
<td>74</td>
<td>100,0%</td>
</tr>
<tr>
<td>DG TREN Internal</td>
<td>1</td>
<td>4,0%</td>
</tr>
<tr>
<td>External</td>
<td>24</td>
<td>96,0%</td>
</tr>
<tr>
<td>Total DG</td>
<td>25</td>
<td>100,0%</td>
</tr>
<tr>
<td>DG ENTR Internal</td>
<td>0</td>
<td>0,0%</td>
</tr>
<tr>
<td>External</td>
<td>39</td>
<td>100,0%</td>
</tr>
<tr>
<td>Total DG</td>
<td>39</td>
<td>100,0%</td>
</tr>
<tr>
<td>DG FISH Internal</td>
<td>27</td>
<td>100,0%</td>
</tr>
<tr>
<td>External</td>
<td>0</td>
<td>0,0%</td>
</tr>
<tr>
<td>Total DG</td>
<td>27</td>
<td>100,0%</td>
</tr>
<tr>
<td>Total Internal</td>
<td>56</td>
<td>15,9%</td>
</tr>
<tr>
<td>Total External</td>
<td>317</td>
<td>84,1%</td>
</tr>
<tr>
<td>Total</td>
<td>373</td>
<td>100,0%</td>
</tr>
</tbody>
</table>

(1) The figures for 2002 have been modified, as compared to the Court’s Annual Report 2002, taking into account additional information made available by the Commission.
THE COURT’S OBSERVATIONS

6.30. The Commission’s audit approach in the field of research defines an overall audit target of 10 % of contractors during FP5 (32). According to the information provided by Directorate-General for Research, the number of audits completed in 2003 corresponds to 3.9 % of the auditable population of contractors as defined by the Commission. As a result, the Commission’s audit activity is below target for the fourth consecutive year (33). Unless the Commission further increases its audit activities for FP5, the target is unlikely to be met (34).

6.31. For the contracts for FP5 indirect RTD actions audited by the Court from 2001 to 2003, the Commission services proceeded with financial adjustments averaging 21.6 % of the costs declared by the beneficiaries. In the Court’s view, as indicated previously, this rate can not be extrapolated to the total budget for FP5 (35). In comparison, the Commission’s statistics on ex-post financial audits show an impact of errors for the Directors-General operating the RTD framework programmes which is significantly lower than those resulting from the Court’s audits (see Table 6.1).

THE COMMISSION’S REPLIES

6.30. The Commission has set an overall audit target of 10 % of contractors of FP5 to be audited.

The Commission has confirmed that it will continue its audits on FP5 contractors, as multiannual projects are ongoing and a new framework contract with an external audit firm is set up for that purpose. The Commission expects the overall audit target for FP5 can be reached at the end of corresponding activities.

By 2006/2007 the Commission plans to have audited a sufficiently large number of contractors to reach the target set.

6.31. The Commission data on ex-post financial audits in question are based on 333 concluded audits relating to 556 contracts for indirect RTD actions. The significant number of audits by the Commission constitutes a reliable basis for overall quantitative conclusions on the underlying system.

The Directors-General operating RTD framework programmes have disclosed this data in more detail in their Annual Activity Reports.
6.32. The Court carried out an analysis of 43 audit reports (related to 56 contracts for different programmes) completed in 2003 by external audit firms on behalf of the Commission and their follow-up by Directorate-General for Education and Culture. The contracts audited covered cost declarations by final beneficiaries amounting to 18.4 million euro, of which 14.3 million euro were accepted by the Commission. In more than half of these cases, the external auditors recommended a financial adjustment to the cost declared and accepted by the Commission. This was mainly because of the lack of adequate supporting documentation justifying the costs incurred, the use of budgeted instead of actual costs, or the declaration of costs outside the eligibility period.

6.33. Furthermore, the Court’s examination of the audit files revealed other shortcomings such as:

— incomplete audit reports accepted by the Commission;

— undue delays between the audit being carried out and the audit findings reported to the Commission and;

— irregularities in the Commission’s management of contracts.

In some cases, the audited contractors also had other contracts with the same Directorate-General or other Commission departments. In these cases, the Commission’s follow-up procedures should provide for verification of the extent to which other contracts are subject to similar problems.

6.32. Expenditure proved to be ineligible which only on-the-spot audits that DG EAC is endeavouring to step up made it possible to discover.

DG EAC’s audit programme focuses in particular on the inclusion of projects which the DG considers to be potentially more risky or where the analysis of breakdowns suggested that they might contain anomalies.

In addition, DG EAC is reinforcing the requirement for compliance by beneficiaries with the contractual provisions. It is also working on a simplification of these contractual provisions. These two factors should reduce such anomalies with regard to beneficiaries. It should be noted that in some cases they have less developed administrative structures in this area than in others (small NGOs).

6.33. The audits examined by the Court correspond to a running-in period for the procedure for carrying out this type of externalised audits. The Commission recognises that certain non-fundamental elements may not have been present in the initial audit report submitted to it. It endeavours to accept and validate provisional audit reports drawn up by audit firms only if they are in accordance with the conditions and level of quality required by the framework contracts concluded between the Commission and these companies.

The Commission stresses that the delays noted by the Court between the audits being carried out and the receipt of the final report by the operational unit are partially due to the time limits allowed for the audited contractors to react to the draft report.

The Commission will nevertheless endeavour to reduce the delays noted by the Court.

The audited projects were contracted out at a time when the contractual requirements vis-à-vis the beneficiaries were less well defined.

The Commission will endeavour to carry out a better cross-check of the information arising from the audits carried out in respect of a particular programme with the funding which the beneficiaries concerned may have received under other programmes; the features of certain beneficiaries (recurrent beneficiaries, in particular) and certain projects are taken into account when drawing up the programme of audits.
THE COURT’S OBSERVATIONS

Review of the Annual Activity Reports and the Directors-Generals’ Declarations

Scope of the review

6.34. The Court reviewed the Annual Activity Reports of 11 Directorates-General and conducted an analysis of the consistency and plausibility of the information contained in the 2003 Annual Activity Reports (AAR) at four Directorates-General, in parallel with its assessment of the Commission’s supervisory systems and controls (36).

General improvement in the presentation of the different aspects covered by Annual Activity Reports

6.35. The Court noted a general improvement in the quality of the reports as compared to 2002. In general the structure and content follow the guidelines issued by the Secretary-General and Directorate-General Budget (37).

6.36. As in 2002, all eleven Directors-General have declared that they obtained reasonable assurance as regards the legality and regularity of the funds managed under their responsibility, although some of them repeated reservations made in 2002. The Court considers that overall the causes of the deficiencies were accurately stated and, to the extent possible, appropriate corrective actions were proposed. The implementation of the action plans can be expected to address a significant part of the identified weaknesses and should ensure an adequate follow-up.

Persistent weaknesses in the formulation of reservations by the Directors-General

6.37. The Court considers that the information contained in the reports reflects to a large extent the reality of the situation as regards the legality and regularity of the operations managed. Nevertheless, persistent weaknesses in the formulation of reservations by the Directors-General were noted. In the case of the Directorate-General for Justice and Home Affairs, for example, last year’s reservations relating to Standard 17 ‘Supervision’ and to the European Refugee Fund should not have been removed, since corrective actions were only partially implemented. The outcome of ex-post financial audits in 2003 which resulted in the recovery of 0.22 million euro representing 6% of the total amount audited should have been taken into account to maintain a specific reservation. Another example is the case of Directorate-General for Research, where the potential material impact of the payment delays was not adequately assessed.


With regard to the European Refugee Fund, the reservations expressed in 2002 were removed since corrective measures had been taken by the Commission, e.g. the programme of monitoring visits relating to management and control systems have been completed in all Member States. The DG did not consider that the material impact justified a reservation.

The DG for Justice and Home Affairs is aware that efforts need to be intensified in the field of ex-post audits. This is already happening in 2004 and will also be the case in 2005.

DG Research’s 2003 annual activity report indicates the weakness concerning payment delays. However, even if there was no evaluation of the material nature of this weakness contained in the text of the report, the impact on reasonable assurance was not regarded as material given the very low rate of requests for delayed payment interest.

(36) Directorates-General for Research, for Information Society, for Justice and Home Affairs and for Education and Culture.
THE COURT’S OBSERVATIONS

Modifications in the legal base insufficient to counter risks of over payments for indirect RTD actions

6.38. In 2002, the Commission defined a specific action in the field of research, Action No 1, in order to address the reservations and observations concerning the RTD framework programmes (38). Following this, the five Directorates-General jointly managing the RTD framework programmes adopted a common action plan, in January 2003 (39), detailing the specific measures required to address the risk of overpayment for indirect RTD actions, and shared-cost RTD projects in particular (40).

6.39. According to the report from the Commission to the Council and the Parliament on the situation as at 31 December 2003 of the implementation of the Commission’s action plans 2001 (41), the specific measures developed by the Commission in response to Action No 1 of the 2001 Synthesis Report had been fully addressed.

6.39. The quoted Commission report indicates that the measures foreseen in the Action Plan have been put in place, but not all of its objectives have been achieved. Some of the actions will only take full effect over time, as in particular the introduction of sanctions.

Other Commission proposals have not been fully retained by the European Parliament and the Council.

6.40. The Court, however, considers that the actions resulting from the Commission’s action plan, as completed in 2003, together with the modifications to the legal bases of the RTD framework programmes for FP6 are still insufficient to address the risk of overpayments for indirect RTD actions (42):

— The FP6 cost reimbursement system is still structured around three models, as was FP5, and the complete elimination of cost categories in FP6 reduces the transparency of the financial statements required for the declaration of eligible costs incurred and reduces the potential for analytical checks;

— When drawing up FP6, the Commission took the initiative of thoroughly reforming the system with a view to achieving genuine simplification for participants. The choice made for FP6 is based on a combination of the five following principles:

  — the definition of a strict cost eligibility framework,
  — participants apply their own accounting rules and principles,
  — systematic recourse to audit certificates,
  — the obligation for consortiums to submit a management report establishing a link between resources and scientific work and results, and,
  — a redeployment of resources in the monitoring of the scientific quality of projects, with the assistance of external experts, in accordance with the simplified procedures and in ex-post audits.

On this basis, the Commission considers that the system established for FP6 is more rational and simpler to implement both for the participants and for the Commission services. Consequently, it provides better protection for the Commission’s financial interests.

6.40.


(40) The common action plan adopted by the Directorates-General operating the RTD framework programmes covers, among others, the following specific measures: as regards the implementation of FP5, the improvement of the organisational cooperation between the Directorates-General through the creation of an inter-service group on the financial management of contracts and a network of correspondents reporting to this inter-service group, the improvement of the contract management through better information for contractors, an increase in the verification of cost claims (involving the implementation of desk audits and the improvement of training on financial issues), and the improvement of the IT systems; as regards FP6, the preparation of clear financial guidelines for contractors, the requirement of audit certificates, the development of a common IT system, the continuation of the audit strategy applied for FP5 and the introduction of sanctions in the model contract.


(42) Special Report No 1/2004 paragraphs 42 to 45.
THE COURT’S OBSERVATIONS

— The principle of joint and several liability introduced in FP6 has been limited at the request of the Council and the Parliament to each participant’s share up to a maximum of the total payments received;

— The introduction of the requirement for the beneficiaries to provide audit certificates with their financial reports has not been accompanied by a definition of the essential aspects concerning the scope and the extent of the audit work to be done;

— Other measures included in the common action plan for research (such as the deployment of a common IT system for all Directorates-General or the implementation of ‘desk audits’, which was only initiated by the Directorate-General for Information Society) were not implemented by all Directorates-General.

In the Court’s view, the Commission should review from first principles the rules for setting the Community financial participation whilst allowing adequate control over expenditure in any future RTD framework programmes. The changes to the cost reimbursement models adopted by the European Parliament and the Council are insufficient to address adequately the underlying problems leading to overpayments (43).

6.41. The analysis of the Commission’s supervisory systems and controls at the four selected Directorates-General revealed that several elements of the Commission’s Internal Control Standards reviewed were still not implemented at the end of 2003. The late completion of the FP6 model contracts led to uncertainty for participants. The incomplete deployment of the common IT system during 2003 adversely affected the implementation of FP6. In the Court’s view, these deficiencies were to some extent offsetting the initial improvements achieved by the earlier adoption of the legal framework and the simplification of the contractual structure. The audit also identified weaknesses in the management and control systems for the European Refugee Fund in the area of freedom, security and justice.

THE COMMISSION’S REPLIES

— The definition of the scope of audit certificates is contained in the model attached to the Guide on Financial Issues for FP6.

— The deployment of the common IT system is being addressed by the common action plan and is being implemented by the respective DGs. See paragraph 6.9.

Relating to the ‘desk audits’, checks continue to be carried out on sampling related to substantiation of cost claims, particularly with respect to the time sheets for personnel costs but sometimes including also subcontracting (contracts, invoices), other costs and durable equipment (invoices), and in certain cases overhead costs. In-depth controls via the request of substantiation of claims by means of supplementary documentation are exercised by the Directorates-General operating RTD framework programmes partly in doubtful cases and partly on random selection.

The Commission has made great efforts to achieve simplification with the introduction of FP6. It will continue to develop the framework programme monitoring model, including in the proposal for a future FP7, paying particular attention to the simplification of procedures.

Conclusions and recommendations

6.41. The Commission considers that the FP6 model contract was completed sufficiently in time for the signing of contracts for indirect RTD actions and therefore did not negatively impact the implementation of FP6 in 2003.

Compared with FP5, FP6 has significantly simplified and improved the management rules with a view to reduce errors and misinterpretations and in order to protect the financial interests of the Communities, notably by introducing the obligation for beneficiaries to provide audit certificates.

(43) Special Report No 1/2004, paragraphs 36 to 41 and 113 to 115.
6.42. The testing of transactions for the internal policies area revealed weaknesses in the Commission's internal controls and a high incidence of errors at the final beneficiaries, confirming the Court’s previous concerns about the legality and regularity of the underlying transactions. The audit of transactions also corroborated the weaknesses identified by the Commission in the control procedures applied by some Member States in the framework of the shared management of the European Refugee Fund.

6.42. Concerning the high incidence of errors at beneficiary level, the Commission recalls its own reporting on actual audit results, but in particular on actions taken to further reduce the incidence and impact of such errors both by preventive actions (simplification of rules and better communication with beneficiaries), by more and better controls and by the introduction of dissuasive penalties and sanctions.

6.43. An analysis of the ex-post financial audits in the field of internal policies, where RTD expenditure represents more than half of the budget, again shows a considerable incidence of errors, mainly due to over-declarations of costs by final beneficiaries which were not detected by the Commission's internal controls. The number of audits in 2003 was for the third year insufficient to achieve the Commission's own audit target for FP5. The Commission’s follow-up of the findings of the ex-post financial audits is not rigorous enough, and the recovery procedures for undue payments of the Community financial contribution were found to be inadequate and slow.

6.43. Only one on-the-spot audit identified the errors in question. These mistakes are made in two senses, some contractors overcharge, and other undercharge their expenditure. The net impact (overstatements minus understatements) on the Commission's budget remains quite limited and decreases over the years.

The Directorates-General operating RTD framework programmes differ from the view held by the Court that the audit target for FP5 will not be reached. The audit effort is continuous over at least four years and the Commission considers that the achievement of the 10% target can indeed be expected by 2006/2007.

Extensive efforts have been made in each Directorate-General operating RTD framework programmes to ensure the effective follow-up of audits and the financial implementation of audit results including when necessary by issuing recovery orders.

6.44. The quality and reliability of the information included in the Annual Activity Reports 2003 improved, contributing to a more accurate assessment of the legality and regularity of the activities reported. Weaknesses persisted as regards the formulation of reservations. The follow-up of the weaknesses stated in the Annual Activity Reports for 2001 and 2002 in the four Directorates-General reviewed by the Court was considered adequate.

6.45. The Commission is recommended:

— to continue its efforts towards the achievement of the full implementation of the Internal Control Standards for those elements where shortcomings were identified by the Court;

— to assure the effective deployment of the common IT system for FP6 proposal, contract and project management, and to provide clarification to contractors and external auditors as regards the preparation of audit certificates;

— to remedy the internal control weaknesses pointed out by the Court for its activities in the area of freedom, security and justice, to further improve guidance to Member States on how to achieve a harmonised control environment at national level across the European Union (including controls carried out by Member States in the framework of the shared management of the European Refugee Fund) and to intensify, where appropriate, its ex-post financial audits at the final beneficiary;

— Following the introduction of internal standards, the Commission monitors the application of these measures.

— The deployment of the common IT system is continuing according to the established plan. The necessary information is sufficiently defined in the model audit certificate attached to the Financial Guidelines for FP6.

— The Commission will continue its efforts to provide guidance to the Member States through guidelines, monitoring visits (cf point 6.16) to the responsible authorities so that the management and control system of the responsible authorities are satisfactory in each Member State. Efforts will also be intensified in the area of ex-post financial audits.
FOLLOW-UP OF PREVIOUS OBSERVATIONS IN SPECIAL REPORT NO 2/2002 'SOCRATES' AND 'YOUTH FOR EUROPE'

Scope of the Special Report and main audit findings

6.46. The Special Report focused on the management system operated by the Directorate-General for Education and Culture for the programmes 'Socrates' and 'Youth for Europe' (1995 to 1999) (**), identifying in particular:

— weaknesses in the design of programmes and their management systems;

— deficiencies in the implementation of the actions and projects covered by both programmes, including delays due to complex administrative and financial procedures;

(44) Opinion No 2/2004 on the 'single audit' model and a proposal for a Community Internal Control Framework.

(45) Special Report No 2/2002 on the Socrates and Youth for Europe Community action programmes, together with the Commission's replies; see in particular paragraphs 10 to 21, 25 to 36, 39 to 56, 75 to 83 and 91 to 102.
THE COURT'S OBSERVATIONS

— inadequacies in the Commission's internal control system; and
— shortcomings in the Commission’s programme evaluation.

The Court’s audit observations were explicitly supported in the European Parliament’s report on the discharge for the general budget for the 2001 financial year (46).

Action taken by the Commission

Programme design and the management system

6.47. The ‘Socrates’ (47) and ‘Youth for Europe’ (48) programmes are divided into a large number of centralised and decentralised actions to address the different policy objectives. Centralised actions are managed by the Directorate-General for Education and Culture together with an external technical assistance office (TAO), whereas National Agencies in the Member States implement the decentralised actions. The Special Report concluded that the policy objectives were too ambitious in respect of the resources allocated to the programmes, that the number of actions was overly large given the target population and that the Commission had unduly delegated its responsibilities to the TAO. The legal bases for the current programming period (2000 to 2006) being unchanged since the completion of the audit, the Court’s observations on the programme design (i.e. policy objectives and number of different actions) remain valid (49). Nevertheless, by modifying the responsibilities and by

6.47. The current programmes, Socrates II and Youth, were adopted at the beginning of 2000 before the Court formulated its observations, and cover the period 2000-2006. Compared with Socrates I and Youth for Europe, they already reflect rationalisation and simplification efforts which the Commission intends to continue for the following period (2007-2013). The Commission confirms that it has stepped up its control over the national agencies and the BAT. In addition, in 2001 it internalised the payments previously made by this BAT.

(46) Report concerning discharge in respect of the implementation of the general budget of the European Union for the 2001 financial year (Commission) 26 March 2003, paragraphs 47 to 55.


(48) The original ‘Youth for Europe’ programme supported informal educational activities (Action 1 ‘Youth for Europe’; Action 2 ‘European Volunteering System’; Action 3 ‘Initiatives in favour of young people’; Action 4 ‘Joint actions’; Action 5 ‘Accompanying measures’; Action 6 ‘Third countries’). The scope of the actions was slightly reduced in 2000 when the ‘Youth Community action programme’ was launched.

THE COURT’S OBSERVATIONS

providing clearer guidance for the TAO, the Commission addressed the Court’s concerns to some extent (50).

Programme implementation

6.48. Since 2000 the selection procedures for centralised actions are exclusively carried out by the Commission and are no longer entrusted to the TAO. An executive agency (51) or a similar body (52) is in the process of being set up, thus responding to one of the Court’s recommendations. However, this agency or body (contrary to what was foreseen in the initial proposal made by the Commission to the European Parliament) is planned to become operational only in 2005, in part as a result of delays caused by concerns expressed by the European Parliament on the Commission’s policy of outsourcing of activities. In the meantime, a TAO continues to provide administrative support to the Directorate-General for Education and Culture. The service contract with the current TAO now clarifies the respective responsibilities of the Commission and the TAO (53).

6.50. In 2001, an initial set of indicators were defined by the Directorate-General for Education and Culture in the work programme of ‘Socrates’ and ‘Youth’: ex-ante indicators will be part of the contract between the Commission and National Agencies, while ex-post indicators will be included in the final activity report to be submitted by the National Agencies (55). Although a significant improvement has been made in this area, further effort is needed to comply with the requirements of the Commission’s Internal Control Standards (56).

6.50. The Commission intends to continue its efforts concerning the definition of measurable indicators. The Socrates II programme committee has adopted guidelines concerning indicators for the final evaluation of the programme. Where the Youth programme is concerned, the Commission is working on the preparation of indicators as mentioned by the Court and provided for in the programme’s interim evaluation report.

(53) See for example Contract No 2003-3007/001001, Article 9.
(55) See for example: Terms of Reference, Tasks to be carried out by the National Agencies for the implementation of the Socrates Programme at national level, Period: 1 April 2003 to 31 December 2004, SOC/COM/02/061; indicators concern among others the number of staff working for Socrates, number of applications received, etc.

6.49. The key principles of the Commission’s administrative reform are decentralisation and the taking of responsibility by management departments, accompanied by increased transparency and accountability (54). The audit revealed inadequacies in defining operational objectives and an absence of relevant and measurable indicators, which are essential for creating transparency and accountability. The audit also concluded that the respective rights and obligations of the Commission and the Member States in the implementation of these programmes should be further defined.

6.49. The Commission stresses that the respective rights and obligations of the Commission and the Member States were defined in the common provisions at the beginning of the current generation of the Socrates and Youth programmes.

6.50. The Commission confirms its intention of setting up an executive agency on the basis of Framework Regulation (EC) 58/2003 which the time limits for the introduction of the general framework and the resulting obligations for the creation of executive agencies did not make it possible to establish before 2005.

THE COMMISSION’S REPLIES

6.48. 

6.49. 

6.50. 


6.51. A recent evaluation report of the 'Youth' programme, covering the period 2000 to 2003, criticised the quality of the projects and partnerships, the specific difficulties of trans-national actions, the insufficient transparency of the selection procedures and the overly complex and incoherent administrative procedures (given the type of proposals submitted) at the level of National Agencies (57). Since 2002, following a recommendation by the Court, all proposals for centralised actions under 'Socrates' must be evaluated by external experts. These experts are selected by the Commission from a reserve list established on the basis of an open call for applications (58). For the 'Youth' programme, the selection procedure for decentralised actions is still not sufficiently transparent (59).

The Commission is endeavouring to improve the quality of projects. The external evaluation report concluded that quality had improved between the previous and current Youth programme. The specific difficulties concerning transnational activities mainly concern obtaining visas for young people from third countries, a matter not directly connected with the implementation of the programme and which can only be resolved with the help of other political sectors such as internal affairs. Various actions were recently undertaken to improve the transparency of the selection of decentralised actions by the national agencies. In addition progress has been made with regard to simplification in the context of the financial rules in force, in particular through the introduction of a flat-rate system.

6.52. The Operating Agreements concluded between the Commission and the National Agencies require the certification of National Agencies' final statements of accounts before submission to the Commission. For decentralised actions, the Commission has introduced a system of mandatory certification of expenditure claims or cost statements (for grants of more than 50 000 euro) submitted by National Agencies. Since 2000, all final reports and cost statements submitted under both programmes to the Commission must be accompanied by an audit certificate ('certification report') established by an external auditor or a competent public official, confirming the reality, necessity and eligibility of costs declared to the Commission (60).

Commission's internal control system

6.53. In early 2001 the Commission informed the National Agencies of the scope and content of these audit certificates, and additional instructions were provided to the Directors of the National Agencies in 2002. Further guidelines were made available in 2003, indicating minimal requirements in terms of materiality and confidence level, type of audit work to be carried out, documentation of audit work, format and content of the contradictory report between auditor and auditee and the right of access by the Commission to the auditor's working papers.

(58) European Commission, ‘Call for applications EAC/60/02 with a view to constituting a list of experts to assess the proposals received in connection with the “Socrates” Community action programme in the field of education and other actions in the field of education’ (OJ C 211, 5.9.2002).
(60) In early 2004, following an internal reorganisation, a specific function within the financial unit of the Directorate-General for Education and Culture was entrusted with assessing the National Agencies' certification reports.
THE COURT’S OBSERVATIONS

6.54. However, most of the audit certificates for 2003 were not immediately accepted by the Commission, or were accepted only subject to material reserves. In some cases, the certification reports submitted by the National Agencies to the Commission revealed inadequate supporting documentation to justify the costs incurred for the decentralised actions (61). This indicates that controls carried out by National Agencies were insufficient in scope and rigour. It also shows that the definition of the scope and extent of the audit work to be carried out by (or on behalf of) the National Agencies for the submission of the audit certificates must be improved by the Commission. Considering the current poor quality of the certification reports for both programmes, there remains a risk that these reports will be insufficient to ensure effective control over payments to National Agencies.

THE COMMISSION’S REPLIES

6.54. The introduction of an expenditure certification procedure is part of the measures taken by the Commission to step up the auditing of the national agencies. For example, as the Court observes, the Commission did not immediately accept most of the audit certificates for 2003. The Commission is endeavouring to improve the operation and utilisation of the results of this certification. However, it considers that the certification of accounts is only one means among others of ensuring effective auditing of payments authorised by the national agencies and has stepped up other methods of controlling these agencies (audit inspections, monitoring inspections, report processes).

Improvements in the Commission’s programme evaluation

6.55. The legal bases of ‘Socrates’ (62) and ‘Youth’ (63) require programme evaluations. The Special Report noted the lack of a genuine control and evaluation culture on the part of the managing bodies, both at national and Community level.

6.56. The Commission has since embarked on an overall strategy of systematically carrying out ‘ex-ante’, ‘mid-term’ and ‘ex-post’ evaluations (64). For its programme evaluations, the Commission has also increased its efforts to provide methodological support for evaluations, including the setting up of an ‘evaluation support network’ for all Directorates-General.

6.57. Moreover, in line with the recommendation made by the Court to reinforce the overall policy of monitoring and evaluation, the Commission has contracted several evaluations targeted at specific aspects, in addition to a global programme evaluation of ‘Socrates’ (65) or ‘Youth’ (66).

(61) See for example the certification reports of the French National Agency of 11 February 2004 or the reports by the Luxembourg National Agency of 10 February 2004.
Conclusion and recommendations

6.58. The Commission has addressed a number of deficiencies identified by the Court in the Special Report. In some areas, such as the programme design and its management structure, the Commission has had only limited room for manoeuvre due to a legal base which will continue to apply until 2006. In other areas, the follow-up of this Special Report revealed continuing shortcomings, some of which were also referred to in the 2002 and 2003 Annual Activity Reports of the Directorate-General for Education and Culture (67).

6.59. In particular the Commission is recommended to take further corrective action in the following areas:

— The Commission should take into account the Court’s remarks on simplifying the programme design and management structure when making a proposal for a future ‘Socrates’ or ‘Youth’ programme.

— On 14 July 2004 the Commission proposed simplified architecture programmes compared with the current generation of the next period of financial perspectives 2007-2013.

— The Commission should continue to develop relevant and measurable indicators in line with the guidelines on defining objectives and indicators established by the Secretariat-General of the Commission (68). These indicators should be periodically reported to senior management, allowing for a benchmarking between different directorates and programmes. In particular, they should also cover the efficient and effective functioning of internal controls.

— It is endeavouring to develop measurable indicators, including concerning internal control.

— The Commission’s administrative procedures, from the preparation of a proposal to the closure of an action, should be further simplified. Using an electronic system for the submission and processing of proposals by National Agencies should allow for additional simplification and efficiency gains.

— It will continue to simplify the management of actions (greater use of flat rates, introduction shortly of an electronic grant application submission tool).

— In order to further clarify the scope and extent of audit work to be carried out by (or on behalf of) the National Agencies for the submission of the audit certificates (i.e. ‘certification reports’), the Commission should provide specific guidance to National Agencies. Moreover, the Commission should define a strategy on how to verify at the level of each Member State that the audit certificates submitted by the National Agencies were produced in compliance with the minimum requirements defined for the scope and extent of the audit work.

— It will strengthen the validity of the arrangement launched with the certification obligation for the accounts of national agencies. The guidelines referred to by the Court in point 6.52 are already available to the national agencies.


THE COURT’S OBSERVATIONS

— The Directorate-General for Education and Culture should also commission evaluations on relevant administrative issues, in particular aiming at proposals to simplify the administrative and financial aspects of the ‘Socrates’ and ‘Youth’ programmes. The results of these evaluations should be communicated in due time to the European Parliament, Council and National Agencies to allow for an in-depth discussion of these aspects so that the conclusions can be taken into consideration for the setting-up of the successor programmes.

— In addition, it will evaluate the programmes in due course in terms of effectiveness (implementation, results) and efficiency (administrative and financial aspects) and ensure appropriate follow-up arising from these two aspects.

PRINCIPAL OBSERVATIONS IN SPECIAL REPORT NO 1/2004 CONCERNING FP5 (1998 TO 2002)

6.60. The Court’s audit focused on the 5th Framework Programme covering research, technological development and demonstration activities (FP5) of the European Community (EC) which was adopted by the European Parliament and Council in December 1998 with a total budget of 13 700 million euro (69). The annual funding provided for the seven thematic and horizontal programmes in the period up to 2002 accounts for approximately a quarter of the public funding for research projects in the European Union.

6.61. Research activities financed under FP5 are carried out through contracts with third parties and partly financed by the Community budget. Both the implementing regulation and the model contracts were adopted late. The large number of different model contracts unnecessarily increased the complexity of the contract management processes.

6.62. Financial contributions from the Community budget are based on the reimbursement of costs actually incurred and duly justified. The complexity of the rules for fixing the Community’s financial participation hinders the effective management of financial and administrative aspects by the Commission and is an unnecessary complication for participants. The introduction of the flat-rate cost reimbursement system in FP5, which aimed at simplification, provided an incentive for participants to change to a more advantageous funding mechanism.

6.61. Some delays have occurred, mainly in connection with the adoption of a legal basis for FP5. However, most of the documentation has been produced, thus enabling negotiations with participants to be started. The number of different model contracts has been reduced significantly in FP6, with only one model contract for all indirect RTD actions (except for Marie Curie actions). Specific annexes take account of the specificities required for the main instruments.

6.62. FP5 cost reimbursement systems reflect the provisions of the legal basis. The Commission has initiated an in-depth reform of the contractual and financial arrangements for Community research programmes as part of FP6.
6.63. A Commission proposal to simplify cost systems for FP6 (2002 to 2006) in line with previous recommendations by the Court was rejected by the Council and the Parliament. The rules for setting the Community’s financial contribution that were subsequently adopted by the Council and the European Parliament only partially address the Court’s concerns. The Court welcomes the introduction of visible and dissuasive sanctions and the requirement for the certification of financial statements by an external auditor in FP6.

6.64. The seven specific programmes of FP5 are managed jointly by five Directorates-General. The fragmentation of programmes results in the dilution of responsibilities, duplication of functions and increased need for co-ordination and consultation. Moreover, the basic concept of programmes composed of key actions is not adequately reflected in the Commission’s organisational structure.

6.65. FP5 experienced significant organisational problems and delays during the starting phase, beginning with the late adoption of the Decision by the Council and Parliament. Because of legal requirements, the Commission’s internal rules and certain administrative practices, the process took eight to nine months, from the receipt of proposals to the Commission’s signing of a contract for indirect RTD actions. The Commission continued to face difficulties in employing staff with the required profiles as well as problems in recruiting permanent officials. By the end of 2001 approximately 2,000 staff members were employed on FP5-related activities, about a third of them for the administration of proposals, contracts and projects for indirect RTD actions. On average only four to five working days per year were available for the scientific monitoring of each indirect RTD action. The procedures and administrative practices for the selection of indirect RTD actions, together with the cyclical nature of the submission of project deliverables defined in the model contracts, led to an uneven caseload at Commission level. The resulting bottlenecks were not conducive to the efficient operation of the management system and also contributed to administrative delays and deficiencies in internal controls.

6.63. FP6 introduced major simplifications for the implementation of research actions. The Commission’s proposals were to a large extent based on the Court’s recommendations, but they were amended by the Council and the European Parliament. The cost reimbursement system set up for FP6 is simpler to implement both for the participants and for the Commission services. Consequently, it should provide better protection for the Community’s financial interests. In addition to the sanctions provided for in the model contract and the FP6 participation rules, possibilities are also indicated in Article 114 of the new Community Financial Regulation.

6.64. The organisational structure established by the Commission has made it possible to develop synergies between research and other Community policies. Responsibilities have been defined accordingly, and common tools gradually made available. Furthermore, the joint management of programmes by different Directorates-General is facilitated by a number of co-ordination mechanisms.

For FP6, the establishment of management tools, including centralised support functions, illustrates the Commission’s concern to ensure greater coordination between its services.

6.65. The management procedures were all established in compliance with the rules and objectives of the framework programme. The time limit up to the signature of contracts is used to guarantee the quality of the essential selection and negotiation phases.

Measures to further reduce the duration of the procedures have been renewed in FP6 and provide a useful complement for the new procedures for the entry into force of contracts established by the FP6 participation rules.

In line with recommendations in the White Paper on Commission Reform, the Commission has addressed the specific difficulties as regards staff policy in the research domain.

Simplified procedures and better planification should make it possible to even out the caseload under FP6, improving internal control and speeding up processes.
THE COURT’S OBSERVATIONS

6.66. The Council Decisions adopting the specific programmes set ceilings for administrative expenditure of between 6.5% and 9.8% of the total expenditure for each specific programme. These ceilings were respected for all programmes. An alternative method of measurement, comparing the expenditure devoted to indirect RTD actions with the total budget, indicates that €837.4 million (6.4% of the total expenditure for FP5) was spent on the management of RTD Framework Programmes over the entire duration of FP5. The Commission monitors its resource allocation through the Activity Based Budgeting (ABB) system. Both for methodological reasons and due to the Commission’s implementation of the Activity Based Budgeting system, this is not the most appropriate way of measuring the operating cost of the RTD framework programmes.

6.67. The Commission did not develop a common or integrated IT system despite the management system being essentially the same for all the services implementing indirect RTD actions. The IT systems deployed by the Commission for the proposal, contract and project management were inadequate, not least because of insufficient investment. Improvements were noted towards the end of the FP5 programme period, but technical and operational problems persisted in most Directorates-General.

6.68. Whilst the RTD Framework Programmes need to be implemented using a common set of principles and procedures, the Commission’s administrative reform aims at the decentralisation and empowerment of services. The contradictions between these approaches lie at the root of many of the difficulties experienced by the Directorates-General in their joint management of FP5. The complexity of the intervention mechanisms and rules for the Community’s financial participation makes efficient co-ordination within the Framework Programme even more important. The tests of the most important controls for a sample of contracts for indirect RTD actions showed that not all had been operated effectively. Other controls were found to be lacking. Overall the level of control differed considerably between the different Directorates-General operating FP5.

6.69. The testing of the legality and regularity of cost claim based payments for FP5 indirect RTD actions at beneficiary level revealed a significant incidence of errors, mainly due to an overdeclaration of costs by final beneficiaries. No overall improvement was noted as compared with audit work related to previous Framework Programmes.

THE COMMISSION’S REPLIES

6.66. The Commission has implemented FP5 within the budget adopted by the European Parliament and the Council. The alternative method proposed by the Court is not required by the rules.

The staff allocation is presented in the Annual Management Plan in accordance with the newly introduced Activity Based Budgeting (ABB) since 2002, but 2004 will be the first year where the General Budget will be officially based on this new system. The Activity Based Budgeting methodology further increases the transparency of the Commission’s budgetary management.

6.67. The progressive integration of IT systems has improved significantly throughout the FP5 programme period. Moreover, IT support in FP5 compares favourably to that in FP4.

Specific deficiencies identified by the Court are addressed by the Commission in the development of a common IT system for FP6.

6.68. The Commission considers that there is no contradiction between the administrative reform objectives and the need to implement principles and procedures common to the various research Directorates-General. The strengthened responsibilities at decentralised level are no obstacle to their being well defined and effective collaboration established.

Following the Court’s audit, both in the perspective of FP6 and in the framework of the financial reform in progress, the Commission has already improved several aspects of its internal control mechanisms. An action plan common to the Directorates-General concerned was implemented by the Commission in 2003.

6.69. The Commission acknowledges the problem, which is due to the fact that the Community’s financial contribution is paid on the basis of eligible costs incurred, as declared by final beneficiaries. The exactitude of these costs and their conformity with the contractual provisions cannot be completely and accurately verified by the Commission prior to the authorisation of payments. Only a financial audit at the beneficiary level can determine with certainty and exactitude the correctness of the costs claimed and their conformity to the contractual provisions.

In order to reduce the frequency of errors, the Commission has increased the ex-post audits and drawn up an action plan following the synthesis report of the 2001 annual activity reports which has been implemented and is regularly monitored. In addition in FP6, audit certificates from beneficiaries will be required.
6.70. The management information systems and reporting to Directors and (deputy) Directors-General still need to be improved. In none of the five Research Directorates-General were there procedures and practices to ensure that management-level information was prepared on time or accessible in a standardised format. In 2002 the management reporting for the framework programmes did not yet fully comply with the requirements defined in the Commission’s internal control standards.

6.70. The Commission’s internal reporting to Directors and (deputy) Directors-General is characterised by the different roles and responsibilities of decentralised and centralised management functions within the Directorates-General and FP5 programmes. Within each Directorate-General senior management meetings are the driving force behind the management and supervision information system.

In addition to the formal internal reporting to management, the Commission produces, as required by the legal basis, an extensive reporting to external users such as programme committees, external advisory groups or monitoring panels.

The Commission’s Internal Control Standards were in effect only for part of the period covered by the Court’s audit but they have been fully implemented now. The deployment of the common IT system for FP6 will help to improve management reporting.
ANNEX 1
Internal policies (including research) — Assessment of key aspects previously observed

| Observations                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             | Action taken in 2003                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | Action to be implemented                                                                                                                                                                                                                                                                                                                                 |
| ---                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| **1.a Supervisory and control systems — ex-post audits of final beneficiaries participating in RTD framework programmes**                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| 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 and 2002). These audits are to a large extent carried out by external audit firms on behalf of the Commission. The Court found that: | — 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);  
— the Commission is unable to achieve its own target of audit coverage (see Annual Reports 2001, 2002, 2003);  
— the Commission has not adopted a common audit approach for FP6;  
— 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). | |  
Commission should define for FP6 a measurable objective, which can realistically be achieved.  
Proposal for common audit approach in 2004, but still not formally adopted.  
Award procedure for a new framework contract (for FP5 indirect RTD actions) launched in October 2003, but not yet signed. |  
A common audit approach for FP6 should be formally adopted by all five Directorates-General.  
A new framework contract for FP6 should be signed to provide adequate external support to the Commission to implement its audit approach for FP6. |
| |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| **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:  
— TEN-T actions were not covered by Directorate-General for Energy and Transport’s audit programme. | | |  
No audit programme for TEN-T audits was established in 2003. |  
An audit programme including TEN-T remains to be established and implemented. |
| **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:  
— these definitions are insufficiently specific to establish the actual costs incurred by the beneficiary;  
— these definitions differ from those applied to similar infrastructure projects co-financed through Structural Measures;  
— 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  
— the absence of standardised cost statements forms complications the Commission's verification work. | | |  
As from 2002, the standard text of the TEN-T Commission Decision has been substantially revised, it was inspired by the Cohesion Fund decision and provides more details of eligible cost.  
A new model Commission Decision has been adopted in 2003, including:  
— a clarification of eligible costs;  
— a modified definition of studies and works; 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 definition of studies and works is still insufficiently clear and precise.  
The model cost statement should be a separate form (stating the costs incurred and supporting information from the beneficiaries). Its use should be mandatory. The beneficiary should date and sign the cost statement, thereby confirming the reality, eligibility and accuracy of the costs declared. The cost statements should be certified by an external auditor, or in the case of public bodies, by a competent public officer. |
## ANNEX 2

**Supervisory systems and controls**

**Area:** Internal Policies (including Research)

**System:** 6th Framework Programme (FP6) for Research and Technological Development and European Refugee Fund (ERF)

<table>
<thead>
<tr>
<th>FP6</th>
<th>Commission</th>
<th>Intermediate level</th>
<th>Beneficiary</th>
<th>Overall assessment</th>
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<tr>
<td>Conception</td>
<td>B</td>
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<tr>
<td>Practical transposition in procedural stages:</td>
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<td>— compliance with standards</td>
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<td>Actual operation:</td>
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<tr>
<td>— compliance with standards</td>
<td>B</td>
<td>—</td>
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<td>— taking into account of experience</td>
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<td>Results:</td>
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<td>— remedial effect</td>
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<td>Overall assessment</td>
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<th>Overall assessment</th>
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<td>Practical transposition in procedural stages:</td>
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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
N/A Not applicable
CHAPTER 7

External actions

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INTRODUCTION

7.1. This chapter deals with the external aid financed from the general budget. The main areas of interest are food aid/food security, humanitarian aid, NGO cofinancing and financial and technical cooperation with Asia, Latin America, the Mediterranean countries, the Western Balkans, the New Independent States and Mongolia. The Directorates-General for External Relations and 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 Humanitarian Aid Office (ECHO) is fully responsible for humanitarian aid. The aid that is provided through the European Development Funds (1) appears only as a token entry in the general budget, as it is financed separately. Graphs 7.1 and 7.2 show how the funds were spent in 2003 for financial perspective Heading 4 (see paragraphs 2.40 to 2.41 for observations on budgetary management).

7.2. In 2003 the devolution process, by which functions and tasks were redistributed from the Commission’s headquarters to its Delegations, was completed for the geographic programmes (2) for the Delegations located in the countries which received funds from the Union’s general budget. Also in 2003 the new Financial Regulation (3) entered into force. The internal audit function, required by the new Financial Regulation, was already introduced in 2002. As the Commission Regulation (4) on the related implementing rules was adopted at the end of December 2002, the consequent modifications in the EuropeAid Cooperation Office’s manuals and guidelines could only be completed, translated and communicated to the Delegations during the first half of 2003. The most important consequences in 2003 for the supervisory systems and controls were the abandonment of the function of centralised financial controller and — as a consequence — the strengthening of the role of the finance units and the introduction of ex ante and ex post verifications under the responsibility of the authorising officer.

(1) See separate report on the EDFs.
(2) Programmes financed by budget lines which are focused on certain geographic regions (like Asia, Latin America, Mediterranean countries, Eastern Europe and Balkan) in contrast to budget lines which finance certain types of operations (e.g. Food aid, NGO co-financing).
Graph 7.1 — Breakdown of commitments by budgetary area in 2003

Total commitments: 5 067 million euro

- Cooperation with partner countries in eastern Europe, central Asia and western Balkans (B7-5)
- Cooperation with Asia, Latin America and southern Africa (B7-3)
- Cooperation with Mediterranean third countries and Middle East (B7-4)
- Other cooperation measures (NGO cofinancing etc.) (B7-6)
- External aspects of certain community policies (B7-8)
- Humanitarian and food aid (B7-2)
- Other (B7-0 4, B7-0 5, B7-7 and B8)

NB: For more detailed information see Diagrams III and IV of Annex I.
Source: 2003 annual accounts.

Graph 7.2 — Breakdown of payments by budgetary area in 2003

Total payments: 4 286 million euro

- Cooperation with partner countries in eastern Europe, central Asia and western Balkans (B7-5)
- Cooperation with Asia, Latin America and southern Africa (B7-3)
- Cooperation with Mediterranean third countries and Middle East (B7-4)
- Other cooperation measures (NGO cofinancing etc.) (B7-6)
- External aspects of certain community policies (B7-8)
- Humanitarian aid and food aid (B7-2)
- Other (B7-0 4, B7-0 5, B7-7 and B8)

NB: For more detailed information see Diagrams III and IV of Annex I.
Source: 2003 annual accounts.
THE COURT’S OBSERVATIONS

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 systems and controls which are supposed to ensure the legality and regularity of transactions, supported by tests of transactions at the Commission headquarters, Delegations and implementing organisations, and a review of the Annual Activity Reports of the Director General of the EuropeAid Cooperation Office and the Director of the Humanitarian Aid Office.

7.4. This audit was carried out at the Commission headquarters, at six Delegations (Albania, Indonesia, Morocco, Peru, South Africa and the Ukraine) and at 13 implementing organisations. The areas mentioned in paragraph 7.1 were reviewed and tested. For Albania and Ukraine the Court's audit was limited to a preliminary assessment of the systems without direct testing. Reconstruction aid for Kosovo and the Federal Republic of Yugoslavia is the subject of a separate annual audit of the European Agency for Reconstruction. Furthermore, the audit included the verification of a limited number of transactions under the International Fisheries Agreements.

7.5. Regarding the supervisory systems and controls 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 the EuropeAid Cooperation Office and the Humanitarian Aid Office.

7.6. The Court was hindered in its work because, at the moment of drafting its report, it had not received full information from EuropeAid Cooperation Office's headquarters on the reports provided to them by the Delegations which are taken into account for the preparation of the EuropeAid Cooperation Office's Annual Activity Report and the Director General’s statement.

7.6. The Commission will endeavour to ensure that this procedure operates smoothly in the future.
Supervisory systems and controls

Internal control standards

7.7. In 2002 both the EuropeAid Cooperation Office and the Humanitarian Aid Office completed the framework for the implementation of the internal control standards as defined by the Commission on 13 December 2000 (1). The introduction of the standards was supported by issuing or updating instructions and guidelines and extensive training programmes, in particular on the administrative and financial procedures. In 2003 the latter have been substantially updated and revised as a result of the introduction of the new Financial Regulation.

Humanitarian Aid Office

Risk assessment

7.8. The Humanitarian Aid Office carried out a satisfactory risk self-assessment, 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 the previous years, efforts to reduce the risks were concentrated on the selection procedure for implementing partners together with a tight system of audits of those selected.

Audit of implementing partners

7.9. In 2002 the Humanitarian Aid Office started a comprehensive approach of auditing the implementing partners. This system was fully operational in 2003. 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. Detailed testing was done of expenditure of projects implemented by the partners. However, it is noted that in 2003, apart from a field visit to a UNHCR project in Sierra Leone, no international organisation (mainly UN-bodies) have been subject to such testing.


7.8. The risk was reduced by several other measures which include: monitoring by the technical assistants (ECHO experts), the use of a specific monitoring tool, the progressively increased use of specific indicators to measure the achievement of the objectives of the project.

7.9. The Commission (ECHO) did not carry out audits at the headquarters of international organisations in 2003 as the new Framework Partnership Agreement (FPA) was being established. At this time negotiations with the UN organisations leading to the Financial and Administrative Framework Agreement (FAFA) were being finalised (completed on 29 April 2003). The FAFA in turn resulted in the revision of the FPA for international organisations.

Further to the above the Commission services (EuropeAid and ECHO) started to review the UN’s control systems used in the management of EU funded projects. The on the spot verifications of these systems and expenditure records, at the UN headquarters, started in 2004. The International Red Cross family was audited in the first half of 2004.
7.10. In 2003 audits were completed on 136 implementing partners, representing 535 projects. The Court reviewed 16 audits, which were of good quality. The most important problems revealed by these audits were: weak tendering procedures (7 cases out of 16), weaknesses in accounting systems, reconciliation problems, financial reporting (7 out of 16) and weak stock controls (3 out of 16). The most frequent reasons for disallowing expenditure were: lack of justification of expenditure in the form of supporting documents and ineligible expenditure. Only one case of non-respect of tendering rules was found because most of the audits did not carry out testing of tendering. The nature of the observations made in these audit reports and the errors found on the expenditure corresponds largely with the Court’s audit findings on implementing organisations (see paragraphs 7.38 and 7.39).

7.11. The implementing partners committed themselves to implement the recommendations made to improve their systems. The amounts which were disallowed will be deducted from payments for ongoing or new projects. These results show that audits of implementing organisations are an effective instrument of supervision and control.

EuropeAid Cooperation Office at central level

Follow-up of 2002 observations

7.12. In its Annual Report on 2002 (paragraphs 7.6 and 7.37) the Court observed that an overall risk assessment remained to be carried out, that questionnaires for the processing of commitments and payments were not systematically used, and that a system of reporting on recovery orders and on weaknesses of internal controls was lacking. In 2003 the situation improved in that the EuropeAid Cooperation Office finalised its risk assessment in October 2003 and questionnaires were found to be used systematically in all Delegations visited by the Court. However, apart from an in-depth review of the recoveries carried out by the section ‘Analysis of financial management and controls’ (FMC), a satisfactory monitoring of and reporting on recoveries by the units ‘Finance, contracting and audit’ of all of the Directorates was not in place (see paragraph 7.23). Equally, there is no evidence that the system which ensures that staff report on internal control weaknesses was functioning correctly.

7.12. The Commission takes note of the Court’s observations concerning progress made by the EuropeAid Cooperation Office in 2003 in comparison to 2002, regarding risk assessment and the systematic use of checklists.

Regarding recovery, the efforts made during the most recent exercise have resulted in a fall in the amount to be recovered that had accumulated at the end of 2002 by almost 100 claims, representing nearly EUR 10 million. These results are partially obscured by the sudden appearance of a new RAR during 2003 (an increase of 50 claims worth EUR 2 million). At the beginning of the 2003 exercise, the number of claims not resolved by their due date stood at 614 (for a total of EUR 64 038 938.27), while by the end of the exercise it had fallen to 567 (for a total of EUR 56 542 997.78) The number of outstanding claims therefore fell by 7.65 %, and their total dipped by 11.7 %.

Regarding the reporting of internal control weaknesses by staff, the Commission will study ways of improving its functioning.
THE COURT’S OBSERVATIONS

Risk assessment

7.13. The risk assessment finalised in October 2003 gives a presentation of risks as applicable to donors of external assistance. It focused on the risks related to partner countries, risks related to development organisations and risks associated with budget support. The assessment indicated which types of action are undertaken to counter the risks, which are mainly in the form of better development aid approaches and procedures or better dialogue with development partners. The actions on financial risks, as described in the risk assessment, focus on the internal audit unit and on the strengthening of external audits of implementing organisations in a global way. In its annual management plan 2004, the EuropeAid Cooperation Office has formulated a number of more concrete actions in this respect, which should create the basis for a coordinated and comprehensive system of supervision and controls.

Information and reporting

7.14. In particular, in the situation where the management and implementation of the development actions is devolved to a large extent towards the Delegations, monitoring on the basis of an adequate information and reporting system by the headquarters in Brussels is essential. This principle, laid down in the risk analysis by the EuropeAid Cooperation Office in December 2002 was confirmed by the risk self-assessment completed in October 2003.

7.15. Most of the financial information which is used for monitoring purposes is obtained from the EuropeAid Cooperation Office’s Common Relex Information System (CRIS). In 2003 the quality of information in CRIS was improved, in particular in respect of monitoring the progress of project implementation. The financial information focuses on decisions, contracting, commitments and payments. The system did not provide information on a project-by-project basis on audits carried out, their outcome and action taken.

7.15. The introduction of new tools (such as CRIS Audit) will contribute to further improving the flow of information on audit results at central level. Data in relation to audits launched by Headquarters and Delegations are registered in CRIS Audit.

Information relating to audits to be provided by beneficiaries before introducing requests for payments (certification audits) will be encoded at two stages, once when the contract is concluded and second, when the certificate or the audit report is presented. The procedural steps, as well as the appropriate fields in CRIS, are envisaged but still need to be developed. It is not intended, however, to register information on certification audits to the same extent as data relating to external audits launched by headquarters or delegations.
Financial monitoring

7.16. At present financial monitoring at the headquarters is primarily carried out by the ‘Finance, contracting and audit’ units. For this purpose the units dispose, among others, of the following instruments:

— financial information provided by the CRIS system and additional information from the Delegations;

— audits of Delegations;

— audits of implementing organisations either launched by Commission services or provided by implementing organisations.

In addition, optional ex ante controls (see paragraph 7.20) have also been carried out.

7.17. All finance units carry out an analysis of a number of financial indicators such as amounts of commitments and payments and amounts remaining to be spent on projects. Each of the Directorates’ finance units is free to decide what aspects are to be monitored. A common analysis of information needs and a common overall methodology could considerably strengthen the financial monitoring.

7.17. The Commission recognises that a common overall methodology on the use of management information could strengthen the monitoring of the implementation and the performance against pre-defined targets and objectives.

7.18. The finance units of two of the five Directorates managing devolved operations carried out audits of their Delegations in the form of a review of their financial systems for processing transactions, their contracting system and their supervisory systems and controls, completed by an audit of transactions processed by the Delegations. They found that the financial systems at this level functioned correctly. This important instrument of audit of Delegations should be used by all Directorates.

7.18. The devolution of the management of external aid has involved a considerable transferral of tasks and responsibilities to delegations, and hence major changes in the quantity, nature and organisation of work done in the delegations. Given the scale of the expected changes, a verification exercise was systematically carried out before devolution was held to be operational in a delegation, in order to:

— confirm with the head of delegation that the conditions necessary to begin devolved operations are in place,

— supply the subdelegated authorising officer in question (the director at headquarters) with sufficient information to form an opinion about each delegation’s capacity to perform in a devolved manner within acceptable levels of efficiency and risk, with particular regard to training and levels of staff expertise,

— provide the head of delegation and the director in question with an opinion on the conformity of the systems that have been created, and on the extent to which transactions conform to the rules in force.

Some directorates have made additional assessments primarily in cases where devolution took place in the first wave (2001).

Directorates where devolution took place later will consider when to carry out such assessments.
Audit of implementing organisations

7.19. In 2003 about 100 audits of implementing organisations were launched by the various Directorates of the EuropeAid Cooperation Office as part of the 2003 audit programme. Most audits were still underway in early 2004. These audits were initiated in addition to about 350 audits carried out on behalf of the Delegations and an unknown number of audits contracted directly by implementing organisations for their own purposes of reporting and discharge. In 2003 considerable progress has been made in terms of the number of audits in comparison to the previous year (250 audits in total in 2002). In terms of planning and coordination of audits an audit programme for 2003 has been established but only for the 100 audits launched by headquarters. In most cases headquarters’ services did not have the information on a continuous basis on the audits launched by the Delegations. Comprehensive information on audits is not yet incorporated in the EuropeAid Cooperation Office’s CRIS financial information system. First steps for creating an audit module have been taken.

7.20. The Commission shares the Court’s views on progress made in 2003. As regards information on audits launched by delegations, since the inclusion of reporting tables in the EAMR (external assistance management reports), such information has become more regularly available. Moreover, CRIS AUDIT (a module of CRIS) has been made available for encoding audits both in headquarters and delegations. The use of this module requires appropriate training. This training started in May 2004.

Ex ante control sections

7.20. Within each of the Directorates a section was created to carry out optional (see paragraph 7.16) ex ante controls on top of the normal ex ante verifications foreseen by Article 60 of the Financial Regulation. This was done as an intermediary measure after the abolition of the function of the Financial Controller. The Court received information on the ex ante financial controls from half of the Directorates. Due to staffing problems, ex ante controls were absent for long periods of the year. In one Directorate all transactions were checked; in the other two about 310 transactions were checked out of a total of 3 500. These checks include those on payments authorised by headquarters or by Delegations to implementing organisations on the basis of the latter’s payment requests, which are supported by financial overviews of expenditure incurred. At that stage no underlying supporting documents, such as invoices, are checked. One out of the three above Directorates presented a report with an analysis of the results of the ex ante controls. Oral explanations were given by the other two Directorates. It showed that the ex ante controls detected mainly formal short-comings, which is in line with the results of the Court’s own audit of transactions at the level of the Commission’s headquarters and Delegations.

7.20. CRIS AUDIT is a second level ex ante optional control function, implemented on an interim basis as a measure to accompany the changes ensuing from the entry into force of the new financial Regulation, in the expectation of the creation of a centralised ex post verification system at EuropeAid level.
Internal audit capability

7.21. The internal audit capability unit in 2003 completed the assessment of the internal control standards and carried out reviews of the control systems of three specific areas. The unit also carried out in March 2004 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 systems and controls. Apart from the above audit tasks the unit also carried out workload assessments both at the level of headquarters and at the level of Delegations. Although the workload assessments have produced interesting results as a first step of assessing staffing needs, it is questionable whether this type of work should be carried out by the internal audit capability unit, particularly 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.

Ex-post verifications

7.22. On the basis of a large sample of transactions the section 'Analysis of financial management and controls', responsible for ex post verifications, has carried out reviews, in particular to arrive at a comprehensive overview of the situation of recoveries and uncleared advances. Given the similarity of work carried out by this section and the monitoring of the Directorates' finance units, it was foreseen in the section's mission statement that it should contribute to a more homogeneous methodology for a system of ex post verification by the finance units. So far, the finance units in the Directorates did not give priority to a coordinated approach. Furthermore, despite the potential complementarity of the work carried out by the section 'Analysis of financial management and controls' and the internal audit capability unit, there is no evidence of a coordination and an exchange of information between the two entities.

7.22. With the setting up on 1 February 2004 of a new unit in charge of both monitoring the implementation of the internal control framework and transaction control, EuropeAid believes that it has created conditions that will ensure better coordination and complementarity between the different actors in internal control.
THE COURT’S OBSERVATIONS

Overall supervisory and control functions

7.23. The previous paragraphs show that several services at headquarters carry out certain supervisory and control functions, on top of those done by the Delegations. An overview is presented in Table 7.1. Now that the devolution process is virtually complete at the level of the Delegations, there is a need to review these activities in a comprehensive manner. By more clearly defining the overall strategy for supervision and control, the Commission would be in a position to explain:

a) how the control functions of the different services should link together and should provide the level of assurance required;

b) what the specific objectives should be, and

c) what and how much detailed work they need to do taking into account, the audits or controls carried out by other services or audits provided by implementing organisations themselves. An example requiring such clarifications is the three different kinds of ex post verifications carried out by the finance units, by Delegations and by the section ‘Analysis of financial management and controls’. In this context the finance units should systematically review recoveries and uncleared advances instead of the section ‘Analysis of financial management and controls’ carrying out ad hoc reviews as done for 2003 (see paragraph 7.12). Information on recoveries and uncleared advances should be systematically presented to and monitored by management at headquarters and Delegations.

7.24. Most of the checks and controls shown in the table are carried out on transactions processed by the EuropeAid Cooperation Office’s headquarters and Delegations. Where the claims are accompanied by a report by an external auditor certifying the expenditure in question or have been the subject of field audit by staff of the Commission, it is possible to assess whether underlying transactions undertaken by the other implementing organisations are legal and regular in substance. In other cases, where the Commission relies on documents provided by implementing organisations, it can only check that the payment claim is plausible within the terms of the contract or financing agreement and the budget foreseen. These verifications revealed a low incidence of error, as confirmed by the Court’s audit (see also paragraphs 7.34 and 7.36).

THE COMMISSION’S REPLIES

7.23. An overview of controls was produced in 2004 in the framework of the follow-up of the 2002 discharge procedure which explains the functions of the various controls. The Commission will examine how the implementation of its overall strategy can be improved.
### Table 7.1 — Overview of supervision and controls for EuropeAid payments

<table>
<thead>
<tr>
<th>Activity</th>
<th>Preparation of payment</th>
<th>Financial monitoring/verification of expenditure incurred by implementing organisation</th>
<th>Supervision by Commission headquarters</th>
<th>Analysis of financial management and controls (FMC)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Authorizing officer (at headquarters or Delegations)</td>
<td>Optional ex ante control</td>
<td>Delegations</td>
<td>Finance, contracting and audit units</td>
</tr>
<tr>
<td>Purpose</td>
<td>Checks before releasing payment (1)</td>
<td>Financial monitoring/follow up/contracts</td>
<td>Audits initiated by Delegation or provided by implementing organisation</td>
<td>Financial monitoring/reporting/follow-up</td>
</tr>
<tr>
<td>Obligation/Basis</td>
<td>Legality/regularity of payments</td>
<td>Legality of transaction before payment</td>
<td>Review of financial situation/signals on unusual situations</td>
<td>Legality of expenditure incurred by implementing organisations</td>
</tr>
<tr>
<td>Initiated by:</td>
<td>Payment request third party</td>
<td>Directorate</td>
<td>Delegation</td>
<td>Delegation/Implementing organisations</td>
</tr>
<tr>
<td>ToR endorsed by Commission/Delegation</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>yes</td>
</tr>
<tr>
<td>Carried out by:</td>
<td>Technical units and finance units</td>
<td>Finance unit</td>
<td>Delegation</td>
<td>External auditors</td>
</tr>
<tr>
<td>Results communicated to:</td>
<td>Results recorded in accounting system</td>
<td>Director</td>
<td>Delegation-Finance section</td>
<td>Delegation-Finance section</td>
</tr>
<tr>
<td>Follow-up by:</td>
<td>N/A</td>
<td>Authorizing officer</td>
<td>Delegation-Finance section/Implementing organisations</td>
<td>Head of unit</td>
</tr>
</tbody>
</table>

(1) A large proportion of payments is in the form of advances to implementing organisations, which have at a later stage to present statements of incurred expenditure.
7.25. The Commission's Internal Audit Service carried out in 2003 an in-depth audit on the EuropeAid Cooperation Office's system of internal control. The audit found that the internal control systems at the level of the Commission's headquarters and Delegations had been considerably strengthened and were as a whole adequate. However, it criticized the lack of coherence between the multitude of control systems, as well as the underdevelopment of the audit cells within the Directorates' finance units. It also recommended significant improvements of the CRIS financial information system and of the Delegations' management reporting system. In general, this is in line with the Court's findings (see paragraphs 7.15-7.20, 7.22-7.24 and 7.48). The Internal Audit Service's work did not include audits of implementing organisations.

7.26. The Court visited six Delegations (Albania, Indonesia, Morocco, Peru, South Africa and the Ukraine) to assess the supervisory systems and controls and to audit a number of transactions for which the EuropeAid Cooperation Office was the Authorising Officer by delegation.

7.27. The management of the implementation of external aid was devolved to the Delegation in Ukraine in 2003 and the prescribed supervisory systems and controls were in place throughout the year. The preliminary assessment of the supervisory systems and controls at the Delegation indicated that the procedures carried out were generally sufficient.

7.28. The management of the implementation of external aid was devolved to the Delegation in Albania at the beginning of 2003. However, due to special circumstances, the devolution process still remains in a very early stage so that the Court could carry out a limited review only. This preliminary assessment did not indicate any major weaknesses in the procedures carried out.

7.29. The management of the implementation of external aid was fully devolved to all four Delegations audited (Indonesia, Morocco, Peru and South Africa) in 2003 and the prescribed supervisory systems and controls were in place throughout the year. The review of the supervisory systems and controls at the Delegations indicated that the procedures carried out were generally sufficient to ensure that the transactions processed by the Commission were legal and regular.

7.25. The IAS in-depth audit on EuropeAid provided a reasonable assurance that its internal control system is generally adequate. Where appropriate, the in-depth audit made recommendations to further improve the internal control system of EuropeAid.
7.30. In the countries visited by the Court, 12 external audits of the implementing organisations were reviewed. This 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. Some of the terms of reference that were not provided or approved by the Commission did not specifically include compliance with EU funding requirements and, in particular, contracting procedures. In three out of the four cases when the terms of reference covered the compliance with EU funding requirements, the audits revealed irregular expenditure.

7.31. Two of the Delegations visited (South Africa and Morocco) had developed a specific approach for following-up external audit.

7.32. Generally, the use of and procedures for the appointment of external auditors are provided for in the project financing agreements. Such provisions are often worded vaguely. The absence until May 2003 of clear guidelines from the Commission such as standard terms of reference leaves the implementing organisation with a wide scope for taking a variety of approaches for the selection and source of remuneration of external auditors and the setting of their objectives.

Audit of transactions

Audit of transactions carried out at central level

7.33. A sample of 22 payments was selected from large contractors in addition to 2 from non-devolved projects visited on-the-spot. Large contractors are those organisations that received the highest total funding during the year.

7.34. In 10 out of 24 cases (mainly international organisations) the Commission made payments on the basis of supporting documents provided by the implementing organisations. In the remaining 14 cases, the checks of payments also involved detailed verifications, among other, at the project level either by Commission staff or external auditors.

7.30. The conditions for audits required by financial agreement and/or contracts as well as their scope and objectives are established by those legal documents. EuropeAid is continuously improving these documents. For example the use of professional auditors for certain contract types has become mandatory as from 2003. However, the variety of types of operations and their legal frameworks requires targeted improvements usually undertaken on the occasion of a revision of those texts. It is certainly a priority for EuropeAid to improve reliance on audits provided by implementing organisations, being an important element within the wider control framework of external aid.

7.31. The follow-up of audit results is part of the line-management functions in delegations and headquarters. Each audit report should be given appropriate attention and follow-up. Certain information will be provided, however, by CRIS Audit, in particular on audits undertaken within the framework of the annual audit plans and other audits launched by headquarters and delegations.

7.32. The Court refers here to ‘certification audits’, these are audits required by financial agreement and/or contracts. Improvements have been made in this respect by introducing specific requirements as to the guidelines and the terms of references and the professional quality of auditors and/or by establishing the need for approval of the auditor by the delegation.

All the payments audited by the Court have been made in full compliance with the relevant contractual provisions and were legal and regular.
Audit of transactions carried out at the level of Delegations

7.35. For each Delegation visited, a sample of transactions was audited at that level. These included 41 payments and 6 tenders in total.

7.36. The work carried out by the Court during the course of the audits in beneficiary countries on payments made to projects for which the Delegations were responsible revealed only a low level of irregularities. This is in part due to the same matters detailed in paragraph 7.24.

Implementing organisations

7.37. The Court carried out on-the-spot audits of 13 projects at the level of the implementing organisations, where a sample of 215 transactions in total was checked with the aim of confirming the functioning of their internal control systems.

7.38. The Court’s audits of the projects revealed, in 6 out of 13 implementing organisations visited on-the-spot, weaknesses in their internal controls for ensuring compliance with contractual requirements. In most cases this involved a failure to adhere to the Commission’s prescribed contracting procedures and maintain proper supporting documentation.

7.39. A significant number of irregularities were found in the transactions examined at the level of the projects. The most frequent types were irregular contracting procedures (encountered in 5 projects out of the 13 audited on-the-spot), insufficient supporting documentation (5 out of 13) and ineligible expenditure (5 out of 13).

7.38. The Commission’s monitoring and control systems aim at ensuring the compliance of contract partners (NGOs, public ‘project management units’, etc.) with the contractual requirements. Checks and audits of the contract partners’ internal control systems 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.

The Commission agrees with the Court that the observance of tender and procurement procedures by project management units and NGOs remain an area of concern. With the devolution of projects stricter controls can be applied on the spot by the respective delegations. Moreover, since June 2003, in line with the revised grant contract provisions, the project accounts are subject to an audit before the final payment is made.

7.39. In addition to the improved controls outlined in reply to 7.38 the Commission has taken action to rectify the specific irregularities indicated by the Court.
7.40. The Court reviewed the Annual Activity Reports and the statements by the Director General of the EuropeAid Cooperation Office and the Director of the Humanitarian Aid Office. 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 2002 (6)) 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 Director General and the Director were justified and based on sufficient evidence.

7.41. In general, it was found that the information presented in the reports was accurate and that it fairly reflected the activities carried out on the follow-up on action plans and on the implementation of the internal control standards. Both the Humanitarian Aid Office and the EuropeAid Cooperation Office have taken appropriate actions to remedy short-comings identified in 2002 and to complete and improve the internal control standards. It is also indicated correctly in the EuropeAid Cooperation Office’s report that the implementation of the internal control standards at the level of Delegations is underway. Responding implicitly to the Court’s recommendations in its 2002 Annual Report (paragraph 7.44), the EuropeAid Cooperation Office also indicated in its report that steps are undertaken to have audits of operations carried out more systematically.

7.42. Action 2 of the Commission’s 2001 action plan stipulated that the external relations services should examine the possibilities of organisational synergy between them and carry out an analysis of risks related to their activities, in particular concerning direct budget aid. As mentioned in the Commission synthesis of the Annual Activity Report of 2002, ‘the competent Commissioners have decided to keep the current organisation as it is in order to give more time to the reform of external aid’. The assessment of risks associated with external aid and, in particular, budget support was carried out in 2003 (see also paragraph 7.12).

THE COURT'S OBSERVATIONS

7.43. In the Annual Activity Reports an appraisal should be given on the internal control systems. Whereas the Humanitarian Aid Office has given a description of the key systems in place together with an assessment of the various elements, the EuropeAid Cooperation Office limited its contribution to a description of the elements of the systems without indicating whether and to what extent the systems function adequately.

7.44. 2003 was the first time that Delegations were required to report to the headquarters (in their January 2004 reports) on the external audits carried out and that the Delegations were explicitly asked to report on legality and regularity aspects and on actions taken in this respect. Although this was an important improvement as compared to 2002, in practice a very limited number of Delegations gave more than global information on legality and regularity issues and the quality of information on external audits varied considerably.

7.45. The Annual Activity Report gives a description of internal control systems (see paragraph 7.43), mainly focusing on transactions between the Commission and the implementing organisations, which function generally satisfactorily. However, although the system of audits of implementing organisations has improved since 2002, the use and follow-up of audit reports were not yet adequate for the purpose of deriving assurance concerning the legality and regularity of transactions managed by those organisations. In July 2004, the Commission adopted an audit strategy.

THE COMMISSION'S REPLIES

7.43. There was in early 2004, an evaluation of the current effectiveness of the various controls, and the declaration of the Director-General of EuropeAid took this into account. An overview of controls was produced in 2004 which explains the functions of the various controls.

7.44. Based on past experiences, the information on audits is now part of the EAMR reports. The Commission agrees with the Court that the inclusion of audit information has been an improvement. It is expected that the completeness and the quality of the information will further improve over time.

The reports are intended to be an overview; they do not give detailed information on every project concerned.

7.45. The key elements of the overall strategy were already applied in 2003, including the annual audit plans, methodological tools, training etc. In July 2004 the overall strategy was formalised in a single document. Improvements have been made through modifications to standard legal texts (7.30), the development of a series of tools (framework contract, methodological guide, training) and the establishment of the annual audit programmes for 2003 and 2004 based on a common methodology and a risk analysis.

External audits are not the only source of assurance available. Other sources should also be included, 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.

Regarding the use and follow-up of audit reports, the introduction of new tools (such as CRIS Audit) will contribute to further improve the flow of information on audit results at central level, notably to feed back the audit strategy and the selection of transactions to be included in the audit plan. However, as mentioned earlier, the follow-up of audit results is part of the line-management functions in delegations and headquarters. The level of audit programming in fact matches that of project authorisation, enabling more effective use to be made of the results. Audits are therefore completely integrated into the whole project management cycle.
THE COURT’S OBSERVATIONS

7.46. The CRIS financial information system and the internal reporting systems do not yet provide sufficient information on the results of audits of expenditure made by implementing organisations.

7.47. The statement given by the Director General of the EuropeAid Cooperation Office included a reservation on the partnership modalities of an Association of NGOs for food aid and food security. The statement does not provide sufficient information on the underlying problem and does not specify what the financial impact could be. At the moment of drafting this report the Commission was examining this problem and could therefore not make further information available.

7.48. The Director General of the EuropeAid Cooperation Office declared, following the standard formulation, 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. This statement is justified 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 not yet adequate enough.

THE COMMISSION’S REPLIES

7.46. The Commission intends to extend the functions of CRIS to provide for the encoding of audit requirements and implementing organisations compliance with those requirements.

7.47. After the problem behind the reservation was identified in 2003, several measures were taken to protect the financial interests of the Community, ensure the continuity of NGO operations and respect the Commission’s legal commitments. This inquiry is still on-going, and the Commission will keep the Court informed of any relevant developments.

7.48. The Commission agrees that all the system components of internal control can and should be improved. All the necessary supervisory and control systems were in place in 2003 to enable the Director-General to give reasonable assurance as to the legality and regularity of transactions carried out by EuropeAid in 2003.

In its replies to the preceding points, the Commission clarified which aspects of the audit system were in need of further development. 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 orders in the framework of the financial circuits set up in accordance with the requirements of the new financial Regulation, when the payment instruction is issued. Such extra assurances also include the audit of the Annual Audit Plan, ex post transactional monitoring, missions on the ground, and monitoring reports.

While efforts must be made to continually improve external audit systems, as part of a set of checks on the legality and regularity of operations, the very diversity of the risks means they cannot be controlled by any isolated element of the verification system, but require the smooth articulation of its different components.

Conclusions

7.49. 2003 was the year in which the new Financial Regulation entered into force and the devolution process for the geographical programmes was completed. The extent to which a balanced combination of checks, reviews, inspections, audits by external firms and internal audits has been established varies markedly between the different Delegations and between the Directorates in the EuropeAid Cooperation Office.

7.49. As part of the reform of the management of external aid, the Commission is aiming to devolve all geographical and thematic programmes in 78 delegations before the end of 2004. On 31 December 2003, devolution was already in place for the management of geographical programmes in 61 delegations, covering all CARDS, TACIS, MEDA, ALA and EPRD programmes. The devolution of thematic lines, which began in 2003, will be carried out for the most part in 2004. A varying combination of checks, reviews, inspections and audits can be used to meet the differing requirements of services in respect of progress made towards devolution, and is consistent with that process.
7.50. The Court's audit revealed few errors affecting transactions at the level of the Commission's headquarters and at the level of its Delegations (see paragraphs 7.34 and 7.36). However, weaknesses in the internal controls, and a relatively high number of irregularities, were detected at the level of the project implementing organisations (see paragraph 7.39). It underlines the necessity to have a comprehensive approach to the supervision, control and audit of these organisations.

7.50. Over recent years, the utilisation of standard contractual documents (contracts, grants and financing agreement) has helped improve the level of control by the Commission. Payments and the verification of supporting documents are made as requested by the financial regulations. Contract provisions for 'certification audits' have also been improved (see replies to paragraphs 7.30 and 7.32). Moreover, the external audit strategy has been strengthened through the establishment of annual audit plans, — on the basis of a risk assessment, — of audits to be launched by headquarters and delegations (see also reply to 7.45).

7.51. The Annual Activity Reports of the Humanitarian Aid Office and of the EuropeAid Cooperation Office gave descriptions of the internal control systems in place. However, in the case of the EuropeAid Cooperation Office, the Court cannot derive assurance from the report and the statement (see paragraphs 7.19 and 7.45) since essential supervisory systems and controls for the legality and regularity of underlying transactions at the level of implementing organisations were not yet fully operational.

7.51. Essential supervisory systems and controls for EuropeAid were operational in 2003. These controls were considered as adequate for the purpose of deriving overall assurance in the context of the Director-General's declaration. Please refer also to the replies to 7.45 and 7.48.

Recommendations

7.52. An audit strategy should be established on the basis of a risk analysis, in combination with contractual requirements applying to the implementing organisations as also indicated in the internal audit capability unit's most recent report on EuropeAid's internal control standards (see paragraph 7.21). The Delegations should systematically transmit their audit programmes, the audits performed and their results to the headquarters in Brussels as foreseen from 2004 onwards. This should also include the audits contracted by implementing organisations. The supervision carried out by EuropeAid's headquarters should focus on the information provided by the Delegations which should be verified during headquarters audits of the Delegations (see paragraph 7.18). Audits of implementing organisations launched by headquarters should in principle be limited to projects and programmes the implementation of which is the direct responsibility of headquarters, in other words, the 'non-devolved' activities. Until such a system is fully functioning, the Director General's annual report should reflect this.

7.52. The key elements of the overall strategy were already applied in 2003, including the annual audit plans, methodological tools, training etc. In July 2004 the overall strategy was formalised in a single document. Reporting on audits is now a mandatory part of the external assistance management reports (EAMR) of the Delegations. The introduction of new tools (such as CRIS Audit) will contribute to further improve the flow of information on audit results at central level, notably to feed back the audit strategy and the selection of transactions to be included into the audit plan.

However, the current systems are considered as adequate for the purpose of deriving overall assurance in the context of the Director-General's declaration.

The Commission can agree that in principle audits of devolved activities should be launched by the delegations concerned. However, there is a need for Headquarters to be able to launch audits of devolved activities either as ad hoc audits or for the purpose of supervision.

7.53. The EuropeAid Cooperation Office should more clearly define its overall strategy for supervision and control, by which the function and tasks of the services at headquarters and the Delegation should be clarified (see paragraph 7.23). In this context the management information system should be further developed to facilitate the supervision and control (see paragraphs 7.14, 7.15 and 7.46).

7.53. The Commission agrees that it would be useful to formalise and consolidate its overall strategy in a single document.

Regarding the management information system the Commission will work on further developing CRIS (see reply to 7.17).
ANNEX

(a) Court’s assessment of supervisory systems and controls in 2003

<table>
<thead>
<tr>
<th></th>
<th>Humanitarian Aid Office</th>
<th>EuropeAid Cooperation Office</th>
<th>Delegations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall concept</td>
<td>A</td>
<td>B</td>
<td>—</td>
</tr>
<tr>
<td>Procedures and manuals</td>
<td>A</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>Functioning in practice</td>
<td>A</td>
<td>B (?)</td>
<td>B (?)</td>
</tr>
<tr>
<td>Internal audits</td>
<td>B (?)</td>
<td>B (?)</td>
<td>B (?)</td>
</tr>
<tr>
<td>Management reporting</td>
<td>A</td>
<td>B (?)</td>
<td>B</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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Quality of audits</td>
<td>A</td>
</tr>
<tr>
<td>Quantity of audits</td>
<td>B (?)</td>
</tr>
<tr>
<td>Definition of terms of reference</td>
<td>B (?)</td>
</tr>
<tr>
<td>Commission’s involvement in appointing auditors</td>
<td>B (?)</td>
</tr>
<tr>
<td>Inclusion of tender procedures in the audit scope</td>
<td>B (?)</td>
</tr>
<tr>
<td>Reporting of results of review of accounting system</td>
<td>C</td>
</tr>
<tr>
<td>Evidence of follow-up</td>
<td>B</td>
</tr>
</tbody>
</table>

(1) Nevertheless the number of audits increased as compared to 2002.
(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>
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</table>
### (c) Key areas followed up by the Court of Auditors in 2003

<table>
<thead>
<tr>
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<th>EuropeAid Cooperation Office</th>
<th>Delegations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Execution risk analysis</td>
<td>Carried out analysis as in previous years</td>
<td>Carried out the risk analysis as in previous years as well as the specific risk analysis outstanding in 2002 (Action Plan, action No 2)</td>
<td>—</td>
</tr>
<tr>
<td>Reporting systems</td>
<td>Maintained good standards.</td>
<td>Reporting systems are improving as compared to 2002, but need further development</td>
<td>Delegations report regularly</td>
</tr>
<tr>
<td>Execution 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>
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CHAPTER 8

Pre-accession aid

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INTRODUCTION

8.1. This chapter deals with the pre-accession aid for countries preparing for accession to the European Union. Heading 7 of the Financial Perspective contains the appropriations for the pre-accession instruments (Phare, ISPA and Sapard) for the 10 Central and Eastern European candidate countries, eight of which became Member States on 1 May 2004 (\(^1\)), and pre-accession assistance programmes for the three Mediterranean candidate countries (\(^2\)).

— The Phare programme (\(^3\)), implemented by the Directorate-General for Enlargement, provides support for institution-building and investment.

— ISPA (\(^4\)), implemented by the Directorate-General for Regional Policy, has been set up to facilitate accession in the fields of environment and transport

— Sapard (\(^5\)), implemented by the Directorate-General for Agriculture, has a similar objective in the field of agriculture and rural development.

*Graphs 8.1 and 8.2* show a breakdown of the funds committed (€3 393 million euro) and spent (€2 240 million euro) in 2003 (see paragraphs 2.42-2.46 for observations on the budgetary management).

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\(^{1}\) The Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia, Slovakia, Bulgaria and Romania. On 1 May 2004 these countries, with the exception of Bulgaria and Romania, became Member States of the European Union.

\(^{2}\) Cyprus and Malta (which became Member States of the European Union on 1 May 2004) and Turkey. These assistance programmes were relatively insignificant in terms of payments in 2003.


\(^{4}\) Instrument for Structural Policies for Pre-Accession, Council Regulation (EC) No 1267/1999. For the countries becoming Member States on 1 May 2004 this instrument is transformed into the Cohesion Fund.

Graph 8.1 - Breakdown of commitments by budgetary area in 2003

Total commitments: 3 393 million euro

- Phare: 50%
- ISPA: 13%
- Sapard: 17%

NB: for more detailed information see Diagrams III and IV of Annex I.
Source: 2003 annual accounts.

Graph 8.2 — Breakdown of payments by budgetary area in 2003

Total payments: 2 240 million euro

- Phare: 69%
- ISPA: 19%
- Sapard: 12%

NB: for more detailed information see Diagrams III and IV of Annex I.
Source: 2003 annual accounts.
8.2. The overall objective of the specific assessment of pre-accession aid for the year 2003 was to contribute to the establishment of the Court’s Statement of Assurance through a conclusion on the legality and regularity of the transactions recorded under Heading 7 of the Financial Perspective (6). The audit comprised an appraisal of the supervisory systems and controls (including reviews of audits carried out by the Commission or on its behalf, and/or of the resulting audit reports), tests of transactions and a review of the Annual Activity Reports of the Directors General concerned. The audit was carried out at the Commission’s central services in Brussels and at Commission Delegations and national authorities in nine candidate countries (7). Most of the work on Sapard was carried out as part of the integrated Sapard audit undertaken in 2003 (8).

8.3. The bulk of the Phare funds are disbursed through contracts concluded and payments made by Implementing Agencies in the candidate countries. Other contracts are concluded and managed directly by the Directorate-General for Enlargement in Brussels (centralised management) or by the Commission Delegations in the candidate countries (devolved management).

8.4. In late 2000 the Commission launched the concept of a fully decentralised implementation system for Phare (as well as for ISPA — see paragraph 8.9) — known as the Extended Decentralised Implementation System (EDIS). Under EDIS the Commission will waive the ex ante control of tendering and contracting by its Delegations, which continued in 2003 to constitute an essential element of the control system. The Commission will decide on full decentralisation on an agency by agency basis, following an analysis of the capacity of the Implementing Agencies.

8.4. The possibility of moving to a fully decentralised implementation system was provided for in the Coordination Regulation ((EC) No 1266/1999) but no legal regulatory requirement to actually do so was stipulated. However, in order to encourage the candidate countries, in late 2000 the Commission launched a working document elaborating the concept of a fully decentralised implementation system for Phare (see reply of the Commission to point 8.9) — known as the Extended Decentralised Implementation System (EDIS).

(6) Excluding the programmes for the Mediterranean countries.
(8) The key observations from this audit are presented in paragraphs 8.45 to 8.53.
8.5. The EDIS process has been further delayed (9). No EDIS accreditations were granted in 2003. By the end of 2003 only six countries (10) had submitted applications. The major delay has been caused by the slow implementation of the public sector internal control reforms in the candidate countries as well as the fact that the Commission was initially late in setting sufficient pressure.

8.6. The process of preparing for EDIS in the candidate countries has strengthened the systems in place in 2003 for the management of Phare funds. However, the Commission’s verification audits in late 2003 and early 2004 found some weaknesses in these national systems, such as not yet finalised operational agreements between the Central Finance and Contracting Unit (CFCU) and line ministries, lack of staff resources and training, and manuals not yet adopted.

Co-Financing

8.7. The Phare Guidelines (11) for the implementation of the Phare programme lay down a minimum of 25% co-financing from national funds for investment projects committed from 2000 onwards. The following improvements have been made in the systems for monitoring and controlling co-financing from 2003 onwards:

a) the National Funds (12) have to report on the co-financing situation each time they send a request for funds to the Directorate-General for Enlargement;

b) the terms of reference for external auditors performing closure audits require them to examine whether procedures are in place to monitor co-financing and whether applicable co-financing conditions have been complied with.

8.5. There was no formal legal requirement regarding EDIS until the Commission inserted Article 33 in the Act of Accession in order to impose it. Consequently, prior to this juncture, beyond the substantial encouragement, guidance and assistance proactively provided by the Commission, it is not clear what level of additional pressure could have been imposed on the sovereign accession countries that would have accelerated the process.

8.6. The Commission has required that the candidate countries resolve the most important system weaknesses identified in the verification audits prior to a Commission EDIS accreditation decision. The accreditation decision itself then requires that further systems improvements should be made within specific timeframes to deal with other weaknesses identified in the verification audits. In fact the first six such accreditation decisions have already been taken and the remaining four are anticipated before the end of 2004.

8.7. Co-financing is monitored during implementation. However, in a decentralised environment, assurance of absolute compliance with many requirements, not only co-financing, can only be obtained when closure audits are carried out.

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(9) See Annual Report concerning the financial year 2002, paragraph 8.4.
(10) The Czech Republic, Latvia, Lithuania, Hungary, Slovenia and Slovakia.
(11) SEC(1999) 1596. These guidelines are binding since they are referred to in Article 8 of Council Regulation (EEC) No 3906/89 and are part of the Financing Memorandum concluded between the Commission and the candidate country concerned.
(12) 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.
THE COURT’S OBSERVATIONS

However, several Implementing Agencies do not verify that parallel (13) co-financing declared by national authorities represents incurred expenditure complying with the requirements of the Financing Memorandum for the Phare programme concerned. While it is the duty of the joint and sector monitoring committees to monitor the co-financing, it remains unclear whether recipients have complied with the parallel co-financing requirements, until the final declarations of expenditure are made by the National Authorising Officers and closure audits are carried out.

8.8. Unlike for Structural Funds, the Commission has not laid down a clear set of rules to define eligibility for Phare parallel co-financing. This has sometimes led to situations whereby the national co-financing has consisted of expenditure incurred prior to the signing of the Financing Memorandum, and national co-financing being provided so late that the projects concerned were delayed.

(13) Parallel co-financing implies that the partners finance different project elements, possibly at different times, and related payments are separately made. The other form is joint co-financing, which implies that each project element is simultaneously co-financed and payments are made simultaneously by the partners.

THE COMMISSION’S REPLIES

8.8. Indeed, the possibility for parallel co-financing for Phare allowed candidate countries greater flexibility than the structural funds on eligibility in meeting their co-financing obligations. This was at a time when the financial cost of preparing for accession was a considerable burden for these transition economies. The Commission considers that the situations mentioned were exceptional and not systemic. Moreover, as of 2002 the Phare Programming Guide made joint co-financing mandatory except in duly justified instances and joint co-financing has the same eligibility rules as Phare.

ISPA

Systems in the candidate countries

8.9. The ISPA Regulation (14) prescribes that candidate countries should have established, by no later than 1 January 2002, an adequate management and control system (15). In 2003 ISPA was being implemented through a system whereby procurement documents are checked in advance (ex ante approval) by the Commission Delegations in these countries. As for Phare (see paragraph 8.4) the Commission could waive this requirement on the introduction of EDIS. Meeting the minimum criteria under EDIS would have ensured compliance with the management and control system requirements of the ISPA Regulation.

8.9. EDIS accreditation would have ensured compliance with the management and control system requirement for ISPA, but was not the only means of meeting this requirement: it was and, unlike the case with Phare (see reply of the Commission to point 8.4), remained optional. With Commission support the candidate countries were making progress in improving their systems for ISPA throughout the implementation period independently of EDIS. In the meantime, the ex ante approval of procurement documents by delegations reduced the risk to EU funds.


(15) As Community regulations are not directly applicable in candidate countries these requirements were included in Annex III to the Financing Memorandum. A Financing Memorandum is signed for each project following the Commission Decision.
8.10. Although it is the responsibility of the candidate countries to set up systems that comply with the ISPA requirements, the Commission did not take sufficient measures to ensure that these requirements were respected by the candidate countries within the time limits. At 31 December 2003, two years after the deadline, no country had achieved compliance with the minimum system requirements for all the national authorities and bodies involved in the management of ISPA (16). Ensuring that reliable internal control systems were set up would have reduced the risk resulting from the removal of the EC Delegations’ ex ante control by the time of accession, when such systems are to be used in the management of the Structural and Cohesion Funds.

8.10. As well as laying down the requirements in the Financing Memorandum attached to each aid award decision, the Commission provided extensive support and guidance and from 2001 onwards audited the systems, taking care to ensure that any deficiencies found were corrected. Before accession a number of implementing bodies in several accession countries achieved EDIS accreditation and the audit work confirmed that many of the bodies met the requirements.

8.11. Notwithstanding the above, the countries made significant efforts to create management structures where they previously did not exist and at the same time to attempt to establish the necessary internal control mechanisms for the effective and transparent management of ISPA funds. However, at the time of the Court’s audit in early 2004 some of these had only recently been set up. Thus, although they appear to be conceptually sound, it is too early to determine whether they are also functioning properly.

8.11. The Commission has audited the operation of the systems for managing ISPA/Cohesion Fund projects. For the Structural Funds it plans to start doing so in 2005 after first assessing the new systems’ compliance with the requirements of the regulations. It is also monitoring the audit work done by the new Member States themselves.

8.12. A common concern for the majority of the bodies visited were the difficulties they were facing in attracting and keeping qualified personnel. Staff were often recruited without the specific experience required. Both the Commission and the candidate countries recognise that there is a need for a continuous programme of human resources development and training. In addition, national structures are often heavily dependent on outsourcing work to foreign experts for project preparation and management. Action plans which further develop the national structures in order eventually to minimise this dependence have not yet been implemented.

8.12. Full complements of staff and adequate training were among the matters the Commission emphasised in the run-up to accession. It is looking closely at the new Member States’ plans in these areas during its scrutiny of their systems. In many of the new Member States the problem of attracting and keeping qualified staff is exacerbated by relative pay levels between the public and private sectors. For ISPA projects, because of the inexperience of national administrations, there was often no alternative but to outsource some of the work to consultants. The implementation of ISPA in itself provided for valuable learning by doing experience since the pre-accession instrument is closely modelled on the Cohesion Fund. Technical assistance funds under ISPA were also intensively used to support training and know-how transfer.

(16) Only for the transport sector in Estonia and the road sectors in Hungary and Lithuania did the Directorate-General for Regional Policy consider it appropriate to start the formal validation procedure for granting EDIS.
THE COURT’S OBSERVATIONS

The ex ante control of the EC Delegations

8.13. Obliged to perform ex ante controls, the EC Delegations were significantly involved at each stage of the tendering and contracting process. The significant number of anomalies detected by the EC Delegations (17) show that the ex ante approval of the EC Delegation thus far has been an indispensable element of control in the procurement process.

8.14. In general, there was an improvement in 2003 in the way the EC Delegations documented their work. Checklists were introduced and notes were in most cases kept in the files examined clearly describing the issues raised during the ex ante control. In addition, it was notable that the EC Delegations have a heavy work load which they carry out under significant time pressure. Nevertheless, the Court noted:

a) in some cases a lack of documentation describing the work performed, the issues raised and how these issues had been resolved (18);

b) often, the provision of ex ante approval had taken too long. The main cause of delays was the poor quality of the documentation submitted during the tender process. In some cases though, it was also due to resource constraints in the Delegations;

c) the approval by the EC Delegation of the evaluation reports on two different tenders at approximately the same period of time, although in one case the Evaluation Committee rejected a tender on the grounds of the nationality of the contract manager and in the other the same contract manager was accepted.

Sapard

8.15. In the Sapard countries, accredited paying agencies reimburse expenditure incurred by beneficiaries. The paying agencies receive these funds through a central treasury fund (National Fund).

THE COMMISSION’S REPLIES

a) Following the Court’s audits the Delegations have introduced stricter requirements for recording the work performed and how issues were resolved.

c) The initial approval of the two reports by the EC Delegation did not affect the outcome of the tender process, as in the first case the Delegation ordered a re-evaluation by a new evaluation committee and a different firm was selected.

(17) Tender dossiers had to be resubmitted a number of times (in one case seven times) prior to their approval and in 3 out of the 12 tendering procedures examined, the evaluation reports were not endorsed by the EC Delegation, and the evaluation had to be repeated.

(18) Not all the official correspondence exchanged as a result of the examination of the different versions of the tender dossiers, submitted to the Delegations for approval, were filed.
8.16. In accordance with the international agreements (19) signed between the Commission and the Sapard countries, each of the countries is required to provide the Commission annually with a certificate on the accounts and an audit report by a certifying body. Based on a review of the seven available reports by certifying bodies, and discussions with their representatives in the four Sapard countries visited, the Court found that these audits provide the Commission with reasonable assurance as to the legality and regularity of the expenditure. However, the three remaining reports could not be reviewed by the Court because they were not received by the Commission before the deadline (30 April 2004).

8.16. Since the Court’s audit the three remaining audit certificates and reports have been received and reviewed by the Commission.

8.17. The Court also reviewed the procedure descriptions and checklists used by the Sapard paying agencies and checked a number of files to test that the systems in candidate countries were working as documented. Notwithstanding the errors found by the Court (see paragraph 8.33), the Sapard systems included the key concepts, procedures were well documented, and the systems as described on paper were generally working in practice.

Audits by the Commission or on its behalf

Phare

Commission systems audits

8.18. The decentralised system of management was introduced in the candidate countries without any systems audits at that time. In order to rectify this, a programme of systems assessments was launched by the Directorate-General for Enlargement. Only a limited number of audits were performed before the resources were fully directed towards completing the EDIS process. This meant that the systems audits could not contribute to the Commission’s assurance as to whether the decentralised system of management was producing transactions that were free of material errors in terms of reality, legality and regularity.

8.18. The decentralised system of management (DIS) was introduced without any systems audits because there was no legal requirement under the old Financial Regulation to do so. Due to the nature of the EDIS process it was only possible to undertake a limited number of systems audits before 2002. This was explained in detail in DG Enlargement’s reservations in its 2002 and 2003 annual declarations. Under the new financial regulation the Commission carried out systems audits prior to decentralisation in Turkey and will apply this approach in all new beneficiary countries.

Closure audits

8.19. In 2001, the Directorate-General for Enlargement adopted a strategy to contract external auditors to carry out closure audits on a risk-based sample covering some 60% of the value of the Phare programmes up to and including the programme year 1999.

8.20. By April 2004, 86 closure audits launched by Head Quarterers covering programmes amounting to a total of 971 million euro had been performed. A further 56 audits were launched by Delegations. The total of 142 closure audits cover approximately 42% of the total value of the Phare programmes up to and including the programming year 1999. By April 2004, 63 closure audit reports (excluding audits launched by the Delegations and previous services) covering programmes amounting to 761 million euro had been approved by the Directorate-General for Enlargement. By March 2004, the Commission had issued recovery orders for 1,9 million euro (20).

8.21. Based on its detailed examination of nine audit reports selected at random and further information available at the Commission the Court concluded as follows:

a) Four of the closure audit reports examined were not delivered on time. This was caused by difficulties in obtaining information from the beneficiaries and lack of resources in the Directorate-General for Enlargement;

b) The closure audits were generally of good quality and revealed a number of financial findings, such as payments including VAT, payments made after the disbursement deadline and shortcomings in the procedures for awarding contracts. In some cases original supporting documents could not be found. However, not all of these financial findings lead to amounts which can and should be recovered.

Audits by National Funds in candidate countries

8.22. According to the Memoranda of Understanding between the Commission and the National Fund in each candidate country, the National Funds have an obligation annually to report on planned audits and to summarise audit findings. However, for 2003 the Commission has not used the summaries of findings for the purpose of deriving assurance concerning the legality and regularity of Phare transactions.

ISPA

Commission systems audits

8.23. The Directorate-General for Regional Policy carried out audits in all ISPA candidate countries in 2003 and at the beginning of 2004. The main objectives of the audits were to assess to what extent the candidate countries had established management and control systems complying with regulatory requirements (21) and to follow up and monitor the progress made towards EDIS.

(20) The figures are as reported by the Directorate-General for Enlargement.
8.24. The objective of the Court's work was to examine the extent to which the Directorate-General for Regional Policy had carried out its work in an effective manner. The work mainly included a follow-up of the findings reported in Chapter 8 (ISPA part) of the 2002 Annual Report (22).

8.25. There has been a notable improvement compared to last year in the audit planning document and in the audit checklists used. However, the checklists used for EDIS need to be expanded in order to address better the functioning of the internal control systems.

8.25. The EDIS checklists were devised at a time when the systems in many of the candidate countries were at an early stage of operation. The limited testing of the internal control systems was due to the fact that in several areas the systems had not operated long enough for conclusions to be drawn. The Commission intends to review the set of checklists on this point in 2004.

8.26. Although there has been an improvement compared to last year, in some cases the audit work carried out was not adequately documented; and in one out of the three audits examined the applicable audit checklists were only partly filled in. In these instances it was therefore not possible to determine whether:

i) the audit work was thorough and complete, and

ii) all significant findings had been included in the audit report.

8.26. The Commission agrees, that there is room for improvement in the referencing between the observations in the audit report and the audit work performed. The Commission is making efforts to standardise audit methodologies for areas of the budget under shared management. In the case specifically referred to by the Court, despite the incomplete checklists, the audit report sets out the work done and the reasons for the Commission's findings. It therefore offered a solid basis for the audit opinion.

Sapard

Audits by the Commission

8.27. The Commission undertakes audits at three stages: systems audits before payments are made, compliance audits to review whether systems are operating as intended and clearance of accounts audits at the end of a financial year. In general these audits provided reasonable assurance as to the legality and regularity of the expenditure.

8.28. However, the Court identified shortcomings in the clearance of accounts audits undertaken in 2003. For three of the eight countries where the Commission undertook clearance audits, key documents were not reviewed and approved, and for four others the audit evidence was insufficiently documented.

8.29. The clearance audits form the basis for the Commission's decision to clear the accounts of the Sapard agencies and the Sapard euro bank accounts. The Commission was unable to meet the required deadline and the decision was taken one month late, on 31 October 2003. The decision also cleared the bank balance in Romania, for which no Commission audit was carried out. Checks should have been carried out to confirm the bank balance of 37,6 million euro and the interest received.

8.28. The Commission has ensured that key documents are reviewed but accepts that evidence of verifications made, and of review/supervision, could be improved.

8.29. There are no financial consequences arising from the delay cited by the Court. For Romania, as there was no expenditure during 2002, the Commission reviewed the certification report sent by the national authorities (Romanian Court of Auditors). This report contained a section on the confirmation of the Sapard euro account. This was considered sufficient by the Commission in order to take its decision.

(22) Annual Report concerning the financial year 2002, paragraphs 8.14 to 8.22.
THE COURT’S OBSERVATIONS

Tests of transactions

Phare payments

8.30. The Court’s audit in candidate countries of 39 Phare (23) payments made by the Implementing Agencies (out of a total sample of 76 (24)) revealed seven errors. These errors, mostly of a formal nature, included an early release of retention funds, advances on a contract above the level permitted, problems with recording time spent on service contracts and two small amounts of ineligible expenditure. Furthermore, in two cases the Court could not obtain evidence confirming that declared parallel co-financing represented incurred expenditure complying with the requirements of the relevant Financing Memorandum (see paragraph 8.7).

8.30. The Commission is of the opinion that in two of the seven cases, the release of the retention funds and the payment of the advances, the reported formal errors are a matter of judgement. In any case, the errors detected regarding ineligible expenditure are so small that they cannot be considered material.

ISPA payments

8.31. The audit of a sample of 17 ISPA payments revealed a high frequency of errors (14 in 13 payments). Seven cases related to failure to observe regulatory provisions relating to the tendering and contracting procedures (two of which could have had a significant effect on the outcome of the tenders concerned); three cases related to failure to observe the regulatory requirement for carrying out an environmental impact assessment before a project is approved; in two cases the rate of assistance did not adequately take into account the project’s potential to generate income and; in two cases ineligible expenditure relating to the purchase of machinery and equipment was declared to the Commission.

8.31. A number of the errors reported by the Court do not have a financial impact and are of a formal nature.

With regard to tendering and contracting procedures (seven errors), the Commission agrees that the regulatory provisions must be complied with and is committed to a transparent evaluation of bids and proper documentation. However, it does not consider five of the alleged errors material.

As regards environmental impact assessments (three errors noted), although the Commission allowed in some cases this requirement to be completed after submission of the application (for example, as already stated by the Commission at point 8.44 of the Court's Annual Report for 2002, in cases where design and build contracts are used it is simply not possible to carry out a full EIA before the project is submitted for approval), it ensured that EIA procedures had been fully complied with before actual work commenced.

The Commission considers that the rates of assistance decided in the cases to which the Court refers (two errors) were appropriate, having regard to all relevant considerations including potential revenue and the affordability for the population served. It recognises, however, that scope exists for standardising the methods for determining co-financing rates and is working in this direction.

The Commission accepts the two errors concerning ineligible expenditure and has taken steps to correct the declarations concerned.

(23) Tendering and contracting procedures were examined only for those payments (13) made under the relatively new Economic and Social Cohesion grant scheme. A wider examination of tendering and contracting procedures was carried out for the Statement of Assurance audit of 2002. See Annual Report concerning the financial year 2002, paragraphs 8.38 to 8.43.

(24) The remaining payments, which were audited at the level of Commission and the European Bank for Reconstruction and Development, revealed no errors.
8.32. In addition, the rules (25) prescribe that except in duly justified cases, assistance granted to a measure where substantial work has not begun within two years from the date of signature by the Commission shall be cancelled (which may be considered unrealistic, particularly in the case of large infrastructure projects). The Commission decided to accept the launch of the first works tender as evidence of the start of substantial work in the case of infrastructure projects. In the Court’s view this interpretation is not in line with the intention of the ISPA Regulation.

8.32. As the Court itself notes, for large infrastructure projects, a two-year deadline after grant approval for starting the works can be unrealistic. The Commission therefore considers that the launch of a works tender is a sufficient assurance that projects will be implemented on schedule.

Sapard payments

8.33. The audit reviewed a sample of 26 payments made in 2003 and covering the main measures implemented at the time of the audit. A high number of errors was found in 13 payments, for which the main explanation is that staff in Sapard countries were still inexperienced. The errors relate to non-compliance with procedures (26) (10 cases), financing of VAT (4 cases, see below) and non-observance of the requirement to meet EU hygiene standards (3 cases).

8.33. The Commission will examine the impact of VAT once the programme has been completed. An assessment will be made in the framework of the clearance of accounts procedure, and the appropriate conclusions will be drawn. However, it does not consider that, at this stage, the VAT identified is ineligible for financing.

8.34. Four of the payments reviewed concern the measure for the ‘development and improvement of rural infrastructure’ in Poland. All four payments included VAT which, in the Court’s opinion, is ineligible (27). Although the ineligible amount in the sample is small (around 11 500 euro), the charging of VAT to Sapard is done systematically in Poland. The total amount of payments made to

8.34. As far as VAT is concerned, the Court of Auditors raises two different issues. VAT is eligible for EU co-financing if it is irrecoverable, in exactly the same way as for Structural Fund expenditure. The only difference is that, under Sapard, it should, as an additional criterion, not bear disproportionately on any part of the programme. It is too early to assess whether this is the case.


(26) In three cases, the requirement that the expenditure should have been incurred was not complied with because Sapard payments were made against unpaid invoices; in three cases the procedure for private procurement to submit three bids for each item costing more than 10 000 euro was not respected; in two cases the limit of public aid stipulated in the Sapard programme was exceeded; and in two cases the approval procedure for checklists was not followed.

THE COURT’S OBSERVATIONS

beneficiaries in Poland booked by the Commission in its 2003 accounts is 79.6 million euro, and the VAT included in this is estimated by the Court to be 4.0 million euro, which represents 1.5% of all Sapard payments made by the Commission in 2003 (including advance payments). In April 2004 the Polish National Authorising Officer informed the Director-General for Agriculture that the certifying body would give an adverse opinion on the 2003 accounts because of another issue related to the eligibility of VAT.

The Commission will examine the impact of VAT once the programme has been completed. An assessment will be made in the framework of the clearance of accounts procedure, and the appropriate conclusions will be drawn.

Regarding the issue raised by the Polish National Authorising officer, the Commission is addressing this with the Polish Authorities.

Annual Activity Reports

The Directorate-General for Enlargement

8.35. In his Declaration in the Annual Activity Report, the Director-General for Enlargement, as in 2002, makes the following reservations concerning the control procedures put in place to give the necessary guarantees concerning the legality and regularity of the underlying transactions:

a) there is an inherent risk in the decentralised systems;

b) there are gaps in systems and transaction audits; and

c) there are uncertainties regarding claims on financial intermediaries.

8.36. The problem of co-financing is mentioned in the Report in the context of management and internal control systems. There is weak control of parallel co-financing (see also paragraph 8.7) and there is a risk that co-financing requirements are not being met by the candidate countries. The Court considers that this problem seems important enough to merit a reservation in the Declaration in the 2003 Annual Activity Report.

8.36. The control of parallel co-financing at the beneficiary level should be improved by the implementing agencies and while there is indeed a risk of co-financing requirements not being met there is only a limited risk of this being undetected and of remedial actions not being taken. Nevertheless, the Commission will further consider a reservation as this issue matures and in the light of developments.

The Directorate-General for Regional Policy

8.37. The Director-General’s Declaration in the 2003 Annual Activity Report for the Directorate-General for Regional Policy includes the reservation concerning ISPA that he does not have reasonable assurance that the candidate countries effectively operate all the key elements of the management and control systems in accordance with the provisions in Regulation (EC) No 1267/1999, with the exception of the bodies for which the Commission is taking an EDIS decision in three candidate countries and for one other candidate country as a whole (Slovenia).
8.38. Although weaknesses revealed by the Commission’s audits are mentioned in section 4.1.3 of the report, it would have been more useful if the Report had included a detailed analysis by candidate country of the elements which needed to be completed in order for the provisions of the Regulation to be complied with. This would have demonstrated the Commission’s exposure to risk in this area. In addition, although Slovenia was exempt from the general reservation on ISPA, it should be noted that the audit of the Directorate-General for Regional Policy did not include an examination of the tendering and contracting systems, so this exemption should not be understood as full compliance with the requirements of Article 9(1).

8.38. Section 4.1.3 of DG REGIO’s Annual Activity Report 2003 summarises the material shortcomings identified in the audit work during 2003 in the accession and candidate countries and thereby justifies the reserves entered by the Director-General. The same approach was used in justifying the reserves for Member States concerned in relation to their management of ERDF and the Cohesion Fund. As far as Slovenia is concerned, the Commission agrees with the Court’s observation. The scope of DG REGIO’s audit of procurement procedures was limited, due to the ex ante controls carried out by the EC Delegation.

The Directorate-General for Agriculture

8.39. No reservations relating to Sapard have been included in the Directorate-General for Agriculture’s 2003 Annual Activity Report. The Court considers that this is correct, because the errors identified are below the Commission’s materiality threshold. However, the Director-General should have included a comment on this issue in the annual activity report, since the Court reported on the problem of VAT in Poland to the Commission in December 2003 and he had no information on the extent of this problem in the other Sapard countries.

8.39. DG AGRI did not refer to the VAT issue in Poland in the Annual Activity Report (AAR) because it does not consider, based on expenditure levels so far, that the financing of VAT in that country has a disproportionate effect on the Sapard programme and is thus ineligible under MAFA rules. Furthermore, in the interests of brevity and clarity, control issues which are not considered to have a material impact on the declaration are generally not mentioned in the AAR.

Conclusions

8.40. In its 2002 Annual Report (28) the Court concluded that the supervisory systems and controls in the area of pre-accession aid needed strengthening. Although progress has been achieved by both the Commission and in the candidate countries in certain areas, further efforts need to be made. The number of errors detected during the Court’s audit of transactions in 2003 indicated system weaknesses and the need to further improve the supervisory systems and controls in order to limit the risk of irregular payments.

8.40. A number of the errors reported by the Court do not have a financial impact and are of a formal nature.

The Commission is aware of the need for further improvement in the management and control systems in the new Member States and the accession countries. It continues to support these improvements, inter alia, through its own audit work.

8.41. In the case of Phare supervisory systems and controls:

— weaknesses were identified by the Commission’s verification audits which mean that EDIS accreditation has been delayed;

— there was inadequate control of parallel co-financing by candidate countries; and

— in addition to the gaps in the Commission’s audits mentioned in the Director-General’s Statement, approval of final closure audit reports was too slow.

8.41. By the end of September 2004 six countries have been accredited and the rest are in advance stages of the process.

Finalisation of the audit reports could be speeded up. However, this partly depends on the resources allocated to the Directorate-General and partly on the time taken by the beneficiaries to reply to queries from the auditors.

(28) See Annual Report concerning the financial year 2002, paragraph 8.45.
THE COURT’S OBSERVATIONS

8.42. In the case of ISPA, although the countries made significant efforts to create management structures and put in place internal control mechanisms, at 31 December 2003 no country had achieved compliance with the minimum system requirements for all the national authorities and bodies involved in the management of ISPA. In addition, the Commission did not take sufficient measures to ensure that the regulatory requirements were respected by the candidate countries within the time limits. The ex ante approval by the EC Delegation was an indispensable element of control in the procurement process, and its removal following accession means that the tendering and contracting procedures would become a high-risk area.

8.42. Before accession a number of implementing bodies in several accession countries had achieved EDIS accreditation and many of the bodies in the countries were considered to meet the requirements. As well as laying down the requirements in the Financing Memorandum attached to each aid award decision, the Commission had provided extensive support and guidance and from 2001 onwards had been auditing the systems and taking care to ensure that any deficiencies found were corrected. EDIS accreditation was not the only means of meeting the requirement for effective management and control systems for ISPA.

8.43. In the case of Sapard, except for the weaknesses identified in the Commission’s clearance audits and the high frequency of errors found in Sapard countries, the supervisory systems and controls generally worked in practice.

8.43. The Commission has ensured that key documents are reviewed but accepts that evidence of verifications made, and of review/supervision, could be improved.

The errors identified by the Court will be followed up as necessary.

Recommendations

8.44. The Court recommends that:

— concerning Phare, the Commission should:

a) do all in its power to ensure that the weaknesses in systems in candidate countries revealed by its verification audits are addressed;

b) take measures to ensure that Implementing Agencies verify co-financing at the time of declaration;

c) speed up the finalisation of closure audit reports; and

d) assess whether or how the audits carried out by National Funds in candidate countries could be utilized for the purpose of deriving assurance concerning the legality and regularity of Phare transactions.

— concerning ISPA, the Commission should:

a) continue its systems audits, so as to ensure that reliable systems have been created for the management of the Structural and Cohesion Funds;

b) assess the extent to which the audits carried out by National Funds in candidate countries could be utilized for the purpose of deriving assurance concerning the legality and regularity of ISPA transactions.

THE COMMISSION’S REPLIES

8.44. Concerning Phare:

a) This is already being addressed, inter alia, through the EDIS process. See reply to point 8.6.

b) This is already being addressed, inter alia, through the EDIS process.

c) The audit strategy of DG REGIO provides for continued system audits in which special attention will be given to compliance of the systems with the requirements of the Structural and Cohesion Funds.
b) for the two countries which will carry on benefiting from ISPA (29), set a specific timetable, with milestones, to ensure that the management and control requirements of the Regulation are observed in due time before their accession; and

b) Following the system audit carried out in Romania in 2003 and several meetings with the Romanian authorities in early 2004, an action plan has been agreed in which the specific recommendations of the Commission relating to identified deficiencies in the management and control systems will be addressed according to a specific timetable. A similar approach is being followed for Bulgaria.

c) intensify its ex post audits of projects to take account of the removal upon accession of the ex ante control of tendering and contracting procedures by the EC Delegations.

c) The audit strategy of DG REGIO includes ex post audits of ISPA/Cohesion Fund projects covering tendering and contracting procedures and giving priority to projects where interim payment claims have been submitted.

— concerning Sapard, for the clearance of accounts audits that are to be undertaken in 2004, the Commission should:

a) remedy the weaknesses identified by the Court;

a) The Commission will further improve its evidence of verifications made, and of review/supervision.

b) ensure that audits are carried out for all countries for which amounts are cleared in its decision and;

b) A systematic audit programme has been carried out in 2004. This programme includes a mixture of desk audits and controls on-the-spot, as appropriate.

c) take appropriate action to recover the ineligible VAT.

c) As stated in its reply to point 8.33 the Commission will examine the impact of VAT once the programme has been completed. However, it does not consider that, at this stage, the VAT identified is ineligible for financing.

PRINCIPAL OBSERVATIONS IN SPECIAL REPORTS

Special Report No 2/2004 ‘Has Sapard been well managed?’

8.45. The Special Accession Programme for Agriculture and Rural Development (Sapard) is the first external aid programme which is implemented in a decentralised manner. The objectives of the programme (30) are to contribute to the implementation of the Community acquis and to solve problems for the adaptation of the agricultural sector and rural areas in the 10 countries which benefit from Sapard aid (31). In 2003, the Court performed an audit which aimed at answering the question: ‘Has Sapard been well managed?’

(29) Bulgaria and Romania.


(31) These 10 countries are: The Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia, Slovakia, Bulgaria and Romania.
8.46. The audit found that management has been of mixed quality. The Commission’s decentralized management for Sapard did not guarantee that implementation problems were actively and systematically identified and followed up and that best practices were applied in all the Sapard countries. This is because the Commission views its responsibility under a system of decentralised management as monitoring the implementation of Sapard.

8.46. The Court concluded that the Commission’s option for decentralised implementation was correct given the likely large numbers of projects to be financed. According to the Commission, a key feature of the system set up is that the countries concerned first identify problems. In such instances the Commission has consistently provided guidance and advice to the Sapard countries.

The Commission considers that it has allocated a sufficient number of qualified staff, in the Sapard unit as well as in the services responsible for overseeing the accreditation process and carrying out audits, to ensure proper monitoring and financial management and control of the use of Community funds in the Sapard countries.

8.47. There were substantial delays in getting Sapard underway, some of which were caused by a failure on the part of the Commission to plan as early as possible and, since the start of Sapard in the countries concerned, by overly heavy administrative procedures. Consequently, budgets were systematically over-estimated and large proportions of available funds remained unused. In the first four years of implementation, only 323 million euro (14.8%) of the available budget of 2 183 million euro was paid to final beneficiaries, more than half of which was paid in the last quarter of 2003. As a consequence of the delays and implementation problems, the main objectives have not been achieved in the pre-accession period.

8.47. While the main elements of the Commission’s proposal on the Sapard Regulation, (EC) No 1268/1999, were maintained, the text of the proposal was subject to ongoing discussions (including discussions on budget headings) until the final stage of adoption of the Sapard Regulation. As long as the legal uncertainty remained the Commission was not in a position to draw up the final legal provisions for the implementing arrangements. Following adoption of the Regulation, a working group prepared the basic provisions for the financial management of Sapard within a few months. These were adopted by the Commission on 26 January 2000.

Whenever it was made aware of ‘heavy administrative procedures’, the Commission advised the countries concerned by correspondence, during bilateral meetings and at the Monitoring Committee meetings. However, the exact procedural choice (subject to respect of MAFA rules) remains with the country concerned.

The Sapard budgets for 2000 to 2004 were drawn up on the basis of the most reliable information available at that time. The sizeable challenges posed by the need to set up an entirely new system, and the lack of experience of the Sapard countries in this area, meant that implementation took time, but in most cases no longer than could be reasonably expected.

Payment applications received indicate that payment execution has now reached cruising speed.

According to the Sapard regulation, the objectives of the programme are to contribute to the implementation of the acquis communautaire concerning the common agricultural policy and related policies, and to solve priority and specific problems for the sustainable adaptation of the agricultural sector and rural areas in the countries.

An essential part of the first objective is to establish a good administrative capacity enabling the demanding tasks of rural development policy implementation to be carried out according to the principles of sound financial management. This is in line with the European Parliament resolution accompanying the 1999 discharge.
8.48. The Commission did not report on how well Sapard achieved the objectives as specified in the Council Regulation, but focused on institution building. This is one of the objectives of the Phare programme and not a specific objective of Sapard. Institution building has been positive, because national administrations were provided with hands-on experience for the management of EU funds after their accession.

8.48. The Commission considers institution building to be one of the fundamental elements of the acquis and a pre-condition for the responsible use of EU funds.

Phare provided assistance to the Sapard countries to set up structures able to implement the acquis, including implementing arrangements for Sapard. Yet the main task of setting up implementation systems to transfer the EU funds was up to the management of Sapard through the procedures of conferral of management and accreditation of measures. The Sapard countries could gain experience from running Sapard to protect the financial interests of the Community after accession, when EAGGF expenditure in the new Member States is expected to be EUR 4 billion in 2005 and rising.

8.49. The first results of completed projects show that the money for agricultural processing has generally been spent on projects which increase the quantity of agricultural production more than on projects which improve its quality (meeting quality and health standards and protection of the environment).

8.49. The Commission considers that increasing production capacity at project level is compatible with improving standards and the need for restructuring to improve market efficiency.

8.50. The audit found that potential beneficiaries lack financial resources, had difficulties in obtaining credit and were faced with heavy administrative procedures. The result of this was that Sapard favoured the financially strong and the better organised with sufficient capital or access to loans. For smaller farms and firms which have the greatest efforts to make in meeting standards, and to modernise and increase efficiency, this was a major handicap.

8.50. The Commission is aware of the problem of lack of own resources and of the difficulties in obtaining credit. To address this issue, the Commission, with the aid of Phare funds, is supporting a project to improve access to credit for SMEs in Sapard countries, which should help widen access to Sapard. This project has recently been extended with a specific subwindow focusing on credit institutions serving farmers and small rural businesses. It also encourages the candidate countries to use national credit schemes as far as they are respecting Community competition rules and aid intensities of the Sapard regulation.

In order to facilitate the application of national credit schemes the Commission in its recent proposal for a modification of Regulation (EC) No 1268/1999 included a specific provision in this respect.

8.51. The rules and the checks for private procurement and for general costs were found to be insufficient. General costs of up to 12 % of total eligible costs may be charged to the project, which at the time of the audit were largely consultants’ fees. The Court’s audit found that there was typically no justification or explanation for the fees charged, and that no checks were made that the costs were in relation to the services provided or indeed that the services were provided in the first place. Effective checks to prevent the acceptance and payment of overstated invoices were not systematically made for private procurement and for general costs.

8.51. Although the Commission has also identified weaknesses in some cases and has made recommendations for improvements, it considers that the situation has improved since the Court’s audit. Where necessary these recommendations will be followed up under the clearance of accounts procedures.
8.52. The audit also found that in one of the countries VAT was systematically being charged as an eligible cost to public bodies. In the Court’s opinion, due to the high amounts involved, this bears disproportionately on parts of the programme, which makes it ineligible under the terms of the international agreements concluded between the Commission and the country concerned (see paragraphs 8.33-8.34).

8.53. The report recommended that the Commission consider whether the practice of prior approval of the systems by the Commission based on audits, which has ensured that good systems were set up in Sapard countries, should be applied more generally.

8.54. Assistance in the preparation of candidate countries for managing the Structural Funds has been an important objective of the Phare programme since 1998. An increasingly high priority has been assigned to this objective by the Commission because it wished to ensure that the countries concerned would be able to benefit fully from the large allocations available to them following accession. The Court carried out an audit to examine how well the Commission had used Phare, the largest pre-accession instrument, to prepare countries for managing the two biggest Structural Funds, the European Regional Development Fund (ERDF) and the European Social Fund (ESF).
8.55. The audit concluded that the Phare programme had had a more limited impact on preparing candidate countries than had been planned in the Commission's policy documents. This was in part due to the inexperience and insufficient institutional development in the candidate countries which could not be fully addressed within the timeframe available before the accession.

8.55. Even if not all initial ambitions were realised within a timeframe reduced by rapid accelerations in the negotiations, this was primarily due to the inherent difficulties and delays in designation of the future institutions responsible for managing Structural Funds. In certain instances, insufficient institutional stability significantly impeded the impact of preparatory pre-accession assistance. Nevertheless, the evidence to date is that the main objectives were indeed realised as reflected in the negotiations themselves and follow-up monitoring reports and in all subsequent programming developments to an extent never achieved before.

8.56. The overall approach followed by the Commission was not as effective as it could have been, partly because a new pre-accession instrument modelled on the ERDF and ESF was not established, whilst the initial approach which the Commission required candidate countries to follow in setting up Phare economic and social cohesion programmes differed from the approach of the Structural Funds.

8.56. No previous enlargement had such extensive preparations for Structural Funds using three pre-accession instruments. Through Phare and the other pre-accession instruments prerequisite planning processes were stimulated and overall planning capacity established. As a result the Council was able to close negotiations on the main Structural Funds related to chapter (21) in 2002 on the basis of legislative alignment and designation of structures, and the accession countries were able to submit draft Structural Funds Development Plans already at the beginning of 2003, thereby ensuring early approval and launch in 2004 of Structural Funds Programming Documents for the 2004 to 2006 period. This has never been achieved before. While not all early ambitions were realised in a timeframe compressed by rapid acceleration in the negotiations, the ESC initiative — among others — had a very significant impact on the negotiations themselves and on institutional developments.

8.57. The Extended Decentralised Implementation System, which was intended to give candidate countries experience before the accession in financial management procedures similar to those in force for the Structural Funds, had not been introduced by May 2004. The delays encountered in introducing a system of ex-post control also made it more difficult to use grant schemes, the main mechanism for implementing the Structural Funds. Furthermore, very little progress was made in introducing multi-annual programming, a procedure employed under the Structural Funds.

8.57. It was foreseen from the outset that extending decentralised management (EDIS) and multiannual programming 'could not start until 2002 at the earliest' (Phare 2000 Review). It transpired that 2002 was the year that negotiation closed and consequently there has been a compression of the timeframe. EDIS is a complex and lengthy process not a one-off event and the countries have been working on this process, for several years. The determining factor for moving to ex post controls is overwhelmingly the acceding countries’ ‘ownership’ of the process to establish their own safe management and control systems.
8.58. Most countries allocated somewhat less than the target figure of 35% of their national programmes to the economic and social cohesion programmes, which were intended to play an important role in preparing them for the ERDF and ESF, mainly due to insufficient absorption capacity and competing priorities. Also, the effectiveness of institution building projects for preparing for the ERDF and ESF was generally reduced by frequent changes in responsibilities for regional development between ministries in candidate countries and delays in designating managing and paying authorities and setting up regional structures.

8.59. There is a significant need for more institution-building support in the areas of managing the Structural Funds after accession. Considerable resources should be devoted to the ex-post control of Structural Fund operations in the new Member States. A clear strategy should be put in place identifying the different steps that still need to be taken for preparing the current and future candidate countries for managing the Structural Funds. The Commission should increase its efforts to bring Phare closer to the Structural Funds by giving future managing authorities the status of Phare implementing agencies, providing the assistance in the framework of an ex-post control system, and introducing multi-annual planning based on National Development Plans.

8.58. Although the objective of allocating approximately 35% of Phare national programmes to ESC was indicative only ‘to be applied with flexibility on a country-by-country basis’ (Phare guidelines Decision 1999), the 2001 to 2003 figures indicate that the average of around 35% has been maintained. The insignificant dip in percentage terms in 2002 due to the action plans on administrative and judicial capacity was fully compensated in 2003 allocations. In 2003, which was beyond the audit period, there was a deliberate focus on ESC. Several countries devoted well over 35% of their 2003 funds to investment in the ESC. The average was 39%. Given that only the first year of ESC (2000 projects) are finishing implementation, the evidence available makes it difficult to base reasonable doubts on absorption capacity on such limited data as well as taking into account the fact that countries had competing priorities in their preparations for accession. In addition, there were both investment and institution-building allocations in other horizontal chapters that had an indirect bearing on preparing for managing Structural Funds.

8.59. After accession the new Member States will continue to receive a great deal of direct support from the Structural Fund Directorates-General to help them manage programmes effectively, just as they have in framing the programmes and designing their delivery and management systems. The new Member States have all set up audit services to fulfil the financial control requirements laid down by Regulation (EC) No 438/2001 and the Commission will monitor their work in the period ahead and will itself test the systems. The lessons learned are already being taken into account and the EDIS roadmaps for Bulgaria and Romania and the revised Phare guidelines already outline the strategy. Designation of implementation agencies is a sovereign decision for the candidate countries themselves and the Commission has no mandate to dictate such a decision. Actually, in the progression of EDIS accreditation, the process is the other way round. Phare implementing agencies, in order not to lose the experience they acquired, should become (or be integrated into) the Structural Funds managing and implementing bodies.
CHAPTER 9

**Administrative expenditure**

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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 (Part A of the budget in the case of the Commission). 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 2003 was 5 305 million euro, as further specified in Table 9.1. The total number of posts assigned to each Institution by the 2003 initial budget is shown in Table 9.2.

Table 9.1 — Payments by Institution

<table>
<thead>
<tr>
<th>Institution</th>
<th>Payments against carry-overs and appropriations for the financial year (million euro)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>European Parliament</td>
<td>1 035</td>
</tr>
<tr>
<td>Council</td>
<td>394</td>
</tr>
<tr>
<td>Commission</td>
<td>3 438</td>
</tr>
<tr>
<td>Court of Justice</td>
<td>145</td>
</tr>
<tr>
<td>Court of Auditors</td>
<td>76</td>
</tr>
<tr>
<td>European Economic and Social Committee</td>
<td>76</td>
</tr>
<tr>
<td>Committee of the Regions</td>
<td>44</td>
</tr>
<tr>
<td>European Ombudsman</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>5 212</strong></td>
</tr>
</tbody>
</table>

Source: Annual accounts of the European Communities.

Table 9.2 — Authorised staff by Institution

<table>
<thead>
<tr>
<th>Institution</th>
<th>Authorised staff (permanent and temporary posts, initial budget)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>European Parliament</td>
<td>4 338</td>
</tr>
<tr>
<td>Council</td>
<td>2 701</td>
</tr>
<tr>
<td>Commission</td>
<td>22 453</td>
</tr>
<tr>
<td>Court of Justice</td>
<td>1 129</td>
</tr>
<tr>
<td>Court of Auditors</td>
<td>575</td>
</tr>
<tr>
<td>European Economic and Social Committee</td>
<td>514</td>
</tr>
<tr>
<td>Committee of the Regions</td>
<td>250</td>
</tr>
<tr>
<td>European Ombudsman</td>
<td>27</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>31 987</strong></td>
</tr>
</tbody>
</table>

Source: General budget of the European Union.
THE COURTS OBSERVATIONS

Specific assessment in the context of the Statement of Assurance

Introduction

Audit objectives

9.2. The objective of the 2003 DAS audit concerning administrative expenditure was to enable the Court to assess

a) the reliability of the consolidated accounts for the year ending 31 December 2003 (dealt with in Chapter 1); and

b) the legality and regularity of the transactions which underlie them.

9.3. The Court’s audit also aimed to assess how the Institutions implemented the most important provisions laid down in the new Financial Regulation.

Audit methods applied

9.4. The audit appraised the legality and regularity of the transactions underlying the accounts of the administrative expenditure of the Institutions. It comprised the following activities:

a) evaluating the operation of the supervisory systems and controls set up by the Institutions in order to comply with the new Financial Regulation, i.e. the implementation of adequate control structures and procedures, complying with minimum standards adopted by each Institution, and implementing an internal audit function;

b) substantively testing a number of transactions from across the whole area of administrative expenditure and an additional number of transactions for each smaller Institution;

c) considering the annual activity reports produced by the Institutions’ authorising officers by delegation.

d) a follow-up to observations from past Annual Reports (Table 9.3).
<table>
<thead>
<tr>
<th>Observations</th>
<th>Action taken</th>
<th>Further action needed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Promotion of staff without competition.</td>
<td>The 2003 establishment plan for the Parliament, but not for the Court of Auditors, showed a provision for promoting one additional person from one category to another without competition (ad personam promotion). Thus the establishment plan for the Parliament allowed the Institution to continue, in 2003, to promote persons who had not passed a competition, even though this did not conform with the Staff Regulations.</td>
<td>No, as the new Staff Regulations have completely modified the structure of staff categories. In consequence, the question of being promoted to a higher category without having passed a competition is not relevant any more.</td>
</tr>
<tr>
<td>Weightings for Members of the Institutions</td>
<td>Council Regulations (EC) No 1292/2004 and (EC) No 1293/2004 state that the rules on transfers are applicable to the members of Institutions.</td>
<td>No, as the new legal situation resolves the problem.</td>
</tr>
<tr>
<td>Scales for mission expenses</td>
<td>The Parliament’s practice did not change in 2003. The new Staff Regulations applying as of 1.5.2004 state that the same scales apply to all members of the staff.</td>
<td>No, as the new legal situation resolves the problem.</td>
</tr>
<tr>
<td>Additional pension scheme for Members of the European Parliament</td>
<td>The additional pension scheme continues and no sufficient legal basis has been created. No such rules have been established.</td>
<td>Yes, a legal basis should be created. Yes, appropriate rules should be established.</td>
</tr>
</tbody>
</table>

**REPLY OF THE EUROPEAN PARLIAMENT**

<table>
<thead>
<tr>
<th>Observations</th>
<th>Action taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional pension scheme for members of the European Parliament</td>
<td>During recent years, Parliament’s administrative units have been actively involved in drafting a single Statute for members which included, among other things, a single pension scheme for members of the European Parliament and, consequently, the abolition of the current additional pension scheme. As it is now clear that the Statute will not enter into force for the new legislative term, the Court of Auditors’ opinion No 5/99 has been taken up again and proposals will be submitted to the new Bureau with a view to defining the respective powers and responsibilities of Parliament and the not-for-profit association incorporated under Luxembourg law and managed by an elected Executive Committee. On the basis of the results of an actuarial study to be carried out at the start of 2005, after the deadline for joining the pension scheme expires, the level of financing required for the Fund will be known and, depending on the position, measures might be envisaged to put the financing of the Fund back on a balanced footing.</td>
</tr>
</tbody>
</table>
THE COURTS OBSERVATIONS

9.5. The Court’s overall DAS conclusion for the area of administrative expenditure is reported in paragraph 9.68. The audit results concerning each Institution are set out in the sections of this chapter in the same order in which the Institutions are listed in the 2003 general budget.

Risks

9.6. Overall risk is low in the field of administrative expenditure. This is because of the absence, firstly, of ‘delegation risk’, as administrative expenditure is directly managed by the Institutions and Community Bodies, unlike most programme expenditure, which is carried out on behalf of the Commission by national bodies or agencies. Secondly, ‘subsidy risk’ is absent as nearly all administrative expenditure involves transactions related to the employment of staff and the purchase of works, goods and services rather than subsidies/project funding. Past audits by the Court show that the errors found were mostly of a formal nature and not due to grave weaknesses in the control environment.

Parliament

Supervisory systems and controls

9.7. In December 2002 the Parliament adopted the basic documents necessary to implement the new Financial Regulation (hereafter ‘the Financial Regulation’) (1). These included the new internal rules for the implementation of the budget, charters for the internal audit services, the authorising officers and the accountant, minimum standards for internal control and a specific code of professional standards. The computerised system used in managing budgetary revenue and expenditure (FINORD) was adapted to the new rules. However, the authorising officers could not set up fully operational control systems from the date of entry into force of the Financial Regulation (1 January 2003).

9.8. The decentralisation of the controls was a difficult task as the financial and internal control procedures had previously been highly centralised and dependent on the work carried out by the Financial Controller. During 2003, the Parliament was able to implement new control methods, based on decentralised ‘Internal Control Frameworks’, including ‘Minimum Standards for Internal Control (MSIC)’, a ‘Central Financial Service’ and an internal audit function. However, the authorising officers were not able to fully apply all the MSIC. This was recognised by the authorising officers themselves in

9.7 and 9.8. REPLY OF THE EUROPEAN PARLIAMENT

In 2003, because of the new Financial Regulation, the institution’s financial and internal control procedures went from being what the Court describes as ‘highly centralised’ to being highly decentralised, with no lead time between adoption of the relevant texts and their entry into force. As a result, the institution faced great difficulties in finding the required numbers of additional, financially-qualified staff, in providing suitable training for all concerned and in organising the necessary central support. The weaknesses identified by the Court are attributable to these circumstances which reflect the ‘teething pains’ inherent in any major upheaval undertaken at short notice.

In March 2004 the principal authorising officer by delegation drew conclusions from the experience of 2003 in the form of a declaration and of an accompanying Action Plan. The Action Plan is designed to tackle the issues of an institution-wide nature which the Court has also identified in its observations. Rightly described by the Court as ‘ambitious’ (see point 9.11 below), the Action Plan is to be implemented as far as possible during 2004. In addition, as the Court points out, departmental action plans have been developed by the Internal Auditor in agreement with the responsible authorising officers by delegation.

THE COURTS OBSERVATIONS

a self-assessment of the level of implementation of the MSIC carried out while preparing the annual activity reports at the beginning of 2004. At that time, none of the MSIC had been fully complied with by all the authorising officers. The implementation of certain MSIC, as MSIC 5 (sensitive posts), MSIC 7 (setting of objectives), MSIC 14 (reporting improprieties) and MSIC 20 (recording and correction of internal control weaknesses) was only at an initial stage. The implementation of MSIC 9 (annual management plan), MSIC 15 (documentation of procedures), MSIC 17 (supervision), MSIC 11 (risk analysis and management), and MSIC 19 (continuity of operations) needed to be reinforced. An action plan aims to correct the weaknesses noted (see paragraph 9.11).

9.9. The standardised control system formerly existing under the responsibility of the Financial Controller was replaced by ten Internal Control Frameworks, based on ex ante verification of each transaction and maintaining certain elements of the previous system, like the possibility of withholding approval and overruling. However, the absence of uniform definitions of errors, of common ways of documenting and classifying errors, as well as different forms of reporting the results of the controls make it difficult to draw any general conclusions concerning the materiality of the errors noted by ex ante controllers. The authorising officers did not introduce any ex post controls. Considering the incomplete implementation of the Internal Control Frameworks, ex post controls are necessary.

9.9. REPLY OF THE EUROPEAN PARLIAMENT

Abolition of the terms ‘withholding approval’ and ‘overruling’ is being considered as part of the current review of the Internal Rules. Under the draft revised rules, the ex ante controllers will establish whether or not the transactions concerned comply with the relevant rules. As regards the questions relating to errors, the former Financial Controller made available, to the authorising officers in late 2002, the typology of errors used by him. However, authorising officers were under no obligation to use that typology and several sought to develop definitions of their own. As a result, problems arose later when it came to comparing and aggregating the data on errors. This issue has therefore been included in the abovementioned Action Plan of the principal authorising officer by delegation. As regards the comment on the absence of ex post controls, the authorising officers have devoted their attention primarily to the instalment of an effective ex ante verification function. Given the nature of the operations dealt with by the Parliament and the absence of both delegation and subsidy risks, this will continue to be the case in the upcoming two years, until such time as the level of ex ante verification is harmonised and stabilised at the level of the Institution. Meanwhile the need for fully developed ex post verification will be evaluated on the basis of a more developed risk- and control self-assessment by the respective authorising officers. However, those of the authorising officers whose services handle a large volume of similar recurrent administrative operations have started to introduce an ex post verification function.

9.10. Moreover, the Court’s audit identified weaknesses at the level of the ex ante controls on staff salary payments. Key controls formerly carried out by the Financial Controller in the field of staff remunerations, were not replaced by equally effective checks. This was due to problems with the availability of a new computer system.

9.10. REPLY OF THE EUROPEAN PARLIAMENT

DG Personnel met technical difficulties in transferring the IT resources used by the former Financial Controller’s services for ex ante checks on the payroll. This limited its ability to effect meaningful checks for a significant period during the first half of 2003. The deficiencies in relation to payroll controls as a result of those difficulties were recorded by the ex ante checkers involved and acknowledged in the annual Cnd interim reports submitted by the authorising officer. However effective payroll checks will have to be viewed increasingly in the future as a sustained and cumulative effort over many months, with ex post checks supplementing an integrated system of operational ex ante checks which guarantees the legality and regularity of the monthly payment orders.
9.11. The Parliament was able to carry out a self-assessment of the level of implementation of the MSIC (paragraph 9.8), activity reports and internal audits identified the main weaknesses of the new systems and action plans were drawn up to correct them. In particular, departmental and central action plans were drawn up in order to address weaknesses detected by the Internal Auditor. In his annual declaration the Secretary General acknowledged the existence of weaknesses and approved an ambitious action plan aiming at the complete implementation of the MSIC without delay.

9.12. Certain provisions of Article 81 of the Financial Regulation and of Article 104 of the Commission Regulation laying down detailed rules for the implementation of the Financial Regulation (hereafter: 'the implementing rules') (2) were not fully implemented by the authorising officers. They concern the distinction to be made in the accounts between different types of payments, the definition of the nature of the supporting documents required for each type of payment and the keeping of these documents. The Parliament's accounts do not allow for the identification of the different types of payments made (payment of the entire amount due, pre-financing, interim payments or payment of the balance of the amount due). The nature of the supporting documents required for each type of payment was not defined. Failure to keep and archive supporting documents in an appropriate way makes internal and external verifications particularly difficult and interrupts the audit trail. In most cases the Court's auditors were able to obtain the supporting documents needed to verify the regularity of the payments, but could not ascertain whether these documents had been examined by the ex ante controllers.

9.13. Pursuant to Article 67(1)(f) of the implementing rules, imprest transactions should be settled by the authorising officer no later than the end of the following month, so that the accounting balance and the bank balance can be reconciled. In respect of travel and subsistence allowances for Members, this deadline was generally not respected throughout 2003. At the end of the year around 11 million euro paid to the Members from an imprest account in September, October and November had not yet been charged to the budgetary accounts.

9.11. REPLY OF THE EUROPEAN PARLIAMENT

See answer to points 9.7 and 9.8.

9.12. REPLY OF THE EUROPEAN PARLIAMENT

As regards the ‘distinction to be made between different types of payments’, given the exclusively administrative nature of expenses managed by the Parliament, most of the payments are ‘payments of the entire amount due’ at ‘the time they are made’. Nevertheless the possibility of introducing changes to the accounting systems to indicate the distinction between the different types of payments will be examined. As regards supporting documents, the Secretary-General issued guidelines on 1 April 2003 on the keeping of original supporting documents by authorising officers. The Guidelines provide that each authorising officer by delegation should adopt a reasoned decision appointing ‘archive agents’. Further work on this aspect of financial management is foreseen under the Action Plan of the principal authorising officer by delegation and, in the last few months, steps have been taken in several directorates-general to bring about the necessary improvements.

9.13. REPLY OF THE EUROPEAN PARLIAMENT

In 2003, the time taken to regularise imprest transactions was between 8 and 10 weeks in the period up to 1 July. A temporary reduction in the number of staff in charge of these operations led to an increase in the time taken since extra staff were appointed on 2004, processing times have returned to their previous levels. It is difficult to reduce processing time to less than two months because of the way in which the work is organised and this would still hold true even if there were a substantial increase in the staff responsible for imprest account controls. To reduce the time taken, each transaction would have to be settled when the payment is made through the imprest account on the basis of the supporting documents received and amounts would have to be recovered systematically in respect of any missing document whatsoever. Each incomplete file would then have to be processed a second time once the missing document was received. What happens now is that the Member is asked to provide the missing document before settlement; although this increases the time taken for settlement it actually reduces the overall time required to process the relevant file.

9.14. **Article 11 of the Parliament's internal rules for implementing its section of the budget allows for the possibility of making payments using a standing order. In this case, expenditure is made without previous validation and authorisation by the authorising officer. 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.**


For some types of expenditure (e.g. rents, utilities) the supplier insists on payment by standing order or direct debit. The Parliament's internal procedures permit such payments only in circumstances where the competent authorising officer is unable to negotiate an alternative payment arrangement. This condition has been written into the draft revised version of the Internal Rules. Furthermore, the Administration will consider possible alternative payment conditions with a view to bringing its Internal Rules and procedures more fully into line with the Financial Regulation.

9.15. **The transactions audited were substantially legal and regular. Non-compliance with formal requirements was noted in certain cases, but this did not imply that wrong amounts were paid.**

9.15. **REPLY OF THE EUROPEAN PARLIAMENT**

Parliament notes the Court’s conclusions.

9.16. **According to Article 60(7) of the Financial Regulation 'the authorising office by delegation shall report to his/her institution on the performance of his/her duties in the form of an annual activity report'. Each of the ten authorising officers by delegation presented three activity reports (two relating to the first and second quarter of the year and an annual one accompanied by a declaration) concerning the year 2003. The reports include a chapter on management and internal control issues, a summary of the self-assessment of the implementation of the MSICs, and comments on the shortcomings identified. Although the reports are useful instruments for the purpose of increasing the accountability of the authorising officers for the financial management of the resources assigned to them, they are extremely heterogeneous; their presentation and structure should be harmonised. It is also necessary to improve the information and reporting systems supporting the content of the reports by ensuring that a risk analysis is carried out and that registers of contracts and documented procedures are established. More detailed information should also be given on the results of the controls carried out.**

9.16. **REPLY OF THE EUROPEAN PARLIAMENT**

The early periodic activity reports required by Parliament’s Internal Rules were drawn up in the absence of firm guidelines as to structure and content. However, for the annual activity reports required by the Financial Regulation, the central financial services made efforts, in consultation with the services concerned, to achieve a substantial degree of harmonisation. Those efforts are continuing, as shown by the Action Plan of the principal authorising officer by delegation which covers several points mentioned by the Court.
THE COURTS OBSERVATIONS

9.17. The information presented in the reports is useful to understand the way the supervisory systems and controls linked to the legality and regularity of transactions worked, but the information at the basis of these reports has to be improved to be a relevant source for the Court’s statement of assurance. All the authorising officers by delegation, except one, certified that they were ‘reasonably certain… that the control procedures established afford the requisite guarantees as to the legality and regularity of the underlying transactions’. One authorising officer omitted this declaration, without formulating any reservation. Though no authorising officer expressed reservations, three commented in their declarations about the lack of qualified staff and the need to adapt to the new Financial Regulation the rules concerning expenditure made by Members of Parliament and political groups, taking into account the observations formulated by the control bodies, including the Court of Auditors. Other authorising officers also commented in their activity reports on the difficulties encountered in fully implementing the new Financial Regulation and the Internal Control Frameworks.

9.17. REPLY OF THE EUROPEAN PARLIAMENT

As regards the question of staffing for posts of a financial nature, this is covered by the Action Plan of the principal authorising officer by delegation.

Council

Supervisory systems and controls

9.18. The Financial Regulation was implemented gradually during the first half of the year 2003. The authorising officers by delegation put in place internal management and control procedures. These control procedures, based on ex ante verifications, respect the required segregation of the duties of initiation and verification of each operation. These procedures were not documented in writing for all activities, in particular, not for staff remuneration.

9.19. According to the Council’s own internal rules for implementing its section of the budget, each authorising officer by delegation had to ensure that a document describing the management and control procedures applied under his authority was drafted and made available to all the staff. The only documents of this kind existing at the end of 2003 concerned the procedures applied by the Units responsible for Information Technology and Buildings, and by the Legal Service.

9.20. Although the Council’s charter for the staff who verify transactions lays down the possibility of carrying out ex post verifications, no such verifications were made. Ex post verifications, as mentioned in Article 47(4) of the implementing rules, would provide the authorising officers with supplementary assurance about the correct execution of operations financed from the budget.

9.18 and 9.19. REPLY OF THE COUNCIL

The conclusion of the Court that not all control procedures are documented in writing was also drawn in the internal evaluation and report on the annual reports established by the authorising officers for 2003. Following this observation, authorising officers who have not yet established a document describing the management and control procedures, have been invited to do so before 1 December 2004.

In order to facilitate this exercise and to ensure coherence between different authorising officers, a standard format for such a document has been developed.

9.20. REPLY OF THE COUNCIL

Though used, the instrument of ex post verification (verification after the payment) has not been applied systematically in 2003.

Although the GSC considers that ex post verification is in particular useful for operational expenditure, it nevertheless foresees to develop a methodology that might be used by its verifying agents for ex post analysis in the future.
THE COURTS OBSERVATIONS

9.21. The actions required by the Financial Regulation and the implementing rules were implemented to a certain extent. The following actions were, however, not carried out by 31 December 2003:

a) the setting up of minimum control standards (Article 60(4) of the Financial Regulation),

b) the definition of a code of professional standards for the accounting officer and imprest administrator (Article 60(5) of the Financial Regulation),

c) the drafting of a charter describing the tasks, rights and obligations of the accounting officer and imprest administrator (Article 44 of the implementing rules).

9.22. In 2003 the internal auditor carried out various sound financial management audits, as well as an audit of the Council’s financial statements for the financial year 2002. As these audits do not concern the legality and regularity of transactions underlying the 2003 accounts, their results are not directly relevant to the Court’s specific appraisal on the legality and regularity of administrative expenditure.

Observations concerning transactions

9.23. Legal services were contracted without any tendering procedure, although their value exceeded the threshold above which a tendering procedure was required.

9.23. REPLY OF THE COUNCIL

The GSC fully accepts the observation of the Court concerning a commitment for legal services.

It should however be noted that the legal service of the SGC has started a tender procedure in order to establish a framework contract for the type of legal services mentioned (legal assistance in the area of anti-dumping).

Annual activity reports and declarations of the authorising officers by delegation

9.24. The authorising officers by delegation base their declarations, among other things, on the results of ex post controls. However, no documentary evidence of ex post controls existed.
THE COURTS OBSERVATIONS

Court of Justice

Supervisory systems and controls

9.25. At the Court of Justice some of the most important requirements of the Financial Regulation or the implementing rules were not fully implemented. The lack of compliance with the Financial Regulation concerned:

a) adoption of minimum control standards and the analysis of the risks associated with the management environment and the nature of the actions financed (Article 60(4) of the Financial Regulation),

b) drafting of charters describing tasks, rights and obligations of the financial actors (Article 44 of the implementing rules),

c) the definition of the scope of the mission of the internal auditor and the objectives and procedures for the exercise of the internal audit function (Article 109(2) of the implementing rules).

9.25. REPLY OF THE COURT OF JUSTICE

With a view to ensuring the implementation, within the institution, of the provisions of the new Financial Regulation, adopted by the Council on 25 June 2002, and of the provisions of the implementing rules, adopted by the Commission on 23 December 2002, the Court approved a new internal financial regulation on 22 January 2003. That basic legal context was to be supplemented by rules to be included in the various provisions and charters referred to by the Court of Auditors. None the less, before those rules were fixed, it was judged timely to consider the operation in practice of the new system, more especially as, having regard to its size and its very particular duties, there was available to the institution for the application of the new provisions only an extremely limited number of persons with thorough knowledge of financial systems and backgrounds.

All the documents cited by the Court of Auditors have as from now been adopted.

The minimum rules of internal audit applicable within the institution were in that manner approved by the administrative committee on 31 March 2004. Of those, rule No. 7 refers to the analysis of risks mentioned in Article 60(4) of the Financial Regulation.

The financial actors’ charters of duties, described in Article 44 of the implementing rules, just like the internal auditor’s charter of duties, were also approved by the administrative committee on 31 March 2004. It ought to be noted that the latter charter defines, in accordance with Article 109(2) of the implementing rules, the internal auditor’s mission and the objectives of that function and the procedures for its exercise.

9.26. A ‘verification unit’ under the authority of the internal auditor was entrusted with the task of verifying ex ante all the authorising officers’ operations. The internal auditor also took on the task, formerly carried out by the Financial Controller, of validating every transaction in the computerised accounting system. This task is not compatible with the independence with which the internal auditor should perform his audit duties and is contrary to the spirit of the financial reform.


In the new administrative unit set up in accordance with the Court’s specific requirements, the functions of ex ante verification of financial operations and those of internal audit are clearly separated.

Ex ante verification of financial operations is carried out by verification officers whose activities are governed by the ‘code of professional rules for members of staff appointed to verify financial operations’.

Those officers are called upon, in particular, to give an opinion, favourable or otherwise, on any file put before them.
The circumstance that, where a favourable opinion is given, the verification officers (or indeed, the departmental secretariat, if necessary) approve the operation in the electronic system of monitoring appropriations is due simply to the fact that, for technical reasons, it was not possible to alter that system in this respect when the new provisions of the Financial Regulation entered into force. The paper route followed by financial operations, in the course of which documents are approved or signed by the various persons involved, is quite in keeping with the new Financial Regulation and places ultimate responsibility on the authorising officer by delegation or by sub-delegation. The role and responsibilities of the verification service are therefore not to be confused with those of the former financial controller.

The procedures just described, which do not involve the internal auditor as such, in no way influence the independence of the latter, whose obligations and responsibilities are defined by the ‘internal auditor’s charter of duties’ adopted by the Administrative Committee of the Court, as indicated in response to paragraph 9.25.

9.27. The internal auditor did not carry out his work programme for 2003, apparently due to lack of staff and to the time spent on ex ante control.

9.27. REPLY OF THE COURT OF JUSTICE
During the year in question the internal auditor has paid particular attention to the grafting of the new administrative unit onto the Court of Justice’s organisation. It was planned to carry out an audit of the management of the appropriations allocated to visitors, spread over several budget headings, but it proved impossible for it to be completed in 2003.

Observations concerning transactions

9.28. A contract concerning the purchase of site licences for the use of software was negotiated by restricted procedure without the prior publication of a notice. Pursuant to Articles 15(2) and 17 of Council Directive 92/50/EEC of 18 June 1992 relating to the coordination of procedures for the award of public service contracts (1), a notice should have been sent to the Publications Office and published in the Official Journal.

9.28. REPLY OF THE COURT OF JUSTICE
The purchase of licences for operating software for the automated ‘servers’ and electronic mail was made by choosing the best offer of those requested from the distributors authorised by the main company to retail its products on the Belgian and Luxembourg markets. Experience has shown that the prices thus obtained were competitive. Henceforth, in dealing with future contracts of this kind, for example, a single product sold through a network of authorised distributors, particular attention will be paid to observance of the procedures applicable relative to the contract thresholds.

Annual activity reports and declarations of the authorising officers by delegation

9.29. As at the beginning of June 2004, the annual activity reports required by Article 60(7) of the Financial Regulation had not been presented.

9.29. REPLY OF THE COURT OF JUSTICE
The authorising officer by delegation’s annual report of activities was sent to the competent authorities on 2 July 2004. It is advisable to state that the Financial Regulation does not impose any deadline for the presenting of the annual report of the institutions’ activities except in respect of the Commission, for the date of 15 June fixed by Article 60 concerns the Commission alone.

THE COURTS OBSERVATIONS

Court of Auditors

Supervisory systems and controls

9.30. Article 44 of the implementing rules requires that each Institution provide each financial actor with 'a charter describing in detail his tasks, rights and obligations'. Charters were drawn up and decided upon by the Court on 18 December 2003. The same was the case for the minimum standards adopted by the Institution pursuant to Article 60(4) of the Financial Regulation.

9.31. The internal auditor of the Court examined the set-up and functioning of the system of ex ante verification, as well as the financial system relating to the carrying out of the Court’s building policy. These audits by the internal auditor did not result in any particular recommendation.

9.32. 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 2003’, accompanied by a report. 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’. The certificate and the report will be published in the Official Journal.

Observations concerning transactions

9.33. No observations arose from the audit of transactions underlying the accounts of the financial year 2003.

Annual activity reports and declarations of the authorising officers by delegation

9.34. An annual activity report, as required by Article 60(7) of the Financial Regulation, has been made by the Secretary-General concerning the most important budgetary areas.

Economic and Social Committee and Committee of the Regions

9.35. The following observations concern problems noted both at the Economic and Social Committee and at the Committee of the Regions. To avoid repetition in the chapter, these problems are set out in this section, which deals with both Committees.
Supervisory systems and controls

9.36. The following rules concerning the supervisory systems and controls were not complied with:

(a) the accountant was not provided with a charter describing in detail his tasks, rights and obligations, as required by Article 44 of the implementing rules;

(b) no minimum control standards were adopted.

(a) REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

The accountant charter was adopted in 2004.

REPLY OF THE COMMITTEE OF THE REGIONS

On 3 May 2004, the delegate authorising officer approved a Decision (No 088/04), establishing the Charter of the missions and responsibilities of the CoR’s Accountant and the sub-delegate accountants. The provisions of the Charter cover as well the question of the professional standards of the Accountant.

The delay in approving such a Decision was due to the fact that some measures foreseen in the calendar for the implementation of the new Financial Regulation had been delayed in 2003 because of other priorities.

(b) REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

A set of minimum internal control standards was adopted in 2004.

REPLY OF THE COMMITTEE OF THE REGIONS

Whereas it is true that there is not yet a comprehensive document enumerating the system of minimum control standards in place in the Committee of the Regions, several control standards were adopted: check-up lists; description of procedures; performance indicators; procedures for the appointment of budget line managers; follow-up of financial matters by the Committee on Financial and Administrative Affairs; draft vade-mecum on tasks, functions and procedures; regulations on reimbursement of members; regulations on representation expenses; decisions on ‘whistleblowers’ and on relations with OLAF; instructions of service; training programmes for financial actors; written descriptions of financial circuits, etc.

In December 2003 the delegate authorising officer requested the Internal Auditor to carry out an audit on the control environment in the Committee of the Regions.
THE COURTS OBSERVATIONS

9.37. In the area of procurement, several requirements of the Financial Regulation and the implementing rules were not complied with. No report on negotiated procedures was sent to the budgetary authority (Article 54 of the implementing rules), and the list of contractors for contracts with a value of less than 50 000 euro was not published on the Internet (Article 119 of the implementing rules). A database of tenderers or candidates excluded from taking part in procurement procedures (Article 95 of the Financial Regulation) was not established at the Committee of the Regions.

9.37. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

It is correct that no report on all negotiated procedures has been sent to the budgetary authority and that no list of contractors for the contracts with a value of less than EUR 50 000 has been published on the Internet. However, regular progress reports on the buildings situation were established and sent to the budgetary authority. Also, the procedures from the new Financial Regulation on the pre-information notices related to larger contracts were respected. It should also be noted that an internal audit on the acquisition procedures of the ‘Belliard 68’ building was started in 2003 and was finalised in 2004. The obligations to send a report on all negotiated procedures to the Budgetary Authority and to publish the list of contracts with a value less than EUR 50 000 on the Internet have been incorporated in the EESC’s annual internal budget closing procedures.

9.37. REPLY OF THE COMMITTEE OF THE REGIONS

Concerning the report on negotiated procedures, it will be sent to the budgetary authority before the 30 September.

As regards the list of contractors for contracts with a value of less than EUR 50 000, it will be published on the CoR internet before 15 October.

As far as the database of tenderers is concerned (Article 95 of the Financial Regulation), the new version of SI2 has finally been installed on 18 September this year, and will allow the exclusion of third parties (not possible until now).

9.38. For staff remunerations, personnel data were input manually and separately in both the personnel database and the payroll system. As there was no computer link between the two systems, an automatic reconciliation of data was not possible. On the other hand, a systematic and periodic reconciliation was not made manually. The administration found a large number of differences between the payroll according to the system used in 2003 and the new system, introduced in May 2004.

9.38. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

In 2003 and the years before, no financial data were stored in the personnel management system, which was used solely for operational purposes. The financial data on staff were stored exclusively in a separate payroll system. There was no need for reconciliation between these two systems.

A new personnel management system and a new payroll system (NAP, running at the Commission) were launched in early 2004. Contrary to the old payroll system, the new payroll system uses financial data from the (new) personnel management system. Initially, there were a substantial number of discrepancies between the old and the new payroll systems. Most of those were due to timing differences between the former payroll procedure and the new payroll procedure. All these discrepancies have been explained and resolved in 2004.
Regarding the procedures involved for the salary system, it has to be noted that personnel data was input manually in the new personnel database (Centurio, an application created by the IT service of the joint services of the CoR and the Social and Economic Committee, which is also used by the Court of Justice), in accordance with the administration’s decision to implement this new system. The decision was made in order to facilitate the transition to the new payroll system (NAP). It is none the less true that prior to the launch of NAP on April 2004 there was no possibility to link the old payroll system with the personnel database, the reason being technical incompatibilities (the two systems are separated by nearly 30 years of age) and the personal data had to be input manually.

The situation has also been made more difficult this year by the entry into force of the new staff regulations, a whole new set of parameters having had to be integrated in both systems.

As soon as the NAP is fully operational, the administration will examine the eventually still existing differences.

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Economic and Social Committee

9.39. The following observations only concern problems at the Economic and Social Committee.

Supervisory systems and controls

9.40. The following rules concerning, in general, the supervisory systems and controls were not complied with:

(a) the imprest account administrator was not provided with a charter describing his tasks, rights and obligations in detail, as required by Article 44 of the implementing rules;

(b) a written description of the specific control procedures applied to the different areas of expenditure was not drawn up.

9.40. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

(a) The imprest account officer charter was adopted in 2004.

(b) The EESC adopted its internal financial rules, compliant with the new Financial Regulations on 8 January 2003. These rules include formal procedures for the nomination of the financial actors, the verification procedures and detailed internal procedures for all main budgetary operations. It should be noted that the EESC has formalised and put into place a sound verification process, requiring validation of operations by an independent verifying agent. This model would normally only be used for operations in a high-risk environment. However, the EESC chose to apply a conservative approach and has adopted this model for all of its budgetary operations (an extensive list is drawn up in the EESC’s internal rules, Article 19), including those in a low-risk environment.

The EESC has documented its recruitment procedures in a vademecum.
THE COURTS OBSERVATIONS

Details and rigorous procedures for the management of the inventory were adopted in October 2003.

In 2004, a decision on the recognition of the electronic signature in the budget management information system SI2 was adopted. It includes a description of all related operational procedures (user registration, maintenance, reporting, etc.).

The internal audit on compliance with the new Financial Regulations recommended the introduction of, or improvements to, several internal control procedures. The enhancement of the documentation of internal control procedures is part of the implementation plan of the internal auditors’ recommendations.

The establishment of written procedures is not, as such, a requirement of the Financial Regulation, but it has been integrated into the EESC’s internal control standards (standard 15), which were adopted on 1 July 2004.

9.41. The Court’s examination of a sample of imprest account payments showed that the deadline for the settlement of imprest transactions by the authorising officer (the end of the following month, pursuant to Article 67(1)(f) of the implementing rules) was generally not respected.

9.42. The internal auditor made an extensive audit of the enforcement of the Financial Regulation, identifying some weak points in the control systems for most budget lines. The audit report was presented in November 2003. At the end of 2003 the weaknesses identified by the internal auditor were being handled by the administration.

9.43. Payments of travel allowances made from the imprest account towards the end of 2002 for meetings held in 2002 were charged to the appropriations of the following budget year, in breach of the budgetary principle of annuality. Similarly, 2003 expenditure was charged to the 2004 budget.

9.44. For all the payment orders regularising payments made from the imprest account between mid October 2003 and the end of the year only a superficial verification was made.

9.41 and 9.44. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

During 2003, severe staffing problems were encountered in the verifying section and, hence, priorities had to be determined. As a consequence, the reconciliation of imprest transactions had to be delayed. In order to be able to close the books at the end of 2003, thorough verification was postponed until 2004. A detailed ex post verification was carried out during the first quarter of 2004. The correcting actions resulting from it are being completed in 2004.

9.41 to 9.43 and 9.45. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

Following earlier recommendations by the Court, the EESC has abolished the imprest account for the payment of members’ allowances as of the beginning of 2004.

9.43. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

According to Article 6.(6) of the Implementation Rules of 23 December 2002, appropriations for allowances for members cannot be carried over. Therefore, the EESC believed that it had to put payments, made by the imprest account officer at the very end of 2002 (for meetings held in 2002) and which were settled in early 2003, on the 2003 budget.
9.45. In three cases, the travel allowance paid to Members of the Economic and Social Committee was twice the amount set out in the Committee’s own rules. These cases concerned flights from Berlin to Brussels, whose scheduled duration was less than or equal to one and a half hour. The Committee’s rules lay down that a double travel allowance is paid for travels by plane lasting more than one and a half hours. It appeared from the audit that the rules were generally not being complied with when the journey had started in Berlin and some other cities.

9.45. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

For the cities referred to, the duration of the flight used to be more than one and a half hours, but has now become slightly less than that. In a few cases, these changes were not taken into account. As soon as the Court had made its remarks, corrective action was taken: the authorising officer by delegation has formally instructed all financial actors involved to apply the regulation in the strictest manner. All the members potentially involved have been informed of this measure. The EESC can therefore state that the present situation is in order.

Annual activity reports and declarations of the authorising officers by delegation

9.46. The annual activity report required by Article 60(7) of the Financial Regulation was presented at the end of July 2004. This report includes a declaration on the procedures ensuring the legality and regularity of the transactions underlying the accounts.

Committee of the Regions

9.47. The following observations are about further problems only concerning the Committee of the Regions.

Supervisory systems and controls

9.48. The following rules concerning the supervisory systems and controls were not complied with:

(a) no risk analysis was performed in order to introduce the most appropriate control procedures (Article 60(4) of the Financial Regulation);

(b) except for a vademecum concerning the imprest account, no written description of the specific control procedures regulating expenditure was drawn up.

9.48. REPLY OF THE COMMITTEE OF THE REGION

a) This question is now being dealt with in a comprehensive manner. The internal Auditor has already produced in 2004 two audits related to this issue.

b) Apart from the vade-mecum concerning the imprest account, there are many other written rules that address the question of the specific control procedures of expenditure, such as the Missions Guide which describes in great detail this type of control procedures concerning any expenditure deriving from missions by officials. The same applies to the written procedures on invoicing between the Committees on the expenditure managed by their joint services (of both the CoR and the European Economic and Social Committee), the written procedures for recruitment of new officials, etc. The performance indicators set up in 2003 for each budget heading, and the instructions to elaborate them, allow for a better follow-up of the way expenditure is carried out. During 2003 the Committee of the Regions established (written) financial circuits which reflect the principles of the new Financial Regulation, thus separating the functions of initiating and ex ante verifying agents. To ensure the compliance with the new Financial Regulation, written checklists were published for the execution of expenditure by the joint services of both Committees.

The CoR envisages to complete before the end of the year the minimum control standards adapted to the specificities of its expenditure.
THE COURTS OBSERVATIONS

9.49. The follow-up of the entitlements of officials and other staff to the various allowances and benefits provided in the Staff Regulations was insufficient. The data requested annually by the administration from the staff should have been checked more carefully. The payment of allowances, as well as transfers to countries other than the country of employment of amounts exceeding the expatriation allowance, should have been suspended when members of the staff had not returned within a reasonable time the information forms they had to fill in.

9.49. THE COMMITTEE OF THE REGIONS’ REPLY

Concerning the follow-up of the officials’ entitlements to the different allowances and benefits provided in the staff regulations, every year in September a form is sent to each official with the purpose of updating personal data. Each official fills this form even if his/her family situation is unchanged. A reminder is sent to every official that did not respond and if the information is still not sent to the personnel unit on a reasonable time deadline the person in charge verifies every case and especially those who might not have the right to receive such allowances; after which the person in charge asks the official again for the requested forms to be filled. Nevertheless, like in the case indicated by the Court of Auditors, some officials have failed to update the required information.

In the future systematic controls will be carried out concerning the follow-up of the special conditions of every official — more particularly in the field of transfers to third countries of amounts exceeding the expatriation allowance — and the suspension of every allowance or transfer until the official concerned provides the requested documents.

The necessary changes will be introduced as of September this year to improve the follow-up of the above-mentioned entitlements.

9.50. The internal auditor did not carry out most of his 2003 annual work programme. In particular, an audit of the implementation of the new Financial Regulation, included in the work programme, was not completed.

Observations concerning transactions

9.51. Payments of travel allowances made from the imprest account towards the end of 2002 for meetings held in 2002 were charged to the appropriations of the following budget year, in breach of the budgetary principle of annuality.

9.51. THE COMMITTEE OF THE REGIONS’ REPLY

Due to delays in the presentation of supporting documents for the participation of three alternates in a commission meeting the corresponding payment order could not be assigned to the 2002 budget. Since the payments from the imprest account were finally accepted in 2003, these were charged to the 2003 budget.

In the future the CoR will treat these allowances as reportable expenditure.

9.52. Some imprest account payments were not settled by the authorising officer by the end of the following month as requested by Article 67(1)(f) of the implementing rules.

9.52. THE COMMITTEE OF THE REGIONS’ REPLY

The verifying officer of the CoR’s own services at that time was alone, and had too much work which resulted in some delays in the presentation of verified dossiers to the authorising officer. A second verifying officer could only be recruited at the end of the year, thus allowing the speeding-up of the ex-ante financial verification of the imprest account payments before signature by the authorising officer.
THE COURTS OBSERVATIONS

Annual activity reports and declarations of the authorising officers by delegation

9.53. The annual activity report required by Article 60(7) of the Financial Regulation was presented at the beginning of June 2004. This report includes a declaration as to the procedures ensuring the legality and regularity of the transactions underlying the accounts. The report informs on certain problems which the verifying staff faced in 2003 and on measures to be taken in 2004 in order to better comply with the requirements of the Financial Regulation.

Commission

Supervisory systems and controls for administrative expenditure (*)

9.54. Unlike the other Institutions, the Commission did not wait for the entry into force of a new Financial Regulation before setting up new supervisory systems and controls. These systems, established within the framework of the Commission’s reform, already responded to a large extent to the main requirements of the new Financial Regulation. This explains why the conformity of the systems operating in 2003 with the requirements of the Financial Regulation is higher at the Commission than in the other Institutions.

9.55. The 24 Internal Control Standards adopted by the Commission in 2000 have been subsequently made more concrete and split into 74 ‘baseline requirements’. An annex to the activity reports of Directors and Directors-General indicates how many ‘baseline requirements’ have been implemented by each Commission department. Concerning administrative expenditure the Court finds that at the end of 2003, most of the ‘baseline requirements’ relative to control activities, audit and evaluation had been implemented.

9.56. The Court has examined the supervisory systems and controls giving delegated and sub-delegated authorising officers the assurance that the requirements of legality and regularity are complied with when implementing expenditure. The operation of systems concerning staff remuneration, information technology, infrastructure and management of services in Brussels, publications, Commission’s Delegations and interpreting services has been appraised.

(*) 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 COURTS OBSERVATIONS

9.57. With the exception of staff expenditure, the authorising officers decided, in accordance with Internal Control Standard No 17, that ex post verifications of operations should be carried out. However, no evidence was found that ex post verifications had been carried out with respect to expenditure relative to the Commission’s Delegations and to publications. In the other fields of expenditure ex post controls were carried out, but they were not based on the examination of transactions selected through a risk analysis.

9.57. REPLY OF THE COMMISSION

The Annual Activity report of DG RELEX draws attention to the absence of an effective system of ex post control related to the delegations’ expenditure. In the light of this, an action plan has been drawn up which envisages the implementation of an ex post control system before the end of 2004.

The Publications Office (OPOCE) has introduced ex post control based on sampling in 2004. The delegated authorising officer has decided to focus on second-level ex ante checks prior to introducing ex post control in 2004.

Regarding other administrative expenditure, DG ADMIN and the Office for infrastructures and logistics in Brussels (OIB) decided, when early in 2003 the ex post controls were started, to select the transactions by uniform sampling so as to avoid prior biases and prejudices. They intend to include risk factors after 24 months of operation, i.e. as from 2005.

The DG for Interpretation (SCIC) also used uniform sampling in 2003 for freelance interpreter payments. However, from 2004 the sampling is based on monetary sampling units (MUS). The intention for later in 2004 is to supplement this with targeted sampling based on risk factors.

As regards staff expenditure, the reply to paragraph 9.58 gives the necessary details.

9.58. Concerning the system dealing with the staff remunerations, discrepancies between the database containing the staff personal data and the computer system used for the monthly calculation of the remuneration were identified and corrected before a new system was set up in October 2003. However, a systematic verification of new data introduced into individual files existing in the database was not made until shortly before the end of 2003.

9.58. REPLY OF THE COMMISSION

As the Court states, the existing discrepancies between the two systems were identified and corrected before the new system – NAP – entered into production, on the basis of verified data on staff, through a component-wise comparison of the old and new salary slips.

Unlike the previous salary system – VAP –, NAP draws its data directly from the personnel management system SYSPER, i.e. by IT interface, and no longer requires double data entry, which previously was at the same time an opportunity for control and a source of errors. The verification workflows had to be adapted, which was done before the end of 2003.

Some ex post checking was already carried out on data for the Luxembourg population in 2003. The Brussels population will be checked in late 2004, when a global ex post control programme will become operational.

Both the comparisons made in the context of the migration to the NAP and the checks made in Luxembourg have shown that the number of errors is very small in relation to the vast amounts of data concerned, and that errors are not systematic.
THE COURTS OBSERVATIONS

9.59. The Court noted weaknesses in the supervisory systems and controls set up by the Publications Office. In particular, precisely defined responsibilities were not formally allocated to the staff charged with initiating and verifying financial operations, no action was undertaken to tackle the specific risk, identified by the Publications Office, that errors in invoices would not be detected, and documentation of procedures was not complete.

9.59. REPLY OF THE COMMISSION

The Commission shares the Court's views on the definition of responsibilities: a system of regular (monthly) updates was set up in November 2003.

As regards documentation of procedures, the Office drew up a list of the key procedures to be documented at the end of 2003. This documentation has been completed in 2004. Secondary procedures will be documented by the end of June 2005.

9.60. The reporting obligation laid down in the Commission's charter for authorising officers by sub-delegation was not implemented at the Publications Office.

9.60. REPLY OF THE COMMISSION

Though the procedure has not been formalised, the Management Committee has been receiving regular (quarterly) operating reports for a number of years. Monthly budget statements are made at central level, and the sub-delegated authorising officers report on programmes, operations and results, inter alia for the purposes of drafting the Office's AAR and annual management report. The Office will introduce the report, as provided for in the Charter for authorising officers by subdelegation.

Observations concerning transactions

9.61. For the payment of a large number of invoices concerning information technology services, infrastructures and management of services in Brussels and publications, the deadlines laid down in the contracts were exceeded. Pursuant to Article 106(5) of the implementing rules, non-compliance with the deadline for payment allows the creditor to demand interest.

9.61. REPLY OF THE COMMISSION

It should be noted that after the introduction of a shorter payment delay in the new Financial Regulation, the contractual delays in the existing contracts concluded before 31 December 2002 under the previous Financial Regulations, were not changed. The major part of the contracts used by the Informatics Directorate and the Office for infrastructures and logistics in Brussels (OIB) during 2003 had been signed before that date, and hence had a payment delay of 60 days.

On this basis, the number of payments carried out after the contractual delay was actually 10.8% for the Informatics Directorate, around 18% for OIB and 3% for the DG for Interpretation (payments other than payments to freelance interpreters).

With a view to reducing the proportion of late payments the Commission has drawn the attention of the operational services to the requirement of swift payment.
THE COURTS OBSERVATIONS

9.62. Towards the end of 2003 the Publications Office paid invoices whose amount exceeded the value of the services actually provided during the year. The surplus was fully recognised by the suppliers by way of credit notes received by the Publications Office in 2004. In this way, the cancellation of appropriations committed in 2002 as a ‘frontloading’ of expenditure expected to be made in 2003 was avoided. The procedure applied by the Publications Office is not covered by the provisions of the Financial Regulation and infringes Article 97(1) of the implementing rules, according to which expenditure has to be validated on the basis of services actually rendered. The Court finds that the correct payment procedures should have been applied.

9.62. REPLY OF THE COMMISSION

The Office recognises the materiality of the error detected.

Annual activity reports and declarations of the authorising officers by delegation

9.63. Generally, the annual activity reports of the Directors-General and Directors who are authorising officers for most of the administrative expenditure give a clear and thorough view of the activities and achievements of the Directorates-General and Offices for which they are responsible.

9.64. Some of the authorising officers report that not all the Internal Control Standards had been fully implemented, in particular with respect to the detailed documentation of all procedures applied, but all of them declare that ‘the control procedures put in place give the necessary guarantees concerning the legality and regularity of the underlying transactions’. The Director-General for External Relations adds to his declaration a reservation concerning the insufficient implementation in the Commission’s Delegations of the Internal Control Standards Nos 16 (‘segregation of duties’) and 17 (‘supervision’).

Overall conclusion and recommendations

9.65. Considerable efforts have been made by the Institutions to adapt their supervisory systems and controls to the requirements of the new Financial Regulation. Nevertheless, the required changes were not entirely achieved by most of the Institutions, where weaknesses were noted which pose a risk as to the legality and regularity of the underlying transactions (5).

9.65. REPLY OF THE EUROPEAN PARLIAMENT

Reply from the internal auditor:

‘As far as the second part of the second sentence and the footnote are concerned, the Court does not specify in which of the institutions it found weaknesses with the internal audit. No observations to this effect have been made concerning the European Parliament’s internal audit either in paragraphs 9.7 to 9.17 of this report which relate to Parliament, or in the statement of findings preliminary to the annual report which were received by Parliament earlier, nor were such observations made by the staff of the Court when those preliminary findings were examined.’

Parliament supports its internal auditor’s reply. It draws attention to the importance of his work in the self-assessment of the level of implementation of the MSIC carried out by Parliament and to which the Court refers in paragraph 9.11. Self-assessment allowed action plans to be drawn up in order to address weaknesses detected.

(5) Namely as regards the effective implementation of internal control standards, insufficient ex post controls and insufficient implementation of the internal audit function.
The Courts Observations

9.65. Reply of the Commission

Implementation of reform is a continuous process. Therefore, the Commission invests much effort and interest in enhancing continuously these practices. On the other hand, supervision is really executed and effective in the services, evidencing of these supervision needs more focus. The Commission is organising specific workshops on this issue in the second half of 2004.

9.66. Except for the cases noted in paragraphs 9.23, 9.28, 9.45 and 9.62 the Court's audit shows that the sample of underlying transactions examined was not materially affected by errors.

9.67. In 2003, for the first time, the authorising officers by delegation of the Institutions produced annual activity reports as required by Article 60 of the Financial Regulation (6). These reports provide useful information as regards the functioning of supervisory systems and controls. However, their contents should be improved so as to allow the Court to consider them as a source of information for its own Statement of Assurance.

9.67. Reply of the Commission

The Commission is already in its third year of experience in this domain. The Court also acknowledges the continuous enhancements done by the Commission. The current AAR are useful source of information on the internal control systems of the DG’s.

9.67. Reply of the Court of Auditor

The Court departments concerned have noted the recommendation and incorporated it in their action plans for the further setting-up of the procedures required under the new Financial Regulation.

9.68. Although for administrative expenditure taken as a whole the transactions examined by the Court were not materially affected by errors, the Court notes that there are risks to the legality and regularity of the underlying transactions. This is due to the fact that the supervisory systems and controls which replaced the former Financial Control in 2003 have not yet met basic requirements of the new Financial Regulation in all the Institutions. The Court recommends that attention be specifically paid to the enforcement of all the requirements set out in the new Financial Regulation.

9.68. Reply of the Commission

The Commission undertook a readiness assessment by the end of 2002, which indicated that services were ready for launching the new Financial Regulation specificities as acknowledged by the Court in paragraph 9.54.

9.68. The Court of Auditors' Reply

See reply to paragraph 9.67.

(6) At the Commission similar reports had already been produced in previous years.
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AUDIT OF THE SATELLITE BODIES

9.69. The Court’s annual audit of the EU’s satellite bodies (SBs) is the subject of specific annual reports (7). The principal data on the SBs are set out in Table 9.4.

9.70. The SBs’ budgets totalled 778.0 million euro in 2003, as against 852.2 million euro (8) in 2002. Their combined staff, as shown in their establishment plans, increased from 2 037 employees in 2002 to 2 204 in 2003.

Table 9.4 — Budgets and staff numbers in 2002 and 2003 — Satellite bodies (SBs)

<table>
<thead>
<tr>
<th>Headquarters</th>
<th>Year of establishment</th>
<th>2002</th>
<th>2003</th>
<th>Authorised staff</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Centre for the Development of Vocational Training</td>
<td>Thessalonica 1975</td>
<td>14.2</td>
<td>14.7</td>
<td>83</td>
</tr>
<tr>
<td>European Foundation for the Improvement of Living and Working Conditions</td>
<td>Dublin 1975</td>
<td>17.4</td>
<td>16.8</td>
<td>88</td>
</tr>
<tr>
<td>European Environment Agency</td>
<td>Copenhagen 1990</td>
<td>25.2</td>
<td>27.5</td>
<td>106</td>
</tr>
<tr>
<td>European Training Foundation</td>
<td>Turin 1990</td>
<td>16.8</td>
<td>17.2</td>
<td>123</td>
</tr>
<tr>
<td>European Monitoring Centre for Drugs and Drug Addiction</td>
<td>Lisbon 1993</td>
<td>10.4</td>
<td>10.5</td>
<td>59</td>
</tr>
<tr>
<td>European Agency for the Evaluation of Medicinal Products</td>
<td>London 1993</td>
<td>61.3</td>
<td>84.2</td>
<td>251</td>
</tr>
<tr>
<td>Translation Centre for the bodies of the European Union</td>
<td>Luxembourg 1994</td>
<td>23.6</td>
<td>29</td>
<td>158</td>
</tr>
<tr>
<td>Community Plant Variety Office</td>
<td>Angers 1994</td>
<td>10.5</td>
<td>11.1</td>
<td>33</td>
</tr>
<tr>
<td>Office for Harmonisation in the Internal Market</td>
<td>Alicante 1994</td>
<td>154.7</td>
<td>157.4</td>
<td>715</td>
</tr>
<tr>
<td>European Agency for Safety and Health at Work</td>
<td>Bilbao 1995</td>
<td>13.2</td>
<td>14.6</td>
<td>31</td>
</tr>
<tr>
<td>European Monitoring Centre on Racism and Xenophobia</td>
<td>Vienna 1997</td>
<td>6.2</td>
<td>6.6</td>
<td>28</td>
</tr>
<tr>
<td>European Agency for Reconstruction</td>
<td>Thessalonica 2000</td>
<td>495.9</td>
<td>358.6</td>
<td>316</td>
</tr>
<tr>
<td>Eurojust</td>
<td>The Hague 2002</td>
<td>2.8</td>
<td>8.1</td>
<td>46</td>
</tr>
<tr>
<td>European Aviation Safety Agency</td>
<td>Brussels 2002</td>
<td>—</td>
<td>4.7</td>
<td>—</td>
</tr>
<tr>
<td>European Maritime Safety Agency</td>
<td>Brussels 2002</td>
<td>—</td>
<td>4.5</td>
<td>—</td>
</tr>
<tr>
<td>European Food Safety Authority</td>
<td>Brussels 2002</td>
<td>—</td>
<td>12.6</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>852.2</strong></td>
<td><strong>778.0</strong></td>
<td><strong>2 037</strong></td>
</tr>
</tbody>
</table>

(7) In the process of publication in the OJ.
(8) The smaller figure is explained by the reduction in the activities of the European Agency for Reconstruction.
9.71. The financial year 2003 saw the introduction of the new framework financial regulation (9), on the basis of which the SBs were to draw up and adopt their own financial regulations.

9.72. During the year, after obtaining the Commission’s opinion, all but three of the SBs had adopted their new financial regulations. Those SBs which were unable to adopt specific financial regulations provisionally applied the framework financial regulation (10) or their specific draft regulation pending the Commission’s opinion (11). All the SBs included the provisions of the framework financial regulation, with minor adjustments due to the nature of their activities. The only notable exception was the European Agency for the Evaluation of Medicinal Products, which chose thresholds for procurement procedures which departed from the standards laid down in the framework financial regulation.

REPLY OF THE COMMISSION

As regards the financial regulation of the European Medicines Evaluation Agency (EMEA), the Commission demanded that the Agency align itself closely on the framework financial regulation. A new text was adopted with the Commission’s approval in June 2004.

Since late 2003 the European Agency for Reconstruction (EAR) has also obtained the Commission’s approval, adopting its financial regulation on 4 June 2004.

9.73. The implementation of the principles of the framework financial regulation entails restructuring the SBs’ internal control systems, in particular following the replacement of financial control and the introduction of an internal audit capability. This restructuring requires the staff responsible for financial matters to adapt to the new situation and retrain; this particularly affects the authorising officers, whose responsibility has increased. For two thirds of the SBs, the systems introduced by the staff responsible for financial matters have not yet been evaluated or audited by an internal audit unit.

9.74. As regards the accounts, the main change is the introduction of the principle of accruals-based accounting, which requires working methods to be altered and accounting tools to be adapted. In order for the accounts of the institutions and other bodies of the EU to be consolidated by the financial year 2005, the SBs’ accounting rules are to be adopted by the Commission’s Accounting Officer pursuant to Article 133 of the general Financial Regulation, a requirement which is reiterated in Articles 85 (keeping of the accounts) and 90 (keeping of the inventory) of the framework financial regulation.

REPLY OF THE COMMISSION

As part of the Commission’s accounting system modernisation project an Accounting Standards Committee was set up to assist in the preparation of the future EC accounting rules. Following a consultative process of the agencies on the EC accounting rules, these will be adopted by the Commission’s Accounting Officer before the end of 2004 and are thus applicable to all bodies falling under Article 185 of the Financial Regulation.


(10) Eurojust and the European Agency for Reconstruction.

(11) The European Agency for the Evaluation of Medicinal Products.
THE COURTS OBSERVATIONS

9.75. As the Commission had not yet finalised standards for switching from the cash-accounting principle to the accruals-based accounting principle, the SBs adopted various approaches for drawing up their annual accounts for the financial year 2003. The majority of SBs kept to the previous principles, while some presented their accounts using the accruals-based accounting principle and the remaining SBs only applied the accruals-based accounting principle to transactions for which they possessed the necessary information. In addition, with the exception of Eurojust, those SBs which applied the accruals-based accounting principle did not reprocess the data for 2002, which makes it difficult to compare one financial year to another. Table 9.5 shows how far the new framework financial regulation has been implemented.

Table 9.5 — Application of the framework financial Regulation as at 31 December 2003

<table>
<thead>
<tr>
<th>Agency</th>
<th>Financial Regulation in force</th>
<th>Internal audit capability</th>
<th>Application of the principle of accrual-based accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Environment Agency</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>European Agency for Reconstruction</td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>European Agency for Safety and Health at Work</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>European Centre for the Development of Vocational Training</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Translation Centre for the bodies of the European Union</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>European Foundation for the Improvement of Living and Working Conditions</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>European Agency for the Evaluation of Medicinal Products</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>European Training Foundation</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Community Plant Variety Office</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>European Monitoring Centre for Drugs and Drug Addiction</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Office for Harmonization in the Internal Market</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>European Monitoring Centre on Racism and Xenophobia</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>European Food Safety Authority</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Eurojust</td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>European Maritime Safety Agency</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>European Aviation Safety Agency</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
THE COURTS OBSERVATIONS

9.76. As well as problems with implementing the principles of the new framework financial regulation, the fixed-asset inventory systems of many SBs have shortcomings which introduce an element of uncertainty to the evaluation of the fixed assets shown in their balance sheets.

9.77. The Commission must take the necessary steps to ensure that, pursuant to Articles 85 and 90 of the framework financial regulation, the SBs have the accounting rules and methods needed to produce their accounts according to the principles set out in their new financial regulations and ensure that the consolidation of the accounts planned for the financial year 2005 is successful.

9.77. REPLY OF THE COMMISSION

The responsibility for the preparation of annual accounts in compliance with the future EC rules rests with each individual accounting officer of these Agencies, including the use of appropriate accounting tools.

The Commission has already taken steps to ensure that the Agencies will be prepared for the future accounting requirements. It arranges regular meetings with the accountants of the Agencies to discuss accounting matters, in particular to provide updates on the progress of the modernisation project, as well as informing them what will be required now, and in the future (the last meeting was held on 11 June 2004). The Agencies are also represented on the Accounting Standards Committee and in early June 2004 all Agencies were consulted on the new EC accounting rules, having already completed a questionnaire in April to help them to identify the gaps between current accounting practices and future requirements. They have also been given access to the first draft of the Commission's on-line accounting manual. For accounting matters, the Commission have a designated contact point for Agencies to answer their questions.

9.78. For two SBs, the Court qualified its opinions on their accounts or on the legality and regularity of the underlying transactions (12). The Court had not yet adopted its report on the European Agency for Reconstruction at the time of adoption of its Annual Report.

9.79. As for the SBs, they should compare experiences more often so as to identify the best current practices and the most effective tools in order to improve their management and achieve economies of scale. They should concentrate on IT tools such as the budgetary accounting system or the fixed-asset inventory system in order to make the budgetary accounts more consistent with the general accounts in the context of their adaptation to the principles laid down in the framework financial regulation. In terms of best practice, the degree of consistency between the work programme, the establishment plan and the budget at the European Monitoring Centre on Racism and Xenophobia is worthy of note. In operational terms, this consistency is a direct and transparent reflection of the Centre's powers as defined in its basic regulation. In terms of tools, the European Training Foundation has an effective IT system for managing and monitoring procurement procedures, which is useful for averting potential irregularities.

9.79. REPLY OF THE COMMISSION

In response to a request from the Agencies the Commission has confirmed to them that the current accounting system (SI2) will continue to be available to them until the end of 2005 while its replacement (ABAC) will also be made available to them in 2005 if they so wish. All documentation and software relating to the future IT systems (including SAP) will be at the disposal of the Agencies.

(12) The Court expressed qualified opinions in its reports on the European Agency for the Evaluation of Medicinal Products and the European Monitoring Centre on Racism and Xenophobia.
9.80. The Court's audit of the European Schools is the subject of a specific annual report (not published in the Official Journal), which is submitted to the Board of Governors of the European Schools. At the start of the 2003 school year, the Schools had 19,248 pupils. As at 31 December 2003, the Schools employed 1,640 staff. The Schools' budget of 201.4 million euro was financed principally by a Commission grant (114.8 million euro) and by contributions from the Member States (44.1 million euro).

9.81. For the financial year 2003, the audit concerned the consolidated accounts of the Schools as drawn up by the Office of the Secretary-General of the Board of Governors and the accounts of the Brussels III and Luxembourg Schools. The audits did not bring to light any anomalies likely to affect the Court's opinion of the Schools' accounts.

9.82. The audits carried out during the financial year 2003 highlighted shortcomings in the management of the calculation of the weighting which ensures that teachers on secondment receive equal salaries. Of the 9,000 files submitted, 2,416 have not yet been processed because they are incomplete. 475 of these files date from 1990-1994 and are very unlikely to be settled. Some Schools have introduced a rigorous system for managing weighting files, as a result of which the Office's backlog is now relatively small. The Schools should be given clear and specific instructions with a view to promoting the best practices observed elsewhere and avoiding excessive delays in the handling of files.

9.82. REPLY OF THE COMMISSION

Considerable progress has been made in recent years in reducing the backlog. Some delay is inherent in the procedure. The Office of the Secretary General of the Board of Governors will take the following further measures:

- review the staff resources allocated for this work;
- examine the older cases with a view to writing off those with little chance of a successful outcome;
- seek to resolve the difficulties experienced in obtaining suitable tax documentation from certain Member States;
- ensure that best practice is built on to establish a uniform and proactive approach in all schools.
CHAPTER 10

Financial instruments and banking activities

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<td>Introduction</td>
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<td>IT weaknesses</td>
</tr>
<tr>
<td>Readaptation aid</td>
</tr>
</tbody>
</table>
10.1. The Community financial instruments related to the banking activities are the following:

- loans granted from budget resources or from borrowed funds;
- loan-related interest subsidies from budgetary funds;
- guarantees on borrowings subscribed and on loans granted by third parties;
- shareholdings in common interest bodies (1);
- 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. The European Coal and Steel Community in liquidation is involved in similar transactions (see paragraphs 10.30-10.34).

10.3. Many of the measures derived from these instruments are managed by banks or financial institutions under mandate from the Community, mainly by the Community’s specialist financial institutions, i.e. the European Investment Bank (EIB) and the European Investment Fund (EIF). As regards their activities in connection with the management of Community expenditure and revenue, three tripartite agreements governing the Court’s rights of access to information are currently in force. Two of these agreements were concluded with the EIB and one with the EIF. The Commission is party to all these tripartite agreements, as it holds final responsibility for implementing the budget (see Annex 1).

(1) For example, the European Bank for Reconstruction and Development (EBRD).
10.4. The Court’s audit covered:

— financial instruments in favour of small and medium-sized enterprises — three of these instruments are managed by the EIF (2) and one is directly managed by the Commission;

— the application of the Guarantee Fund for External Actions (see Table 10.1), and

— the activities of the European Coal and Steel Community in liquidation (ECSCIL) (see Table 10.2).

<table>
<thead>
<tr>
<th>Financial year</th>
<th>Total guarantee outstanding at 31 December (1)</th>
<th>Total Fund resources at 31 December (1)</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>
</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 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.

Source: Commission.

(2) The EIF was established in 1994 with the task of contributing to the pursuit of Community objectives. As of 2000 the EIB owns over 60 % of the EIF’s shares, the European Commission owns 30 % on behalf of the EU; the remainder is held by public and private financial institutions. As of 2001 the EIF provides venture capital and small and medium-sized enterprises portfolio guarantees for financial intermediaries.
### Table 10.2 — ECSC in liquidation balance sheet and outstanding commitments of the ECSC operating budget at 31 December 2003

**ECSC in liquidation Balance Sheet at 31 December 2003**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EUR million</td>
<td>%</td>
<td>EUR million</td>
</tr>
<tr>
<td>Loans and advances to banks (including balances with central banks)</td>
<td>155,62</td>
<td>6.36</td>
<td>113,57</td>
</tr>
<tr>
<td>Loans and advances to customers</td>
<td>682,42</td>
<td>27.87</td>
<td>628,95</td>
</tr>
<tr>
<td>Bonds and other fixed income securities</td>
<td>1 528,90</td>
<td>62.44</td>
<td>1 551,46</td>
</tr>
<tr>
<td>Shares and other variable income securities</td>
<td>28.00</td>
<td>1.14</td>
<td>18.77</td>
</tr>
<tr>
<td>Tangible assets</td>
<td>0.00</td>
<td>0.00</td>
<td>0.01</td>
</tr>
<tr>
<td>Other assets</td>
<td>6.02</td>
<td>0.25</td>
<td>3.30</td>
</tr>
<tr>
<td>Prepayment and accrued income</td>
<td>47.57</td>
<td>1.94</td>
<td>73.04</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>2 448,53</strong></td>
<td><strong>100.00</strong></td>
<td><strong>2 389,10</strong></td>
</tr>
</tbody>
</table>

**Liabilities**

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>23 July 2002</th>
<th>31 December 2002</th>
<th>31 December 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amounts owed to credit institutions</td>
<td>779,12</td>
<td>31.82</td>
<td>714,36</td>
</tr>
<tr>
<td>Accruals and deferred income</td>
<td>22.56</td>
<td>0.92</td>
<td>49.77</td>
</tr>
<tr>
<td>ECSC operating budget (outstanding commitments)</td>
<td>400.92</td>
<td>16.37</td>
<td>342.56</td>
</tr>
<tr>
<td>Provisions for liabilities and charges</td>
<td>586.01</td>
<td>23.93</td>
<td>554.74</td>
</tr>
<tr>
<td>Budget for financing coal and steel research</td>
<td>240.00</td>
<td>9.80</td>
<td>240.00</td>
</tr>
<tr>
<td>Reserves and surplus</td>
<td>419.92</td>
<td>17.15</td>
<td>487.67</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td><strong>2 448,53</strong></td>
<td><strong>100.00</strong></td>
<td><strong>2 389,10</strong></td>
</tr>
</tbody>
</table>

**Outstanding commitments of the ECSC operating budget at 31 December 2003**

(million euro)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Readaptation</td>
<td>128.96</td>
<td>132.61</td>
<td>10.97</td>
<td>0.40</td>
<td>121.24</td>
<td>35.13</td>
<td>10.35</td>
<td>75.76</td>
</tr>
<tr>
<td>Research</td>
<td>174.02</td>
<td>180.83</td>
<td>14.70</td>
<td>7.42</td>
<td>158.71</td>
<td>56.14</td>
<td>3.46</td>
<td>99.11</td>
</tr>
<tr>
<td>Interest subsidies (Article 56)</td>
<td>25.01</td>
<td>16.84</td>
<td>0.80</td>
<td>0.00</td>
<td>16.04</td>
<td>16.04</td>
<td>4.64</td>
<td>11.20</td>
</tr>
<tr>
<td>Social measures coal (Rechar)</td>
<td>52.93</td>
<td>70.64</td>
<td>20.62</td>
<td>3.45</td>
<td>46.57</td>
<td>46.57</td>
<td>3.67</td>
<td>36.40</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>380.92</strong></td>
<td><strong>400.92</strong></td>
<td><strong>47.09</strong></td>
<td><strong>11.27</strong></td>
<td><strong>342.56</strong></td>
<td><strong>97.97</strong></td>
<td><strong>22.12</strong></td>
<td><strong>222.47</strong></td>
</tr>
</tbody>
</table>

10.5. In 1998 (1) the Council established measures to support innovative and job-creating small and medium-sized enterprises (the Growth and Employment Initiative). The policy in favour of small and medium-sized enterprises was further developed by a Council Decision in 2000 (2) establishing a Multiannual programme for enterprise and entrepreneurship, and in particular for small and medium sized enterprises (2001-2005).

10.6. The Growth and Employment Initiative and the Multiannual Programme include the following measures in favour of small and medium-sized enterprises:

— Small and Medium-sized Enterprise Guarantee Facility, managed by the EIF, providing guarantees or counter-guarantees to intermediaries (3) for loans granted by financial institutions to small and medium-sized enterprises;

— European Technology Start-up Facility (ETF), managed by the EIF, providing equity investments in venture capital funds investing in small and medium-sized enterprises;

— Seed Capital Action, managed by the EIF, providing subsidies to venture capital funds; and

— Joint European Venture, managed by the Commission, providing subsidies for the establishment of joint ventures of small and medium-sized enterprises.

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(3) These intermediaries, which conclude guarantee contracts with the EIF are either institutions granting loans or mutual and national credit guarantee schemes.
10.7. When the EIF manages the measures on behalf of the Commission, the funds are operated outside the general budget in separate trust accounts. Cash is transferred from the general budget and accounted for as budgetary expenditure at the date of transfer. The trust accounts are interest-bearing and the interest earned in addition to other income, such as capital repayments and dividends, is also added to the trust accounts (6).

The Court’s audit

10.8. The overall audit objective was to obtain assurance that the Commission is implementing the programmes in line with the terms of the Council Decisions and to verify the regularity of the use of the funds. The focus was on the following topics: use of appropriations, the management of funds and the control of funds.

Overall observations on the programmes

Reporting data on employment

10.9. Under Council Decision 98/347/EC of 19 May 1998 the Commission is required to report annually to both the European Parliament and the Council on the implementation of the measures, including their immediate effects on the creation of employment and the prospects for the creation of employment in the long term (7). Furthermore, the Council Decision also foresees an evaluation of the programme within 48 months at most from the date of its adoption. This evaluation (8) was carried out on the basis of a survey of beneficiary companies and transmitted to the European Parliament and to the Council in December 2003.

10.10. As far as employment creation figures are concerned the Commission relies for its annual report (9) to the European Parliament and the Council on information communicated by the intermediaries to the EIF.

(6) The amounts in the trust accounts are recorded in the Community balance sheet under item VII ‘short term assets’, subheading ‘Sundry debtors’.


THE COURT’S OBSERVATIONS

Reporting data on financial participations

10.11. Inaccuracies have been detected in the information provided in EIF reports to the Commission concerning the share of Community participation, the legal structures of venture capital funds and the net asset values.\(^{10}\)

Observations on the specific measures

Small and medium-sized enterprise guarantees

Calls on guarantees

10.12. Total calls on guarantees for the SME Guarantee facility\(^{11}\) amounted to 57.2 million Euro as per 31 December 2003. In Germany (by far the largest beneficiary) all charges, including defaulted interest, were included in the amounts called down by the intermediaries from the EIF guarantee. In other Member States visited the defaulted amounts were claimed without charges. In the contracts between the EIF and the intermediaries, the Commission should endeavour to provide similar guarantee benefits in all Member States.

Commitment fees

10.13. According to the agreements between the EIF and new intermediaries,\(^{12}\) commitment fees have to be paid by the intermediaries to the European Investment Fund\(^{13}\) if the guaranteed loan volume is lower than forecast, in order to encourage intermediaries to use the measure. The fee set by the European Investment Fund is 0.3 % per annum calculated on the basis of the difference between portfolio volume\(^{14}\) and fixed target volumes\(^{15}\).

10.11. The Commission is generally satisfied with the quality of the reports received from the EIF. The EIF has corrected the inconsistencies and errors detected by the Court, none of which had any material impact on the information given to the budgetary authorities or on the Community financial statements.

THE COMMISSION’S REPLIES

Differences in the specific conditions of the guarantees or the type of guarantee systems that intermediaries have put in place may lead to differences in the guarantee benefits.

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\(^{10}\) Since 2002 these participations are included in the Community balance sheet under item IV B 1 (Financial fixed assets, other financial fixed assets, subscriptions and participations).

\(^{11}\) SME guarantee facility under the Growth and Employment Initiative and under the Multiannual Programme.

\(^{12}\) Intermediaries that are new for participation in the SME guarantee facility, new contracts with intermediaries that participated already in the past are not concerned.

\(^{13}\) The fees are allocated to the trust accounts, they are not income of the EIF.

\(^{14}\) In the case of loan guarantees the loan volume, and in the case of counter-guarantees the guarantee volume.

\(^{15}\) The method has been changed recently in that the commitment fee is now calculated on a lower basis taking into account the percentage of the guarantee part and not the whole loan volume.
THE COURT’S OBSERVATIONS

10.14. However, in the case of two intermediaries (one in France and one in Italy) payment of these commitment fees was not required in the guarantee letters (contracts). The Court is not convinced by the explanations provided by the Commission.

Equity guarantees

10.15. The audit showed that an equity guarantee had been extended by an intermediary to a fund in which the European Investment Fund already had a direct investment. The terms of the agreement between the EIF and the intermediary stipulate that: ‘Guarantees may only be included in the portfolio […] provided that the guarantee has not been extended by the intermediary to a venture capital fund in which the European Investment Fund is a direct investor’. The EIF is invited to review the adequacy of the information made available to intermediaries.

State aid rules

10.16. The selection criteria for guarantee agreements with intermediaries require compliance with State aid rules (16) and intermediaries must declare that they are in compliance with these rules at the beginning of each scheme. However, the Commission does not ascertain compliance with the rule during the life period of the guarantee schemes.

European Technology Facility (ETF) — Start-up Facility

Valuation methods

10.17. At the end of 2003 the net investments in venture capital funds in the context of the ETF start-up facility amounted to 64,6 million EUR. The current net asset value of the participation was 38,9 million euro at the end of 2003.

THE COMMISSION’S REPLIES

10.14. The two intermediaries referred to under point 10.14 were approved under the Growth and Employment Initiative (G & E). Under G & E, the EIF may charge commitment fees, where practicable. In the EIF’s professional opinion, it was not judged practicable to charge commitment fees for these two intermediaries as they cover their losses directly from Member States’ budgetary resources.

10.15. Consistent with the terms of the agreement, the equity guarantee in question was never included in the EIF portfolio. The Commission takes note of the Court’s invitation to the EIF.

10.16. The State aid rules, as applicable to guarantees under the SME Guarantee Facility, do not provide for the Commission to ascertain compliance during the life period of guaranteed loans.

The EIF is already contractually required to resubmit to the Commission a request for approval in case of a substantial modification to a guaranteed scheme.

10.18. The Court’s audit has shown that the majority of venture capital funds audited had no clear, precise rules on the valuation of their investments (17).

10.18. The four venture capital funds to which the Court refers had contractual obligations to apply the guidelines of the European Venture Capital Association (EVCA), and disclosed information in accordance with these guidelines. The reference to EVCA guidelines is clearly stated in the funds’ contractual documentation, annual reports or in their quarterly reporting to the shareholders. The other case involved an investment that took place before the EVCA valuation guidelines were released in March 2001, so the contract does not refer explicitly to EVCA. However, the fund describes its valuation methodology which does not materially deviate from EVCA and has been validated by the fund’s external auditors.

10.19. The Commission should ensure that the venture capital funds, in which the EIF invests, apply recognized industry standards including common and reliable valuation methods, such as the EVCA guidelines, in order to ensure transparency and to provide a fair view of their investment portfolios.

10.19. The Commission contractually requires that funds into which the EIF invests under the EC mandated programmes apply the valuation guidelines of the European Venture Capital Association (EVCA), which are current industry standard. Funds under older agreements that were entered into before the release of the EVCA guidelines in March 2001 have either adopted these guidelines or do not materially deviate from these principles. The valuations are audited by external auditors and further reviewed by the EIF.

Seed Capital Action

10.20. The Seed Capital Action was set up by Council Decision 2000/819/EC. The relevant Fiduciary and Management Agreement between the Commission and the European Investment Fund provides for subsidies of 100,000 euro per person for up to three additional staff for venture capital funds, business incubators or their respective management companies. A total of 5.6 million euro was committed by the Commission up to the end of 2003.

10.21. The market has shown practically no interest in this measure. Out of seven funds initially interested, only two concluded contracts for these subsidies. No payments have been made.

10.21. An external evaluation of MAP is currently being carried out, which includes an evaluation of the Seed Capital Action.

Joint European Venture

10.22. The Joint European Venture provides financial contributions of up to 100,000 euro to small and medium-sized enterprises for the setting-up of new transnational joint ventures within the EU (19).

10.22. The Joint European Venture provides financial contributions of up to 100,000 euro to small and medium-sized enterprises for the setting-up of new transnational joint ventures within the EU (19).

(17) Out of five venture capital funds visited on the spot only one had detailed guidelines and justification for all valuations of investments made.

(18) European Venture Capital Association.

THE COURT’S OBSERVATIONS

10.23. However, the measure has not proved attractive for small and medium-sized enterprises and to date only 44 joint ventures have been created. The Commission is proposing to phase out this programme which ‘is expensive, slow and complicated to administer’ (20).

10.23. Following an evaluation of the Joint European Venture (JEV) and the other financial instruments of the Growth and Employment Initiative (1998-2000) as at 29 May 2002, the Commission submitted on 8 December 2003 a proposal for a decision of the European Parliament and of the Council to amend the multiannual programme for enterprise and entrepreneurship (2001-2005) and to phase out JEV. This proposal was adopted by Decision No 593/2004/EC of the European Parliament and of the Council of 21 July 2004 and JEV will be closed on 29 December 2004 to new applications for financial contributions submitted by the financial intermediaries.

Conclusions

10.24. There is a need for improvement of reporting quality, in particular in respect of the data used for valuation of European participations in the Funds (see paragraph 10.11).

10.24. The Commission is generally satisfied with the quality of the reports received from the EIF. All funds in which the EIF invests are already contractually required to provide data for valuation in accordance with EVCA Guidelines, which are current industry standard. Financial statements including valuations are audited by the venture-capital funds’ external auditors. Valuations thus reported are reviewed by the EIF to ensure that they do not materially deviate from EVCA Guidelines.

10.25. Consistent principles should be applied in respect of calls on guarantees in the various Member States (see paragraph 10.12).

10.25. Consistent rules are already being applied in respect of guarantee calls, as pointed out in the reply to point 10.12.

10.26. As regards the valuation of investments in venture capital funds, there is a need for closer checks on the application of recognised industry standards (see paragraphs 10.18 and 10.19).

10.26. The Commission points out that it already contractually requires the EIF and the venture-capital funds in which the EIF invests, to apply EVCA Guidelines, which are the recognised industry standard, and that these standards are generally applied.

10.27. The Commission has proposed the abolition of the ‘Joint European Venture’. It should also review the ‘Seed Capital Action’ measure. (See points 10.20-10.23).

10.27. An external evaluation of MAP is currently being carried out, which includes an evaluation of the Seed Capital Action.

GUARANTEE FUND FOR EXTERNAL ACTIONS

10.28. The Community budget is particularly exposed to credit risk as regards the guarantees for loans granted by the EIB to third countries. The purpose of the Guarantee Fund for External Actions is to reimburse the EIB in the event of a beneficiary’s defaulting and to avoid direct calls on the Community budget.

10.29. The audit procedures applied by the Court to the accounts of the Guarantee Fund did not reveal any issues concerning the existence and valuation of the assets held by the Fund (see Table 10.1).

THE EUROPEAN COAL AND STEEL COMMUNITY IN LIQUIDATION

Introduction

10.30. On 23 July 2002 the Treaty establishing the European Coal and Steel Community (ECSC) expired. A Protocol annexed to the Treaty establishing the European Community transferred the ECSC’s assets and liabilities to the European Community. The net worth of these assets, referred to as the European Coal and Steel Community in Liquidation (ECSC in liquidation), is to be allocated to research in sectors related to the coal and steel industry. The European Commission is entrusted with winding-up the financial operations still in progress when the ECSC Treaty expired (21).

The ECSC in liquidation Financial Statements

10.31. The ECSC in liquidation financial statements have retained the same structure as that used prior to the expiry of the ECSC Treaty and have been examined by an external auditor. As in previous years the Court examined the work carried out by the external auditor. By doing so the Court took assurance on the fact that the Financial Statements of the ECSC in liquidation fairly present its net worth and financial situation as at 31 December 2003.

IT weaknesses

10.32. Some IT weaknesses mentioned in the Court’s Annual report concerning the financial year 2002 were only partially resolved (22). The Commission should take the necessary steps to remedy the problems that are still outstanding.

10.32. The IT weaknesses mentioned by the Court in the 2002 report have all been addressed and the issue of ‘physical and logical security’ has been resolved. With regard to the ‘Plan de continuité des activités’, a Business Continuity Plan and a disaster recovery plan for the accounting software have been implemented. The only remaining issue is the establishment of a disaster recovery site planned to be finalised before the end of 2004.

(22) Especially those concerning the ‘sécurité logique et physique’, the ‘plan de continuité des activités’, and the accounting software used by the Directorate-General for Economic and Financial Affairs.
10.33. At 31 December 2003 readaptation aid amounted to 75.76 million euro and represented the second largest category of outstanding commitments of the ECSC.I.L (see Table 10.2).

10.34. In 2003 an audit was carried out by the Court in Germany to complement similar audits undertaken in previous years (23). Although the audit did not show any general weaknesses regarding the management of the readaptation aid, differences were found in the eligibility criteria for workers benefiting from this aid as compared to the criteria applied in the other countries visited in previous years.

(23) Previous years audits of the Court covered steel traditional aid in the United Kingdom and in Italy. Audit in Germany concerned both traditional aid and RECHAR (Volet social charbonnier).

10.33. Ongoing activities since the expiry of the Treaty consist of the liquidation of outstanding commitments of ECSC readaptation aid. This will continue until 2007.

10.34. The difference in the eligibility criteria is due to the fact that the German national criteria are stricter than those established by the European Commission. Member States had the opportunity to implement such national schemes and if they did, they were free to impose different eligibility criteria than those agreed with the Commission in the bilateral conventions.
## Annex 1 — Tripartite agreements currently in force

<table>
<thead>
<tr>
<th>Parties</th>
<th>Subject</th>
<th>Date of conclusion or latest renewal</th>
<th>Date of expiry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Court of Auditors, European Commission, European Investment Bank</td>
<td>Audit by the Court on loan operations under the mandate conferred by the European Communities on the Bank and on the operations managed by the Bank which are entered in, and guaranteed by, the general budget of the European Communities Applicable also to the operations financed from the European Development Fund which the Bank manages.</td>
<td>27 October 2003</td>
<td>27 October 2007 Renewable by tacit agreement for further four-year periods</td>
</tr>
<tr>
<td>Court of Auditors, European Commission, European Investment Bank</td>
<td>Audit by the Court of the financial management of the Guarantee Fund</td>
<td>11 January 1996</td>
<td>No expiry or renewal clause</td>
</tr>
<tr>
<td>Court of Auditors, European Commission, European Investment Fund</td>
<td>Audit by the Court of the Community shareholding in the European Investment Fund</td>
<td>25 September 2003</td>
<td>25 September 2005 Renewable by tacit agreement for further two-year periods</td>
</tr>
</tbody>
</table>