

COURT OF AUDITORS



In accordance with the provisions of the Treaties (Article 45c(4) of the ECSC Treaty, 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 8 and 9 October 2003, adopted its

ANNUAL REPORT

concerning the financial year 2002

(2003/C 286/01)

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.

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GENERAL INTRODUCTION

Structure and content of the report

0.1. In recent years the Statement of Assurance has become an increasingly important element of the Court's Annual Report. This year's Report places the Statement, together with the information supporting it, in chapter 1. For the first time the Statement is also published with the consolidated accounts ⁽¹⁾ of the European Community in a separate edition of the *Official Journal of the European Union*.

0.2. A further change to the Report is the consolidation of the Court's observations on budgetary management into a separate chapter (chapter 2). In previous years these observations were presented in the individual chapters dealing with the European Union's revenue and spending.

0.3. The chapters covering revenue and the major areas of spending, which reflect the headings of the financial perspective ⁽²⁾, have as their main element detailed analyses and results of the audit work carried out in the context of the Statement of Assurance for the respective area. In the terminology of Article 248(1) of the EC Treaty, as amended by the Treaty of Nice, these sections are described as 'specific assessments'. These assessments form the main basis for the Statement of Assurance, as described in paragraphs 1.1 to 1.6 of this Report. The chapters also contain the results of reviews following up progress made on implementing the recommendations made by the Court in previous Special and Annual Reports. Summaries are given of the 13 Special Reports published by the Court since the last Annual Report ⁽³⁾. There is also a chapter covering financial instruments and banking activities. The

Annexes to chapters 3 to 9 provide monitoring elements for evaluating financial management of the EU budget.

0.4. As the European Development Funds are financed outside the EU budget, the Court's observations, including a Statement of Assurance, are presented in a separate section of this report.

0.5. The Commission's replies, and, where appropriate, those of the other institutions, are published alongside the observations of the Court.

0.6. This 26th Annual Report is being published at a time when there are two major developments affecting the financial management of the European Union. The first is the continuing reform of the Commission in general, and of financial management in particular, and the second is the accession in May 2004 of 10 new Member States.

The reform of the Commission

0.7. The reform of the Commission, begun in 2000 ⁽⁴⁾, comprises a number of ambitious and fundamental measures aimed at improving both financial and operational management and control. Progress continued to be made during 2002, building on that begun in 2001. In particular positive steps were taken in respect of readying the Commission for implementation of certain provisions of the new Financial Regulation from 1 January 2003. These included the increase in the responsibility of authorising officers by delegation, especially regarding internal control, and the introduction of a central internal audit service, complemented by internal audit capabilities within each Directorate-General.

0.8. Other highlights of the reform include establishing and applying internal control standards, establishing key performance indicators, undertaking accounting reform, the introduction of activity-based management, and the devolution of much of the responsibility for the management of external actions to delegations. The Commission itself recognises that whilst progress has been made, much remains to be done and cites difficulties in recruiting sufficient numbers of staff with the required financial experience, and establishing and promoting the necessary risk-management culture.

⁽¹⁾ Article 129(4) of Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities (OJ L 248, 16.9.2002, p. 1).

⁽²⁾ The financial perspective, which is determined by an interinstitutional agreement between the European Parliament, the Council and the Commission, sets limits on expenditure for each of seven categories (headings) of expenditure for commitment appropriations, and on total expenditure for payment appropriations. The Court does not present a separate chapter for the Reserves heading, as its resources are only used through transfer to one of the other headings.

⁽³⁾ A full list of the reports and opinions adopted by the Court in the last five years is included in Annex II to this Report.

⁽⁴⁾ White Paper on reforming the Commission issued on 1 March 2000 (COM(2000) 200 final).

0.9. Of critical importance for ensuring sound financial management within the Commission are the internal control standards ⁽⁵⁾. These represent the minimum level of tools and procedures designed to help in defining the internal control systems within the Commission's Directorates-General. By the end of 2002 these standards were not being applied to the minimum level throughout all Directorates-General, despite the fact that they were intended for full implementation one year earlier. The Court can only underline the necessity of ensuring the effective and complete application of the standards, as they, together with the principle of the responsibility of Directors-General, represent the cornerstone for much of the reform within the Commission.

0.10. The year 2002 is the second that Directors-General have been required to produce annual activity reports and accompanying declarations. These set out their own assessment of compliance with financial management requirements such as operating adequate internal control systems, and to what extent they provide assurance that Union finances are soundly managed. As noted in this Annual Report, the Court found some improvements in the quality and consistency of these reports, many of which are based on the recommendations made in its 2001 Annual Report. However, further progress is needed, particularly in the definition and quantification of reservations, and in the consistency of the approach followed by the different Directorates-General.

0.11. As the Court has pointed out repeatedly in the past, the areas of the budget for which management is shared, for example with Member States, pose particular challenges due to their complexity and the many layers of administration involved. The expenditure concerned represents the vast bulk of the budget by value and comprises notably agriculture and structural measures. In these areas the Directors-General have many reservations on the systems in place in Member States and their ability to assure the legality and regularity of underlying transactions.

0.12. The scale of the task facing the Commission in these areas is considerable and it is likely to take several years before significant progress is made. Some Directorates-General are only at the stage of obtaining a detailed description of systems in Member States. Furthermore, it was only in 2002 that the Commission

sought a legal opinion clarifying the respective rights and responsibilities of the Commission and the Member States in the area of shared management. The Court will continue to follow this closely.

0.13. The need for progress in the management of funds where responsibilities are shared should not, however, divert attention away from improvements still needed in the management of expenditure for which the Commission is directly responsible.

0.14. The Commission is seeking to apply a comprehensive and systematic approach to managing and monitoring the reform process. Identified weaknesses are accompanied by practical action plans agreed by the Commission, against which progress is subsequently measured. However, as pointed out in chapter 1 ⁽⁶⁾, there is a need to consolidate all the various action plans and updates of the White Paper, in order to make it easier to monitor progress of the reform and ensure that it is being applied coherently and consistently throughout the whole organisation. This would enhance the open and transparent approach to which the Commission is committed.

Enlargement

0.15. In late 2002 the European Union agreed upon the largest wave of enlargement in its history. The accession of the 10 countries concerned requires significant efforts for them in terms of adopting and implementing the *acquis communautaire*, setting up the necessary management and control structures to administer EU aid and coping with the challenges arising from decentralisation. From the outset the Commission has operated a policy of decentralisation for the administration of the EU funds, albeit starting with a high level of *ex ante* Commission control often exercised through its delegations. As accession has approached, the level of decentralisation has increased in order to provide a good basis for administering shared management schemes — agriculture and structural measures — when the accession countries become full Member States.

0.16. As this report describes, delays in setting up the required structures for financial management and control have meant that EU funds have been made available more slowly than initially planned to potential beneficiaries in the countries concerned. The Court has also found weaknesses in the Commission's monitoring

⁽⁵⁾ Communication to the Commission of 18 December 2001 (SEC(2001) 2037/4).

⁽⁶⁾ Paragraph 1.115.

of the systems being put into place. Efforts are therefore still required by both the accession States and the Commission to ensure efficient and effective management of EU funds, and timely delivery of aid to beneficiaries.

0.17. The period following enlargement will see other significant changes such as the implementation of activity-based management and accrual accounting together with the full application of the provisions of the new Financial Regulation. It is imperative that the Commission devotes adequate resources to these tasks to help assure a quality of management that meets the legitimate expectations of the citizens of the Union.

0.18. By the time the Court's next annual report is published, the Union will have welcomed 10 new Member States. Enlargement will add both to the size of the Union's budget and the scale and complexity of the management challenge faced by the Commission and Member States. It will also increase the scope of the Court's work as external auditor of the budget of the enlarged EU. The Court, as a fully independent audit institution, is preparing for this challenge.

REPORT ON THE ACTIVITIES FINANCED FROM THE GENERAL BUDGET

CHAPTER 1

The Statement of Assurance and supporting information

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STATEMENT OF ASSURANCE

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 2002. 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 21 December 1977 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 observations in paragraphs (a) to (d) and the remark in paragraph III, they faithfully reflect the revenue and expenditure of the Communities for the year and their financial position at the year-end:

- (a) in the absence of sufficient budgetary appropriations, 820 million euro of legal commitments are included amongst the off-balance sheet commitments;
- (b) the called-up part (240 million euro) of the Commission's commitment (520 million euro) to the capital of the Galileo joint undertaking does not appear as such on the assets side of the balance sheet;
- (c) the transitional accounts entered on the assets side of the balance sheet in the sum of 91,1 million euro and in the sum of 714,9 million euro on the liabilities side should be redistributed amongst the various other balance sheet or revenue and expenditure (operating) account headings according to the nature of their individual components;
- (d) 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.

III. As has been the case in the past, the origin of the Court's observations lies in the Community accounting system, which was not designed to ensure that the assets are fully recorded. In this context, the Court notes that on 17 December 2002 the Commission adopted an action plan for the modernisation of the European Communities' accounting system. The action plan is supposed to become fully effective as from the 2005 financial year.

⁽¹⁾ Namely 'Revenue and expenditure account: execution of the budget' and 'Consolidated balance sheet', which make up Volume I of the annual accounts of the European Communities, 2002 financial year.

⁽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 2002.

Legality and regularity of the underlying transactions

IV. 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 the revenue, commitments, administrative expenditure and pre-accession aid, although in the latter case the supervisory systems and controls are particularly in need of strengthening.

V. As regards other payments, the Court established that:

- (a) in the case of EAGGF Guarantee Section, the payments were, again, materially affected by errors. Arable crops are less exposed 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 (IACS), are exposed to greater risk, as well as being subject to less efficient controls;
- (b) in the case of the structural measures, in spite of an improvement in the supervisory systems and controls, especially at Commission level, the same types of error occurred at Member State level with the same frequency as in previous years;
- (c) in the case of internal policies, the transactions are still affected by significant errors in terms of legality and regularity. 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, the irregularities noted in the past are persisting at local level. As a result of a process of management decentralisation that is still ongoing, the supervisory systems and controls do not yet provide the Commission with assurance of the legality and regularity of the payments at the level of the bodies responsible for implementing development projects.

8 and 9 October 2003

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THE COURT'S OBSERVATIONS

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INFORMATION IN SUPPORT OF THE
STATEMENT OF ASSURANCE*Introduction*

1.1. Pursuant to Article 248 of the Treaty, the Court of Auditors provides the European Parliament and the Council with a Statement of Assurance concerning the reliability of the accounts and the legality and regularity of the underlying transactions (the DAS). The Treaty of Nice clarified this mandate by authorising the Court to supplement this statement with specific assessments of each major area of Community activity. For the 2002 financial year the Court therefore wished to consolidate the basis for its statement by relying more systematically on an examination of the operation of the supervisory systems and controls set up by the Commission in each of these major areas. This development in the Court's audit approach takes into consideration the key elements of the administrative reform undertaken by the Commission at the beginning of 2000 and, in particular, the reorganisation of its internal control system.

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 financial statements 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 obtain 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 operation of the supervisory systems and controls set up both in the Community institutions and in the Member States and third countries;
- (b) an examination of samples of transactions for each major area by carrying out checks down to final beneficiary level;

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- (c) an analysis of the 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 process of reform at the Commission and, more especially, to the follow-up given to the action plan annexed to the Synthesis of the annual reports and declarations of its directors-general for the 2001 financial year (see paragraphs 1.62 to 1.110)

1.6. Lastly, 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 Chapters 3 to 9.

Action plan for the modernisation of the accounts

1.7. On 17 December 2002 the Commission adopted an action plan for the modernisation of the European Communities' accounting system ⁽⁴⁾. This plan, which is a response to a number of previous observations by the Court, is designed as a follow-up to the new provisions of the Financial Regulation adopted in June 2002 ⁽⁵⁾. It states that the reformed accounting system is to be completely in accordance with accruals-based accounting principles and will be applied gradually and, will only be fully effective in the 2005 financial year. The plan is made up of two strands, one concerning the adoption of the new accounting framework ⁽⁶⁾ and the other the development of the information systems required for its implementation ⁽⁷⁾ (see paragraph 1.92). Provision was made for two committees under this plan and they were constituted during the first quarter of 2003 (a project oversight board and an advisory committee for accounting standards).

⁽⁴⁾ Communication from the Commission — Modernisation of the Accounting System of the European Communities ((COM(2002) 755 final of 17 December 2002).

⁽⁵⁾ See also Resolution of the European Parliament concerning discharge for the 2001 financial year, paragraph 23 (OJ L 148, 16.6.2003).

⁽⁶⁾ Action 16 of the Action Plan (COM(2002) 426 final of 24 July 2002).

⁽⁷⁾ Action 17 of the Action Plan (COM(2002) 426 final of 24 July 2002).

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1.8. At this stage the action plan calls for two comments:

- (a) introduction of the accounting standards necessary for a genuinely accruals-based accounting system is singularly complicated by the constraints associated with, firstly, applying the principle of annuality of appropriations and, secondly, the rules on sharing management with the Member States. In fact, the Commission very often 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 ⁽⁸⁾. 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 ⁽⁹⁾. 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 any ambiguity ⁽¹⁰⁾;
- (b) in view of the scale of the work to be undertaken, the timetable laid down for the development and introduction of the new systems appears over-ambitious. As a consequence, there is a risk that the Commission will be forced merely to make gradual adjustments to the current, fragmented systems and not take advantage of the opportunity for rationalisation which would be provided by an in-depth reform of the management information systems that ultimately lead to entries in the accounts ⁽¹¹⁾.

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1.8.

- (a) *The Commission has established an accounting standards committee, in accordance with its action plan referred to in the Court's point 1.7, the members of which include two internationally renowned experts in public accounting standards, and in which representatives of the Court of Auditors participate as observers. This committee is examining the issues mentioned by the Court, and the standards to be adopted by the Accounting Officer will fully reflect this committee's opinions.*
- (b) *The Financial Regulation requires that accrual accounting be introduced by the year 2005. The Commission's first priority when modernising its accounting systems is to respect this deadline. The Commission's other aim is that the central system should integrate all accounting functions and provide all services with extensive information on the financial implementation of their programmes, projects and commitments. This second aim may be reached over a longer time-scale, as mentioned in the Commission's action plan. Given the specificities of its many heterogeneous activities, there will still be a need for local information systems in certain services but these will not have any accounting function.*

⁽⁸⁾ In many areas, the Commission is often only able to record invoices and applications for payment which it often receives long after work has been carried out or services rendered.

⁽⁹⁾ See in this connection the provisions of Article 133(2) of the Financial Regulation of 25 June 2002 (OJ L 248, 16.9.2002, p. 1).

⁽¹⁰⁾ A system cannot be assumed to be an accruals-based system as long as the economic event that gives rise to an entry is not always the same one that underlies the entries in the accounts.

⁽¹¹⁾ To be precise, a new integrated system applying the software currently in use and retaining or developing local systems within the existing architecture. In addition, it is laid down in the action plan itself that between now and 2005 the accruals data will not all be taken from the central accounting system.

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Reliability of the accounts

1.9. The Court's observations concern the final consolidated annual accounts for the 2002 financial year drawn up by the Commission in compliance with the provisions of the Financial Regulation of 25 June 2002 ⁽¹²⁾.

Observations concerning the consolidated statements on the implementation of the budget*Provisional components of the implementation of the budget*

1.10. Certain transactions are likely to be corrected at a later date by the Commission's services or by the Member States. In the course of subsequent financial years checks may lead to corrections, which will only be recorded at the time they are made. Such corrections may arise, for example, in the context of the procedure for clearance of the EAGGF-Guarantee paying agencies' accounts (see paragraphs 4.60 to 4.62), sometimes several years after the end of the financial year concerned. In the case of the VAT and GNP own resources, the provisional amounts are adjusted during subsequent financial years in terms of the final information for the financial year in question. These adjustments may be decided up to the end of the fourth year following the financial year in question ⁽¹³⁾. Lastly, this is the case in the context of the closure procedure for projects and programmes (internal policies, external actions and Structural Funds) when adjustments are made to allow for ineligible expenditure.

1.11. The possibility of such corrections is not currently acknowledged in the end-of-year accounts. In order to make readers aware of the scale of possible corrections, the amount involved in corrections made in previous financial years to entries for the most important areas could be mentioned in a note to the annual accounts. Apart from these 'clearances', which finalise the amounts of expenditure or revenue for past financial years, there are other uncertainties that may affect the accounts temporarily, for example, the reservations, amounting to some 300 million euro, issued by the bodies certifying the accounts of the agricultural pay

1.11. *The Commission will analyse the best method of including explanations of these matters in the consolidated annual accounts.*

Any corrections arising from Certifying Body reservations and the exclusion of certain accounts from the financial clearance decision (disjunction) are dealt with in identical fashion to the conformity corrections. The accounts can only recognise the amounts recovered when the Commission's decision is final.

⁽¹²⁾ Article 129(3) and Article 181 of Council Regulation (EC, Euratom) No 1605/2002.

⁽¹³⁾ Except where questions have been raised either by the Commission or by the Member States within the four-year period. In such cases there is no deadline.

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ing agencies (see paragraph 4.8(b)). Another source of uncertainty is the fact that the Commission excluded from its financial clearance decision for the 2002 year paying agency accounts representing a quarter of the expenditure declared for the 2002 financial year, pending further information or the finalisation of certain audit work (see paragraph 4.58(a)).

Budget revenue

1.12. A number of observations relating to the recording of own resources are to be found in paragraphs 3.4 to 3.13, 3.37 and 3.55.

*Expenditure (commitments and payments)***Agricultural expenditure — Modulation**

1.13. In the context of the common agricultural policy ⁽¹⁴⁾, the Member States have the possibility of reducing the payments due to farmers under certain aid schemes and using the sums thus withheld to finance additional rural development measures. The amounts retained must be used by each Member State before the end of the third financial year following the one in which the sum was withheld. After that date any unused funds are returned to the Community budget.

1.14. The effect of this system (known as 'modulation') is to subtract from the funds for aid schemes under heading 1a of the financial perspective, amounts which appear under similar headings in the consolidated statements on the implementation of the budget, and, in reality, to allocate them to rural development measures under heading 1b. This complies with neither the principle of specification nor the principle of annuality, both of which apply to EAGGF-Guarantee expenditure. In addition, the Commission's accounts present expenditure which has not yet been implemented as having already been effected.

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1.14. What the Court interprets as a *de facto* reallocation of amounts from heading 1a to 1b is expressly foreseen by Articles 4 and 5 of Council Regulation (EC) No 1259/99.

The accounting treatment of modulation will be examined in the context of the move to accrual accounting in 2005.

⁽¹⁴⁾ Council Regulation (EC) No 1259/1999 (OJ L 160, 26.6.1999, p. 113) and Commission Regulation (EC) No 963/2001 (OJ L 136, 18.5.2001, p. 4).

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External actions

1.15. In the case of the international agreements in the fisheries sector, the legal commitments exceeded the appropriations available for 2002 by 538 million euro. Likewise, for other external actions, the legal commitments exceeded the appropriations available by 282 million euro. These amounts are shown under the off balance sheet commitments.

1.16. At the end of 2002, the off balance sheet commitments relating to the financial protocols with Mediterranean third countries totalled 193,4 million euro compared to 159,1 million euro at the end of 2001. They represent the difference between the total amount for the signed protocols and the total commitments entered since 1978. Some of these protocols were concluded more than 20 years ago ⁽¹⁵⁾. The Court reiterates the observation made in its Annual report concerning the 2001 financial year ⁽¹⁶⁾, calling on the Commission to initiate the negotiation procedure for winding up these protocols together with the accounting commitments still in abeyance (164 million euro).

Observations concerning the consolidated financial statements: balance sheet

Participations and loans granted from the budget

The Galileo joint undertaking

1.17. The Galileo joint undertaking was set up on 28 May 2002, following the adoption of Council Regulation (EC) No 876/2002 of 21 May 2002. The called-up part (240 million euro) of the Commission's commitment (520 million euro) to the capital of this undertaking does not appear as such on the consolidated balance

1.15. While the agreements run over several years the financial obligation of the Community is clearly broken down into annual instalments in the basic text (financial protocol). For this reason, in a given financial year, the Commission only makes the commitments for the relevant instalment.

The New Financial Regulation, which came into force on 1 January 2003, provides both under Title I 'General provisions' and Title II 'Implementation of the budget' for the possibility of annual instalments for commitments where the action extends over several financial years, as long as the basic instrument provides for this.

1.16. The Protocols with the Mediterranean third countries are international treaties that cannot be wound up without the agreement of both parties. Satisfactory progress is being made in gradually winding up the remaining projects under these protocols year after year.

1.17. The Commission will consider the various aspects of its involvement with the Galileo programme so as to analyse further the best accounting treatment for the annual accounts of 2003. To best reflect the current situation in the definitive accounts of 2002 and given the fact that there are no accounts available for the joint undertaking for 2002, the EUR 120 million paid to the programme in 2002 has been treated as an advance payment, i.e. as an asset under the heading 'Sundry debtors'. The amounts committed not yet paid (EUR 120 million) are already included in the commitments not covered by carryovers of payment appropriations in

⁽¹⁵⁾ Commitments in the 1970s and 1980s.

⁽¹⁶⁾ Annual Report concerning the 2001 financial year, paragraph 9.16 (OJ C 295, 28.11.2002).

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sheet of the European Communities at 31 December 2002. Sundry creditors is also understated by 120 million euro, corresponding to the fraction of the capital called up by the joint undertaking that has not yet been paid.

ECIP

1.18. ECIP (European Community Investment Partners) is a financial instrument created more than 20 years ago to support joint ventures between undertakings of Community origin and undertakings in developing countries (Alamedsa ⁽¹⁷⁾). In 2002, the Commission wrote off in the full residual value of the loans and investments entered into under this financial instrument. Although the Commission's justification for this decision is that it is a matter of prudence, the Court considers that, in the absence of adequate analytical information, there is a risk to the financial interests of the Communities for the following reasons:

- (a) at 31 December 2002, the write-down ⁽¹⁸⁾ was registered without it being possible to identify the constituent parts of the gross amount of 67,6 million euro to which it applies;
- (b) in spite of the commitments it made in 2002, investments in joint undertakings (22,9 million euro) have still not been evaluated by the Commission, which has not made the necessary effort to acquaint itself with the true situation.

MEDIA I

1.19. The MEDIA I programme was launched at the beginning of the 1990s to support development of the European film industry over the period 1991 to 1995. The aid granted takes the form of grants and loans. The loans are only to be repaid if the revenue earned by the

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the off-balance-sheet liabilities. An amount has also been included on the off balance sheet for the amounts not yet committed of EUR 280 million and an explanation added to the explanatory notes.

1.18. *The 100 % reduction in value was applied because the information required to calculate the exact value of the participations and loans granted under the ECIP was not available.*

- (b) *The Commission is presently establishing a coherent approach for valuation and is collecting data from the 15 different financial institutions concerned. The conclusion should be available in time for the 2003 accounts.*

⁽¹⁷⁾ Asia, Latin America, the Mediterranean and South Africa.

⁽¹⁸⁾ 'Write-down' in the sense used in Article 195 of Commission Regulation (EC, Euratom) No 2342/2002 of 23 December 2002 laying down detailed rules for the implementation of Council Regulation (EC, Euratom) No 1605/2002 on the Financial Regulation applicable to the general budget of the European Communities (OJ L 357, 31.12.2002, p. 1).

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films reaches the set targets. Failing this, the loans are converted into grants. The loans granted under MEDIA I totalled 26,7 million euro at 31 December 2002.

1.20. In 2002, because of a lack of adequate information about certain transactions, the Commission recorded a write-down of 6,8 million euro. However, the Commission has carried out no follow-up of these transactions. The Court considers that there is insufficient justification for the 26,7 million euro and that, in addition, any debt write-offs resulting from these write-downs should be formally decided by the authorising officer by delegation ⁽¹⁹⁾.

Eurotech Capital, Venture Consort and Joint Venture Programme

1.21. These instruments were set up in cooperation with financial intermediaries. Community aid was paid into venture capital funds which invested in various industrial sectors (high-tech sectors in particular). The amounts invested are not repaid to the Community budget unless the project is successful. At the end of 2002 the balance for the three programmes amounted to 19,2 million euro.

1.22. The Commission was not able to provide a detailed valuation of its investments in these programmes. In addition, the Commission wrote off in full the amounts invested in these venture capital funds, even though repayments are still being made for all the instruments. The write-downs recorded should have been formally decided by the authorising officer by delegation before they were entered in the accounts.

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1.20. *In the case of the MEDIA programme the Commission has not written off any amounts due to it. Based on the prudence principle, it has written down the value of the receivable relating to two files where recovery orders (totalling EUR 6.8 million) have already been raised.*

Furthermore, the Commission has undertaken to bring its analysis up to date regarding the situation of all the loans granted under MEDIA I. It should, therefore, be in a position to present an up to date situation of these loans in the assessment at 31 December 2003 after having taken actions, that may be called for as a result of this analysis.

1.22. *As far as the presentation of the invested amounts in the balance sheet of the Community is concerned, the Commission considers that a write-down of 100 % is fully justified on the basis of the principle of prudence. In fact the very nature of investments in risk capital and other high risk business areas such as joint ventures in the CEEC and NIS countries carries an inherent potential risk of loss.*

⁽¹⁹⁾ See paragraph 4.6 of the charter of authorising officers by delegation (see SEC(2000) 2203/5 of 13 December 2000).

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*Amounts receivable***Recording of sundry debtors**

1.23. The Commission has not yet resolved the problem of producing a complete record of sundry debtors. In spite of the new tools which have been placed, step by step, at the disposal of the authorising officers (documented procedures and computer applications), the Court's audits again showed that provisional payments had been treated as final expenditure and that the entering of amounts to be recovered in the accounts is not timely (see paragraphs 1.17 to 1.22 and 1.25 to 1.27). In the absence of effective internal control procedures for miscellaneous revenue in the authorising officers' departments, the Court cannot obtain assurance that the Commission's record of amounts receivable is complete and accurate. In a report submitted in March 2003, the Commission's internal auditor also expressed reservations about the reliability of the recording procedures, and, like the Court, considered that Action 96 of the White Paper ⁽²⁰⁾ on more effective management of the recovery of unduly paid funds must be continued. In this respect, it is unlikely that the reasons for lifting the reservation which the Director-General for Budgets gave in his declaration for 2002 will overcome the shortcomings of the procedures followed in the authorising officers' departments. The Court considers that the Commission must set up a system which ensures that all departments actually fully assess and record miscellaneous revenue, without delay, as soon as the relevant economic event occurs ⁽²¹⁾.

Traditional own resources

1.24. At 31 December 2002 the established entitlements recorded in the separate accounts, known as the 'B accounts' (see paragraphs 3.8 to 3.13), were the subject of a value adjustment of 1 136,2 million euro. This reduction is an acknowledgement that there is doubt about full recovery of many of the amounts receivable entered in the B accounts. Due to the lack of detailed information about the sums in question, this value adjustment is only an approximate total.

1.23. *The Commission is improving its mechanism for the identification and recovery of debts.*

It has undertaken a review of all commitment balances which have remained open for an extended period in order to identify overdue payments. Within the framework of the modernisation project, it will assure accounting controls over prefinancing which will assist authorising departments to identify items for which justification is overdue.

As from 30 June 2003, it has put in place a system of regular reporting to authorising departments of forecasts of revenue and of recovery orders which are overdue. This reporting mechanism will be improved along with developments in its IT systems.

1.24. *As noted by the Court of Auditors, the value adjustment is at present the result of an approximation based mainly on statistics about recoveries. On 1 July 2003, the Commission tabled a new proposal to amend Regulation No 1150/2000, incorporating a proposal for an improved management of the amounts entered in the B account (COM (2003) 366 final). It is expected that a more accurate value adjustment can be effected once this proposal is adopted.*

⁽²⁰⁾ Annual Report concerning the financial year 2001, paragraph 9.67.

⁽²¹⁾ This is a particularly relevant field for application of internal control standard No 17 concerning supervision (see table 1.3).

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EAGGF-Guarantee

1.25. A number of certifying bodies expressed reservations concerning the exhaustiveness and accuracy of the evaluation of the sums due to paying agencies from those entitled to aid under EAGGF-Guarantee. The amounts owed by these debtors were estimated to be 2 376 million euro at the end of 2002 (2 263 million-euro at the end of 2001). The Commission applied a write-down for irrecoverable debts totalling 1 086 million euro, i.e. 46 % of the gross amount of the debt. The write-down identified was that proposed by the paying agencies. The Commission has no knowledge of the detail of the transactions in question.

1.25. *The write down created is based on an estimate of each paying agency. The requirement for such an estimate was introduced for the financial year 2001 for the first time. It was then decided to review the estimate considering the lack of experience of the paying agencies in this respect.*

For 2002, the Commission considered more appropriate to base the write down on the initial estimate, assuming that the paying agencies were in a position to better evaluate the chances of recoveries. The findings of the certifying bodies on the management of debts are being dealt with in the framework of the 2002 clearance procedure ('Article 8' letters following the analysis of the certifying bodies' reports), including, if necessary, the proposal for application of financial corrections.

In the meanwhile, in the framework of the Task Force Recoveries created by the Commission in December 2002, all the irregularity cases communicated by the Member States until 1999 are being cleared. The relevant decision will give rise to a clear situation concerning whether the financial consequence of the lack of recovery shall be borne by the Community budget or not.

Structural Funds

1.26. At 31 December 2002, the amounts receivable in respect of the Structural Funds were understated by 80 million euro because of an error in applying the provisions relating to repayments of advances for 24 programmes still in the process of being implemented (see paragraph 5.35).

1.26. *This observation is based on a different interpretation of one provision of the regulations. The Commission does not share the Court's view that it ought to have requested the repayment of the advances in these cases and therefore that this amount is owed.*

External actions

1.27. At 31 December 2002, an amount of 1 090 million euro ⁽²²⁾, based on a listing of the amounts held by financial intermediaries, is shown in the balance sheet under sundry debtors. The Commission cannot provide the justification for the sums thus entered in the accounts

1.27. *The Commission would highlight the large amount of work it carried out in order to draw up the list of financial intermediaries. This work will be useful for the changeover to accrual accounting as all the relevant information will already have been collected. From that point onwards, the use of*

⁽²²⁾ Including 81 million euro of interest.

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and the declaration of the director-general responsible for enlargement again includes a reservation concerning the reliability of the estimate (amounting to 519 million euro). These uncertainties stem from the lack of an accounting system which allows valuation of the actual use, by financial intermediaries, of the sums paid by the Commission. In previous annual reports ⁽²³⁾, the Court has already pointed out that the Commission should set up an appropriate accounts monitoring system.

1.28. The Commission stated in reply to the Court's previous observations ⁽²⁴⁾ that it would follow up, as appropriate, a recovery order for 3,05 million euro issued in 1999 to a bank which had not made the payments due, as stipulated, to one of the Commission's partners in the field of external aid. The only development on the file, however, is a request for an opinion from the Legal Service of the Commission, to which there was still no reply at the end of June 2003.

Interest on advances and payments on account to third parties

1.29. In its Annual Report concerning the 2001 financial year ⁽²⁵⁾, the Court pointed out that the interest yielded by funds deposited with financial intermediaries had not been recorded as budgetary revenue. As at 31 December 2002, the unrecorded interest for the financial year (see paragraph 1.27) amounted to 15 million euro, increasing the total interest still to be recorded to 54 million euro. Where the interest received is used to finance expenditure on actions and programmes, these transactions are not included under budgetary expenditure, which distorts the figures for the actual Community contribution.

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non-accounting records will be minimal as the New Financial Regulation requires that prefinancing payments be identified. The financial statements received from the national authorities are certified by them, and are accompanied by extracts from the bank accounts.

In the framework of the modernisation project for the accounting systems, an accounting standard for prefinancing payments is being prepared. The improvements to the IT systems will allow for the correct bookkeeping and clearing of the pre-financing payments.

1.28. *After a thorough analysis of the legal situation, contacts between the Commission services and the debtor took place with a view to achieving an amicable settlement of the case. Further procedural steps are being envisaged with a view to obtaining recovery of the debt in question.*

1.29. *While not all the interest generated by pre-financing payments made to third parties was recorded as budgetary revenue, all interest due has been included in the general accounts and the balance sheet.*

A new accounting procedure for this interest has been foreseen by the New Financial Regulation, which applies from 1 January 2003 onwards and the Commission is committed to its implementation and thus to the correct accounting treatment of this interest in the future.

⁽²³⁾ Annual Report concerning the financial year 2000, paragraph 9.7 (OJ C 359, 15.12.2001) and the Annual Report concerning the financial year 2001, paragraph 9.25 (OJ C 295, 28.11.2002); the Court considered it advisable for the Commission to obtain certification of the data in question by an independent auditor.

⁽²⁴⁾ The Commission's reply to paragraph 9.26 of the Annual Report concerning the financial year 2001 and paragraph 5.65(d) of the Annual Report concerning the financial year 1998 (OJ C 349, 3.12.1999).

⁽²⁵⁾ Annual Report concerning the financial year 2001, paragraph 9.27.

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Joint Research Centre

1.30. An amount of 16,4 million euro relating to advances of VAT in connection with purchases by the Karlsruhe and Petten establishments of the Joint Research Centre appears in the claims on Member States. This amount covers transactions in the period 1998 to 2002. The Commission is unable to obtain recovery of these sums, because its accounting system does not allow it to provide the two Member States in question with the detailed information which they need in order to reimburse the VAT. At the end of 2002 the Commission had neither recorded a write-down for a doubtful debt nor raised with the authorities in the Member States in question the possibility of effecting recovery by means of an alternative ad hoc procedure.

1.30. Due to technical problems that accompanied the introduction of a new accounting system the backlog in VAT reimbursement can only be eliminated now that this new system has become fully operational. Since there is no prescription for Commission reimbursement claims provided for in the application agreements of the Protocol with the Member States concerned, the Commission considers that these debts can still be recovered and that these debts do not need to be written down. The Commission agrees, however, that recovery has become a very urgent matter even without such time limits. This is why the Commission has undertaken efforts during the last months to guide and facilitate the necessary recovery actions. Furthermore, the IT systems have now been enhanced to give the level of detail required for the recovery of VAT payments made to Member States. The Commission will therefore be submitting supported requests to both the German and Dutch tax authorities to recover VAT advanced since 1998.

Provisions for liabilities and charges

1.31. The provision for pension rights increased by 27 % in 2002, from 15 300 million to 19 500 million euro. This increase covers a reduction in the discount rate (2,28 % at 31 December 2002 compared to a rate of 3,35 % at the end of 2001). In its annual report for the 2001 financial year ⁽²⁶⁾, the Court considered that the way in which pension rights were treated in the accounts was inappropriate. In effect, it consists of entering a provision for pensions in the balance sheet under liabilities, to be deducted from the economic result and, as a counterpart, an amount receivable from the Member States which guarantee payment of the pensions. This neutralises, *ipso facto*, the impact on the economic result. Pending the adoption of a definitive method by the Commission's accounting officer, following an opinion by the advisory committee for accounting standards (see paragraph 1.7), the Commission has retained this presentation for the 2002 financial year.

1.31. A new accounting standard for pensions is currently being prepared as part of the modernisation of the accounting systems project. This will be discussed by the Accounting Standards Committee. The Commission feels that it would be more appropriate to deal with this issue in the accounts when the standard has been adopted to avoid making numerous changes in the meantime.

⁽²⁶⁾ Annual Report concerning the financial year 2001, paragraph 9.17.

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1.32. The amount of the provision is based on an update, according to a simplified model, of an actuarial study made in 1997. Until such time as a completely new actuarial study has been carried out (one is scheduled for 2003), the reliability of the amount entered in the balance sheet cannot be verified ⁽²⁷⁾.

1.33. As a result of a calculation error, the additional depreciation of stocks from agricultural intervention measures has been understated by 17,4 million euro. In doing this the potential loss on disposal of the stocks, which is included among the off balance sheet commitments, has been over-stated by the same amount.

Current liabilities

1.34. An amount of 4 847 million euro is included as payment appropriations to be carried over under current liabilities. This includes an amount of 3 254 million euro ⁽²⁸⁾ which is in the nature of a provision, in that it has been calculated as a global amount based on expenditure estimates by the Member States and the reliability of those estimates is the subject of reservations by Commission services. In view of the unusual global character of the estimate, presenting these payment appropriations to be carried over under current liabilities is inappropriate.

Transitional accounts

1.35. Sums of 91,1 million euro and 714,9 million euro appear under the transitional account headings on the assets and liabilities sides of the consolidated balance sheet. These accounts contain transactions of various kinds and the amalgamation that this entails adversely affects the transparency of the information. For example, the assets side includes revenue to be collected (12,5 million euro), charges entered in advance (63,1 million euro) and expenditure to be charged (15,5 million euro). On the liabilities side the item includes

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1.32. For the calculation of pension rights, the Commission employs an expert to carry out a full actuarial study every five years. Besides this five-yearly analysis, the figures are adjusted every year, using the method suggested by the expert, on the basis of changes in interest rates.

Following independent expert advice received the Commission is awaiting the results of the latest valuation (end 2003) to verify if the simplified approach used in calculating the changes in the provision is appropriate.

1.33. There was a calculation error in respect of the depreciation of stocks due to the use of an erroneous coefficient for purchases in September.

1.34. The presentation of the 'Appropriations to be carried over' in the annual accounts of the Commission will be analysed as part of the project to establish the accounting standards. The Commission feels that it would be more appropriate to make changes when the standard has been adopted and new information about the expenses cycle will be available.

1.35. The Commission agrees with the Court's finding. It points out that under the new accounting standards currently being developed, such amounts will be shown under other balance sheet headings and revenue and expenditure not booked will be treated as it should using the accrual principle. The Commission feels that it would be more appropriate to make such a reclassification when the standard has been adopted to avoid making numerous changes in the meantime.

⁽²⁷⁾ Annual Report concerning the financial year 2001, paragraph 9.30.

⁽²⁸⁾ The breakdown of this amount between the budget headings concerned is not supported by any specific information about the actions actually in progress.

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carryovers of appropriations (147,5 million euro), revenue not booked (515,3 million euro) ⁽²⁹⁾, and amounts owing to the European Investment Bank (51 million euro). These various items should be reclassified according to their nature under other balance sheet headings. Revenue and expenditure to be recorded should not appear on the end-of-year balance sheet, but should be included in the accounts of revenue and expenditure ⁽³⁰⁾.

*Legality and regularity of the underlying transactions**Own resources*

1.36. The scope of the Court's audit work was subject to the limits explained in paragraphs 3.5 and 3.35.

1.37. An examination of the work done by the Commission's traditional own resources control unit showed that the unit has well-established working methods, that the selection of investigations is based on risk analyses and that each Member State receives at least one visit per year (see paragraph 3.15). However, it is not the task of this unit to provide assurance that resources have been fully identified and established (see paragraph 3.17).

1.38. With regard to the systems for collection of customs duties for freight arriving at European airports, the Court noted that a number of customs services did not devote enough attention to the risks of omission or incorrect treatment of the imported goods (see paragraph 3.34).

1.39. As regards the VAT and GNP own resources, national procedures do not always allow the audit trail to be followed through to the amounts notified in the Member States' VAT returns (see paragraph 3.44). The Commission's VAT inspections revealed shortcomings in the recording of the bases required to calculate the

1.38. *The Commission is working with the Member States to improve the exchange of risk information between the major EU airports. Risk information relating to financial and non-financial risk categories is being exchanged directly between the customs services located in EU airports and this system will continue to be developed in partnership between the Commission and the customs services of the Member States.*

1.39. *The Commission has replied in detail to the Court's observations in Chapter 3, and in particular in its replies to paragraphs 3.44, 3.45, 3.51, 3.52 and 3.57. The Commission will examine the problems raised by the Court regarding audit trails, the recording of VAT payments and the nature of GNP controls with a view to taking measures to ensure that the data communicated by the Member States meet the highest possible standards.*

⁽²⁹⁾ Includes 387 million euro corresponding to advance collection of own resources for two Member States.

⁽³⁰⁾ In view of their incidence on carryovers of appropriations.

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amounts owed by the Member States (see paragraph 3.37), as well as delays in forwarding data, which hampered inspection activities (see paragraph 3.39). The Commission's checks in respect of GNP contributions focus mainly on methodological questions without any standardised control procedures having been set up (see paragraphs 3.40, 3.41 and 3.51). In this area, controls should be intensified in order to improve the reliability of the calculation of the most important own resources (see paragraph 3.57).

1.40. Subject to the above observations, the work carried out by the Court on the supervisory systems and controls and on the underlying transactions and data did not reveal any material errors affecting the legality and regularity of own resources (see paragraphs 3.34 and 3.55).

Common agricultural policy

1.41. In the agricultural field, the Court examined the system for certifying the annual accounts of the paying agencies for the 2002 financial year, as well as the operation of the integrated administration and control system (IACS) administered by the same paying agencies. This work completed the verification, with the final beneficiaries, of a sample of payments covering the whole of heading 1 of the financial perspective. The relevance of the declaration by the Director-General of the Directorate-General for Agriculture in respect of the transactions of the year 2002 was also studied. As the declaration relies, to a large degree, on information relating to financial years previous to 2002, it is still of only limited use in the context of the Court's Statement of Assurance (see paragraphs 4.18 to 4.20). Whilst it is accepted that agricultural expenditure is subject to special procedures relating to the clearance of accounts, the fact nevertheless remains that there are other sources of information that would make it possible for the Director-General for Agriculture's declaration to be based, to a greater extent, on an assessment of the legality and regularity of the transactions for the year for which the declaration is issued.

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1.41. Article 53.5 of the new Financial Regulation provides that '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 final responsibility for the implementation of the budget in accordance with Article 274 of the EC Treaty and Article 179 of the Euratom Treaty'.

Thus, the assurance on the EAGGF Guarantee can be based on the existence of an effective clearance of accounts procedure. The fact that corrections are decided some years after the year of the expenditure concerned is an integral part of the clearance procedure. The correction mechanism is completed by the assurance which can be gained from the accreditation of paying agencies, the annual certification procedure and the IACS, which permit a great deal of reliance on the control over the expenditure declared.

In the Annual Activity Report 2003 Directorate-General for Agriculture will present in more detail the functioning of the clearance procedure and of the control systems related to the transactions of the financial year for which assurance is given.

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1.42. Although the certifying bodies provide the Commission with useful information about the operation of the paying agencies, they are only required to certify whether the paying agencies' management and information systems are capable of ensuring that payments are effected correctly (see paragraph 4.8(d)). This being the case, their conclusions provide only limited assurance when it comes to evaluating the legality and regularity of the payments to final beneficiaries.

1.43. Apart from the case of Greece (see paragraph 4.17(c)), IACS is an appreciable source of information in respect of the legality and regularity of approximately 58 % of EAGGF-Guarantee payments. In the sub-field covered by IACS, there is a lower risk of error for arable crops than for animal premiums (see paragraph 4.49(b)).

1.44. As regards expenditure which is not covered by IACS, for example aid paid in relation to quantities produced (olive oil, cotton, tobacco and dry fodder), rural development aid, export refunds or intervention storage, the Court found, for 2002, control weaknesses and lack of plausibility. The Court also found errors affecting, amongst other things, payments relating to storage of grape must and support for bananas and dried grapes. The aid for replanting vineyards was subject to special risks (see paragraphs 4.34 to 4.42). The shortcomings which the Commission found in the execution of Member States' *ex post* checks for some of the measures in question mean that the Court cannot use the results of those checks in the context of its Statement of Assurance (see paragraphs 4.46 and 4.47).

1.45. In general terms, the Court found that common agricultural policy expenditure was materially affected by errors. However, it also emerged that 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 efficient controls (see paragraph 4.49).

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1.43. *The insufficient implementation of the IACS in Greece has been addressed by the Commission both through legal proceedings and financial corrections imposed within the clearance of account procedure. The Commission has in 2003 put in place a particular follow-up of the implementation of the IACS in Greece to support the effort made by the Greek paying agency (OPEKEPE) to rectify the situation.*

1.44. *Issues arising concerning bananas, dried grapes and the storage of grape must continue to be dealt with under the clearance of accounts procedures, with corrections proposed where appropriate. The same approach is adopted where Member States' physical and documentary checks (Regulation 386/90) or the a posteriori controls (Regulation 4045/89) are found to be inadequate. The Commission also makes recommendations for further improvements and provides feedback on information received from Member States.*

1.45. *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 taxpayers' interests. For the other categories of expenditure the Commission has imposed, wherever appropriate, compatibility with IACS, thereby allowing cross checks. Dissuasive sanction systems have been introduced in the relevant schemes (fruit and vegetables, tobacco, dried grapes, etc).*

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Structural measures

1.46. In 2002, the directorates-general responsible for the Structural Funds worked to improve the supervisory systems and controls. Progress was noted in the organisation of the Commission's departments (see paragraph 5.53). Nevertheless, there were still shortcomings in the implementation of the internal control standards (see paragraphs 5.7 and 5.8) and in the application of the procedures for repayment of unused advances (see paragraph 5.35).

1.47. In a shared management framework the main supervisory systems and controls on the implementation of the Community budget are located in the Member States. The Court's audit confirmed that there are still weaknesses in these systems (see paragraphs 5.15 to 5.32).

1.48. For example, there was found to have been little progress on the closure of the various forms of intervention from the 1994 to 1999 programming period (see paragraphs 5.16 to 5.21). The introduction of Regulation (EC) No 2064/97 for the 1994 to 1999 programming period was hampered by a delay in the distribution of adequate guidelines, which led to misinterpretations on the part of the Member States. It also meant that the necessary systems were not set up in time for them to be fully effective before programmes were closed. Although the Commission increased the number of inspections carried out in the Member States, these did not provide it with the required guarantees as regards the legality and regularity of the transactions in the 1994 to 1999 programming period (see paragraphs 5.16 to 5.21).

1.49. In general terms, Regulation (EC) No 438/2001 provides a framework which favours improvement of the control systems for the programming period 2000 to 2006 (see paragraphs 5.26 to 5.32). The Court's audit nevertheless revealed a repetition of errors of the same type and with the same frequency as in previous years. The Commission should therefore intensify its on-the-spot checks on the implementation and sound operation of the supervisory systems and on the legality and regularity of the underlying transactions (see paragraphs 5.39 to 5.41).

1.46. *The Commission has undertaken to implement the internal control standards as soon as possible and, as the table annexed to Chapter I shows, is already in the process of implementing them where there are still shortcomings. It will ensure that they are applied. The Commission considers that any remaining deficiencies identified do not seriously put in doubt the quality of its internal control systems.*

On the issue of repayments of unused advances, see the Commission's reply to paragraph 1.26.

1.47. *Through its own audit work in the Member States, the Commission has found that in general Member States have made significant improvements both in relation to the systems for closure of 1994-1999 programmes and for the implementation of the 2000-2006 period. However, further improvement is necessary in some cases and the Commission will take the necessary steps to ensure that weaknesses are corrected.*

1.48. *The slower than expected progress achieved in closing 1994-1999 programmes in 2002 was due to the fact that for most programmes Member States only submitted closure documents shortly before the deadline of end-March 2003.*

After the adoption of Regulation No 2064/97 the Commission did provide detailed guidelines in plenty of time on the key aspects of application, particularly in the audit manual for the Structural Funds, and on the requirements for the closure of the 1994-1999 programmes. It has also carried out a great many audits to check that the necessary systems have been put in place. This process will continue with the verification of the final documents and ex post audits of a sample of the programmes completed.

1.49. *From the substantial work that has been carried out for the 2000-2006 period, the Commission has been able to conclude that Member States have in general made significant steps in improving their systems. However, there are certainly further improvements required, and the effective functioning of the systems needs to be regularly verified. The Commission will pursue its audit strategy to achieve this aim in order to provide a basis for assurance as to payments made by the Funds.*

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Internal policies

1.50. The Court's audit revealed delays in the implementation of some internal control standards by directorates-general responsible for internal policy actions (see paragraphs 6.14 to 6.16).

1.51. At Commission level, the audit did not reveal any material errors. This is due to the fact that the Commission can only check the reasonableness of the expenditure declared (see paragraph 6.21).

1.52. On the other hand, on-the-spot audits carried out by the Commission itself or on its behalf showed a large number of over-declarations of expenditure by the final beneficiaries of indirect research contracts (see paragraph 6.50). The volume of errors found confirms the findings of audits carried out by the Court in recent years. To a large extent these errors are a consequence of the rules governing the research framework programmes, and there is a fair risk that they will persist if the rules are not changed (see paragraph 6.58). The procedures for recovery of unduly paid sums also proved to be slow (see paragraphs 6.51 and 6.52).

1.53. The Court's work on the TEN-T ⁽³¹⁾ showed that the Commission's decisions to grant aid were flawed in form (see paragraphs 6.25 to 6.27) and that deficiencies were affecting the implementation of controls (see paragraphs 6.28 to 6.32).

1.50. *The implementation of internal control standards is a matter for each directorate-general and is explained in the annual activity reports.*

1.51. *Only full financial audits can determine with certainty and exactitude the correctness of the costs claimed by beneficiaries and the conformity with the provisions of the research contracts. It is for that reason that the Commission has substantially reinforced its audits on the level of beneficiaries since the launch of the Fifth Framework Programme. For the Sixth Framework Programme cost claims by beneficiaries will need to be certified by independent auditors.*

1.52. *In an effort to reduce the number of errors in the declarations of expenditure, an action plan following on from Action 1 of the synthesis of the annual activity reports for 2001 was put into effect in January 2003. The rules on managing the research framework programmes were essentially laid down by the legislator (Parliament and Council).*

As regards the recovery of sums paid in error, the Court's investigations concern only one directorate-general. As part of the reform, work is being undertaken at Commission level to improve recovery procedures.

1.53. *Further to the recommendations made by the Court last year, the Commission took immediate steps to improve the standard text of the 2002 Decisions, in particular, the technical annex, as mentioned above. From 2003 onwards the final beneficiaries also will be informed by the Commission of the financial Decisions awarded. Further improvements continue to be developed within the new version of the Commission decision 2003 for the Multiannual Indicative Programme (MIP) and mainly the clarification of each partner involved in the implementation of the project and in the using of funds.*

Necessary action to considerably increase the number of ex-post audits have been taken. In addition to the normal on-the-spot ex-post controls before releasing the final payment, a framework contract with an external audit company (to be

⁽³¹⁾ Trans-European transport network.

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1.54. For 2002, the Court's observations confirm its conclusions from previous years, namely that the transactions in the area of internal policies are still affected by significant errors in respect of their legality and of their regularity at beneficiary level (see paragraphs 6.57 and 6.58).

External actions

1.55. In 2001 the reorganisation of the departments responsible for external aid focused on the redistribution of tasks between headquarters' departments and delegations. This is a lengthy exercise, and 2002 was a year of transition. Although most of the supervisory systems and controls were in place by the end of 2002, they had not all been operational for the full year (see paragraph 7.3).

1.56. Few errors were found in the transactions at headquarters and delegation levels, even though internal control weaknesses were found there. A fairly large number of irregularities was found among the bodies responsible for carrying out development aid projects. These irregularities were usually contraventions of contract provisions, especially those concerning tendering procedures, the probative value of supporting documents and the eligibility of expenditure (see paragraphs 7.34 and 7.43).

1.57. In the area of humanitarian aid an audit approach was introduced in 2002 whereby the bodies responsible for implementing actions (most frequently non-governmental organisations) are subject to systematic audits (see paragraph 7.9). In the area of development aid the number of audits relating to operations financed by the general budget increased, but remains moderate.

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operational end 2003) together with the reinforcement of the Directorate-General's financial audit cell will allow an increase in the number of ex-post audits undertaken on TEN-T projects.

1.54. *In an effort to reduce the number of errors in the declarations of expenditure, an action plan following on from Action 1 of the synthesis of the annual activity reports for 2001 was put into effect on 1 January 2003. The synthesis of the annual reports and declarations by directors-general for 2002 also provides for a joint financing operation, which will look into the possibility of introducing flat-rate elements into the subsidies so that, for example, checks can focus on the situations involving the highest risks. The measure would also involve developing common standards for risk management and the assessment of the costs and benefits of control activities.*

1.55. *The major improvements in procedures and structures, which began in 2001, continued in 2002 and 2003.*

1.56. *Measures have been taken to address the concerns of the Court, in particular through the application in 2003 of new standard contracts. Any request for intermediate and final payments under these contracts must be accompanied by duly audited accounts. The Commission is aware of the need to ensure implementing organisations understand and follow contract provisions accurately. The transfer of management responsibilities to delegations should allow better monitoring of implementation on the ground.*

1.57. *The annual external audit plan for 2003 aims at the development and implementation of a methodology for 'audit of external operations' and work was set in hand to develop a coherent and comprehensive audit strategy.*

THE COURT'S OBSERVATIONS

No overall strategy for the recourse to and follow-up of audits was adopted (see paragraph 7.10).

1.58. The Court's audit showed that, in 2002, the Commission's supervisory systems and controls were not yet sufficiently developed for them to provide it with assurance as to the legality and regularity of the underlying transactions at the level of the bodies responsible for carrying out development projects (see paragraph 7.43).

Pre-accession aid

1.59. In the area of preaccession aid, the Court examined, for each of the three programmes Phare, ISPA and Sapard, the quality of the supervisory systems and controls (see paragraphs 8.3 to 8.5, 8.14 to 8.22, 8.23 to 8.26) and a sample of transactions at the level of beneficiaries of Community funds (see paragraph 8.38). In addition, it analysed the audits and checks carried out by the Commission (see paragraphs 8.6 to 8.9, 8.14 to 8.22 and 8.24 to 8.29) and by the paying agencies in the candidate countries within the framework of these programmes (see paragraphs 8.12, 8.13, 8.30 and 8.31), and also examined the declarations of the directors-general (see paragraphs 8.32 to 8.37). The Court noted that, although the errors found did not have a significant impact, it appeared that further improvements to the supervisory systems and controls set up by the Commission were still necessary (see paragraphs 8.45 to 8.49).

Administrative expenditure

1.60. The Court's audit revealed weaknesses in the operation of the supervisory systems and controls in the institutions audited (see paragraphs 9.5 and 9.12). Shortcomings were also noted in the implementation of internal control standards by the Directorate-General for Administration (see paragraphs 9.6 to 9.11 and 9.26 and 9.27).

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It is composed of two parts: a first that focuses on the support function of the 'external audit' unit of the Office and a second that lays down a list of projects and programmes to be audited.

The horizontal actions by the 'external audit' unit include the development of a methodology for external audits and the setting up of a training programme for officials at headquarters and in delegations.

The implementation of the 2003 audit programme should address many of the concerns expressed by the Court.

1.58. *All the necessary supervisory and control systems were in place in 2002 to give reasonable assurance as to the legality and regularity of transactions effected by EuropeAid in 2002.*

1.59. *The Commission is tightening up its controls, is carrying out further training measures and issuing instructions to its delegations in candidate countries.*

1.60. *In his 2002 Annual Activity Report, the Director General of Directorate-General for Personnel and Administration does indeed mention the existing weaknesses in the implementation of the Internal Control Standards, but a remedial plan was approved (see 9.6) and individual points were addressed (see 9.26. and 9.27.).*

THE COURT'S OBSERVATIONS

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Supervision, control and risk assessment can always be refined, strengthened and updated, and Directorate-General for Personnel and Administration will consider the Court's suggestions to improve its risk assessment methodology.

1.61. Apart from these weaknesses, the Court's findings for 2002 confirm the conclusions concerning previous years, that the transactions relating to administrative expenditure are not, on the whole, affected by material errors (see paragraph 9.28).

Reform of the Commission's internal control system

1.62. In the context of the Statement of Assurance (DAS) for the 2001 financial year the Court examined the progress of the administrative reform of the Commission⁽³²⁾ and concluded that it would have to wait for the reform to take effect fully before it could evaluate the impact of the reform on its own audit approach⁽³³⁾.

1.63. For the 2002 year, the Court continued its examination of the reform and sought to assess the assurance provided by the Commission's new internal control system as regards the legality and regularity of the transactions underlying budgetary payments. In doing so it studied in particular:

- (a) how directorates-general's annual management plans were able to contribute to this assurance of legality and regularity (see paragraphs 1.68 to 1.74);
- (b) the execution of the action plans instigated in response to the declarations of the directors-general for the 2001 financial year (see paragraphs 1.75 and 1.76);
- (c) the annual reports of the directors-general and declarations for 2002 and their Synthesis (see paragraphs 1.77 to 1.105).

⁽³²⁾ In January 2000 the European Parliament invited the Commission to undertake a reform of its management. Accordingly, on 5 April 2000, the Commission presented its White Paper 'Reforming the Commission' (COM(2000) 200 final).

⁽³³⁾ See the Court's Annual report concerning the financial year 2001, paragraphs 9.48 and 9.71.

THE COURT'S OBSERVATIONS

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1.64. According to Article 274 of the EC Treaty the Commission is responsible for implementing the budget. Not all operations follow the same management model however and the impact of the Commission's reform varies, depending on the area in question. There are thus several possible scenarios:

- (a) in the case of own resources, management (basis of assessment and recovery) is delegated to the Member States. In this instance the reform is only concerned with supervision of the arrangements that have been put in place;
- (b) in the case of expenditure, the Financial Regulation (Article 53) provides for four separate scenarios:
 - (i) the Commission has sole responsibility for implementing actions. In this case it is acting on a centralised basis (direct management) and the reform affects all the procedures for executing expenditure;
 - (ii) the national authorities in the Member States have been given responsibility for operational management (EAGGF-Guarantee and Structural Funds). In this case, management is shared and the Commission must verify that the national authorities' application of the regulations has been compliant. In this case the Commission reform affects only the Commission activities that are concerned with supervising implementation;
 - (iii) the Commission may leave the beneficiary States to implement certain operational aspects once it has carried out an *ex ante* control (preaccession aid). Management is then said to have been decentralised and the reform impacts on most aspects of management, in the same way as when the Commission calls on the services of a proxy in a centralised management context;
 - (iv) lastly, the Commission may entrust certain operations to international organisations and it is then a matter of joint management. In this case the reform's impact is the same as for centralised management.

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The White Paper actions

Area: 'Audit, financial management and control'

1.65. Chapter V of the White Paper 'Audit, financial management and control' defined the internal control arrangements that the Commission was to introduce before July 2001. As of 31 December 2002 nine of the 36 actions described in that Chapter were still in progress (see **table 1.1**).

Table 1.1 — Main unfinished actions in Chapter V 'Audit, financial management and control' of the White Paper (Situation at 31 December 2002)

Action No	Objective	Measures still to be undertaken
66	Financial irregularities panel	The panel was instituted by the new Financial Regulation (Article 66(4)). It is to become operational in 2003.
74	Contracts database	The prototype of the contracts database exists. Two pilot projects have been implemented. The end product is expected to be in general use by the directorates-general at the end of 2004.
78	Minimum standards for internal control	The internal control standards were adopted on 13 December 2000 (SEC(2000) 2203) and amended on 21 December 2001 (SEC(2001) 2037). Their implementation is still in progress (see paragraphs 1.81 to 1.88 and table 1.3). Additional guidelines for sensitive functions and supervision are being drafted (see paragraph 1.76).
81	Strengthening the role of the directorates-general control function (audit capabilities)	A communication was adopted on 30 October 2000 (SEC(2000) 1803). Three directorates-general stated that introduction of the audit capability is not yet complete.
82	Declaration by the Director-General in her/his annual activity report	There are still shortcomings in the 2002 declarations as regards the scope of the reservations and this makes it difficult to form a reasoned assessment of the Commission's management (see paragraphs 1.89 to 1.98).
85	Design of adequate internal controls and financial processes	Following the first stage of change in financial procedures as required by the White Paper, various risks were identified as part of the 'Overall assessment of the readiness of the Commission services for integrating the new Financial Regulation in their internal control systems' procedure. On 17 December 2002 the Commission instructed the directors-general to take steps to overcome these risks and to inform the central financial service of any problems (SEC(2002) 1362 final).
92	Guidelines for sound project management	Adoption of the guidelines was delayed by the change in the lead manager department.
95	Optimisation of early warning system	The central database for all contracts and subsidies, which is for monitoring financial relations with beneficiaries, should be made operational as soon as possible.
96	More effective management of recovery of unduly paid funds	Decentralisation of debit notes to directorates-general will be implemented in 2003. The audit capabilities' observations and recommendations are to be taken into consideration and supervision of recoveries at central level should be introduced (see paragraph 1.23).

Source: Court of Auditors.

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1.66. A fair number of the actions linked to the reform of the internal control system have medium or long term aims which will not be achieved until after the dates initially set. For example, for nine of the 27 areas covered by White Paper actions that have theoretically been completed, the targets have not yet been fully achieved, or implementation is not yet satisfactory ⁽³⁴⁾. All these areas are also covered either by the Commission action plan of 24 July 2002 ⁽³⁵⁾ (see paragraph 1.75) or by other action plans adopted since then ⁽³⁶⁾. To these action plans can be added the various action plans mentioned by the directors-general in the context of their annual activity reports in reply to the reservations set out in their declarations.

1.67. In view of the numerous developments since April 2000 ⁽³⁷⁾, the Court considers that an update of the White Paper would be useful, in order to have a full picture of the targets that still have to be achieved and to establish a revised timetable ⁽³⁸⁾ taking the new constraints into account. This would simplify follow-up of all the initiatives that are currently being implemented within the overall framework of the reform of the Commission's internal control system.

Area: activity based management

1.68. Chapter III of the White Paper instituted activity based management. It is a matter of refocusing the

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1.66-1.67. *An up-date of the White Paper action plan implementation has been provided on a regular basis since 2000 and widely disseminated. The last Reform progress review was produced in January 2003 (COM/2003/0040 final/2) and the Synthesis of the 2002 Annual Activity Reports and declarations of the directors-general adopted on 9 July 2003 presents an overview of the main Reform achievements in 2002 (COM(2003)391 final). The Commission is considering the manner in which a state of play of the reform will be made, in order to hand over the task of consolidating the reform to the new college.*

⁽³⁴⁾ Actions 66, 71, 78, 80, 81, 82, 85, 95 and 97.

⁽³⁵⁾ 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 of 24 July 2002).

⁽³⁶⁾ See SEC (2002) 1362 final of 17 December 2002, 'Overall assessment of the readiness of the Commission services for integrating the new Financial Regulation in their internal control systems' and SEC(2002) 1378 final of 20 December 2002, 'Commission action plan pursuant to the recommendations of the Court of Auditors in its Annual Report relating to the 2001 budgetary year' and COM(2003) 391 final of 9 July 2003, 'Synthesis of annual activity reports 2002 of DGs and services'.

⁽³⁷⁾ See Communication from the Commission 'Progress review of reform' (COM(2003) 40 final of 30 January 2003, p. 2).

⁽³⁸⁾ For eight of the nine actions currently in progress (actions 74, 83, 87, 90, 92, 93, 94 and 96) the initial deadlines have been exceeded.

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Commission's strategic objectives on its main areas of responsibility, optimising the use of available resources by matching the strategic objectives to services' operational programmes and then, by means of an evaluation process which includes indicators, assessing the impact of the actions undertaken.

1.69. At the end of 2002, the Commission had completed the first full management cycle using its new approach (strategic planning, programming, implementation and accounting). At that point progress had been made in allocating resources by objectives and monitoring performance against indicators.

1.70. The observations that follow analyse the role of the annual management plans of the directorates-general, in providing a solid foundation for the main aspects of the reform of the internal control system which are supposed to ensure that the underlying transactions are legal and regular.

1.71. In order to choose between allocating resources to policy implementation or investing them in strengthening the internal control system ⁽³⁹⁾, each directorate-general should:

- (a) take stock of the activities that help to provide reasonable assurance that the underlying transactions are legal and regular;
- (b) link these internal control system activities to one or more specific objectives, together with impact indicators for measuring the progress achieved;
- (c) estimate the financial and human resources needed for the pursuit of these objectives.

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1.69. *The allocation of resources to priorities is done through the Annual Policy Strategy. It is based on the assessment of the objectives and initiatives proposed by the services regarding their contribution to the achievement of the priorities defined by the college. The Annual Policy Strategy constitutes a reference framework for the preparation of the Commission's preliminary draft budget.*

1.70. *The Annual management plans have been developed and implemented in all services to translate the Commission's priorities into concrete objectives and actions with the related resources allocations. The main function of the DGs annual management plans is therefore to monitor the implementation of the activities through all directorates-general. Only the major impacts on resources related to the reform of the internal control system are reflected in these plans.*

1.71. *The monitoring of the internal control standards implementation is conducted through the annual activity reports and the related declaration of each directorate-general, and the overview reports to be elaborated by the Central Financial Service, (see Action 5.4.5. of the 2002 Synthesis).*

The resource needs estimation relating to the management and control activities are made by the services in the framework of the Annual Policy Strategy and the Preliminary Draft Budget exercises.

⁽³⁹⁾ See COM(2002) 426 final of 24 July 2002, p. 31.

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1.72. In general, the substance of the directorates-general's annual management plans is improving, but interpretation of the concepts of activity, subactivity, action, objective and indicator sometimes varies. It is thus difficult to compare the annual management plans and to evaluate the relative effort devoted to strengthening supervisory systems and internal controls. Further gains could be made by improving the definition of the indicators to be used both to measure the extent to which the objectives of legality and regularity of transactions have been achieved and to gauge the use of resources ⁽⁴⁰⁾.

1.73. Financial and human resources are assigned to activities without it being possible to discern which of them are allocated to supervision, which to the internal control systems and which to issues relating to the legality and regularity of the underlying transactions.

1.74. The main objective of the management plans is to enhance the efficiency of the Commission's services and so ensure that policies are implemented, but the plans are not yet sufficiently operational as far as the internal control system and issues relating to the legality and regularity of the underlying transactions are concerned. If management plans are to enhance the quality of expenditure, they must include specific objectives and performance indicators for these aspects of each directorate-general's activity ⁽⁴¹⁾.

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1.72. Important efforts have been deployed in 2002 and are further developed to ensure a common comprehension of the ABM concepts (training, ABM-Guide, ABM working groups). Where the 'activity' concept is quite clear as it corresponds to the budgetary nomenclature, further effort is still needed to clarify the notions of corresponding actions, objectives and indicators. This should improve the comparability sought by the Court.

However, it has to be stressed that the Commission does not intend to impose a totally uniform structure for the services' management plans, as they have to reflect their specific activities and related organisation.

1.73. As all management plans are structured following the budgetary activities nomenclature, it is today not possible to identify the resources that are specifically devoted to control and issues relating to the legality and regularity of the underlying transactions. However, further developments are envisaged in the Commission's Job Information System, which would allow to identify the number of staff involved in management and control issues, and an investigation has been launched to check whether in a later stage it would be possible to obtain even the full time equivalent, taking into account the proportion of time spent on these activities.

1.74. Even though the management plans are not primarily intended for the purpose of either monitoring the internal control standards implementation or measuring the extent to which the legality and regularity of transaction have been respected (see the Commission's reply under 1.70 above), the Commission is prepared to explore the possibility of strengthening the use of the management plans as operational tools with respect to the internal control systems.

⁽⁴⁰⁾ The 2002 year was a transitional period during which indicators were introduced on an experimental basis.

⁽⁴¹⁾ Internal control standards: 7 objective setting; 10 monitoring performance against targets and indicators.

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Implementation of the action plan annexed to the Synthesis of the annual activity reports of the directors-general at the Commission for the year 2001

1.75. For the 2001 year ⁽⁴²⁾, the Synthesis of the annual activity reports and declarations of the directors-general highlighted the main difficulties encountered in introducing the reform of the internal control system and proposed a plan of 18 actions for resolving them (13 cross-cutting actions ⁽⁴³⁾ and five specific actions ⁽⁴⁴⁾).

1.76. Progress on most actions was encouraging. Six actions are still problematic (see **table 1.2**). In the case of the cross-cutting actions the problems encountered in 2002 essentially concerned the treatment of 'sensitive functions', supervisory issues related to internal control, especially the need to perfect the methods, tools and technology of supervision ⁽⁴⁵⁾, and the non-inclusion of action plans in annual management plans ⁽⁴⁶⁾.

1.76. The Commission takes note of the table 1.2., which concerns the situation of the actions planned in the 2001 Synthesis as at 31 December 2002. In the meantime, progress has been achieved, or actions completed. Actions still ongoing have been included in the 2002 Synthesis' action plan and as concerns more specifically the inclusion of these action plans in the annual management plans, follow up will be strengthened under the 2002 Synthesis' action plan.

Table 1.2 — Implementation of the action plan annexed to the synthesis of the annual activity reports and declarations of the directors-general for 2001, actions still in progress on 31 December 2002

Action	Area	Final date for implementation	Description of action
1	Research programmes	End 2002	Simplify financial management, rationalise standard contracts and reinforce controls
2	External actions	End 2002 Not set In 2003	Review reciprocal responsibilities of directorates-general responsible for external actions Highlight inherent risks of external actions Evaluate the operation of decentralisation towards Commission delegations
4	Structural Funds	Not set	Clarify Commission responsibilities as regards shared management of the Structural Funds
8	Internal control standards	End 2002	Practical guidelines for the treatment of sensitive functions and supervision
12	Shared management	March 2003	Analyse difficulties associated with shared management and communication specifying authorising officer's responsibilities in areas of shared management
18	Action plans	September 2002	Include action plans in annual management plans

Source: Court of Auditors.

⁽⁴²⁾ COM(2002) 426 final of 24 July 2002.

⁽⁴³⁾ Actions 5, 6, 7, 8, 9, 10, 11, 13, 14, 15, 16, 17 and 18.

⁽⁴⁴⁾ Actions 1, 2, 3, 4 and 12.

⁽⁴⁵⁾ See paragraph 2.1.5 of the Communication 'Overall assessment of the readiness of the Commission services for integrating the new Financial Regulation in their internal control systems', SEC(2002) 1362 final of 17 December 2002.

⁽⁴⁶⁾ For the specific actions (see paragraphs 5.9, 6.8 and 7.37).

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Annual activity reports and declarations of the directors-general for the year 2002*Preparation*

1.77. As of mid-2002, all the Commission directorates-general had, for the first time, lodged an annual activity report on the policies followed in 2001. At the end of this first year the Court had hoped for improvements in the guidance given by central services, in the methodology and terminology to be used, and in the consistency of the directors-general formulation of reservations ⁽⁴⁷⁾.

1.78. For the 2002 financial year, with a view to the entry into force of the new Financial Regulation, the Commission endeavoured to remedy the shortcomings reported in relation to the 2001 financial year:

- (a) by drawing up instructions with the aim of clarifying the methodology for establishing annual activity reports ⁽⁴⁸⁾;
- (b) by advancing presentation of the circular on the 2002 annual activity reports by four months, so that they would not have to be drafted with undue haste;
- (c) by introducing a peer review prior to finalisation of the annual activity reports, in order to improve consistency, especially as regards any reservations expressed in the declarations.

The measures adopted helped to improve certain situations. However, it might still be useful if past experience could be turned to good effect as clarification for the content of certain reservations or, as an illustration of shortcomings mentioned in the body of the activity report.

1.78. *With reference to the 2002 Annual activity reports exercise, a number of methodology points for improvement have been identified and mentioned in the 2002 Synthesis (section 4.4). They will be addressed through an up-date of the guidelines for the preparation of the 2003 Annual activity reports, based amongst other on the best practises identified in the 2002 Annual reports exercise. Further details are given under 1.90, 1.91, 1.93-1.94 and 1.95 hereinafter.*

⁽⁴⁷⁾ Annual report concerning the 2001 financial year, paragraphs 9.72 to 9.91.

⁽⁴⁸⁾ 'The 2002 review of the implementation of activity-based management in the Commission, including clarification of the methodology for the establishment of annual activity reports', COM(2003) 28 of 21 January 2003 (falls under action 10 of the Synthesis report), and 'Clarification of the responsibilities of the key actors in the domain of internal audit and internal control at the Commission', SEC(2003) 59/3 of 21 January 2003 (falls under action 13 of the Synthesis report).

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1.79. The guidelines for the 2002 financial year introduced new elements into the annual reports, which in future must:

- (a) report on progress with the implementation of previous action plans;
- (b) specify the extent to which the 24 internal control standards have been implemented.

1.80. In their annual reports for 2002 the directorates-general have on the whole reported on the situation regarding action plans adopted in response to the 2001 annual activity reports. In many cases they note that significant progress has been made, leading to the withdrawal of their reservations. On the other hand, very few directorates-general mentioned the implementation of the cross-cutting actions provided for in the 2001 Synthesis report (see paragraph 1.75).

Implementation of internal control standards

1.81. In their activity reports all the directorates-general gave an evaluation of the extent to which the 24 internal control standards had been implemented relative to the Commission's baseline standard. The information thus given was generally well-balanced (see **table 1.3**).

The control environment

1.82. In this area, which covers the organisational measures necessary for internal control, application of the internal control standards was satisfactory, with the exception of the treatment of sensitive functions (Internal control standard 5) and the management of staff competence from the point of view of recruitment, training and mobility (Internal control standard 3).

Performance and risk management

1.83. This area includes the essential management aspects (programming, risk management and performance monitoring). Around one third of directorates-general considered that they had not yet reached the Commission's baseline standard for both Internal control standard 10, 'Monitoring performance against objectives and indicators', and Internal control standard 11,

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1.80. *The Commission acknowledges that, while the reporting on actions planned in response to reservations made in the 2001 Annual activity reports of each directorate-general has proved satisfactory, not all the directorates-general have given sufficient indication on the implementation by them of the Synthesis action plan. More precise guidelines will be issued in this respect in the context of the 2003 Annual activity reports.*

1.81. *The Commission recognises that improvement is needed in certain areas of the internal control framework (section 3.2. of 2002 Synthesis). A major effort is being performed by the Commission directorates-general, with the support of the central services, to achieve as much as possible full compliance with the baseline requirements of the 24 Internal Control Standards by end 2003 (See Action 5.4.5. of the 2002 Synthesis).*

Table 1.3 — Introduction of internal control standards: situation at 31 December 2002

Directorates-general	Execution of payment appropriations 2002 (million euro)	Control environment						Performance and risk management				Information and communication				Control activities						Audit and Evaluation			
		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24
ADMIN	2 783																								
AGRI	44 846																								
AIDCO	3 331																								
EAC	768																								
ECFIN	431																								
ECHO	475																								
ELARG	1 263																								
EMPL	6 859																								
ENTR	172																								
ENV	167																								
FISH	623																								
INFSO	965																								
JRC	304																								
REGIO	15 881																								
RELEX	356																								
RTD	2 209																								
SANCO	820																								
TREN	809																								

(*) Not applicable.

Minimum standard in place
Minimum standard being put in place
Standard not in place

Control environment	Performance and risk management	Information and communication	Control activities	Audit and evaluation
1 - Ethics and integrity 2 - Mission, role and tasks 3 - Staff competence (recruitment, training and mobility) 4 - Staff performance 5 - Sensitive functions 6 - Delegation	7 - Target setting 8 - Multiannual programming 9 - Annual management plan 10 - Monitoring performance against targets and indicators 11 - Risk analysis and management	12 - Adequate management information 13 - Mail registration and filing systems 14 - Reporting improprieties	15 - Documentation of procedures 16 - Segregation of duties 17 - Supervision 18 - Recording exceptions 19 - Continuity of operations	20 - Recording and correction of internal control weaknesses 21 - Audit reports 22 - Internal audit capability 23 - Evaluation 24 - Annual review of internal control

Note: directorates-general having effected payments of more than 100 million euro in 2002.

Source: Commission.

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'Risk analysis and management'. This corresponds to the weaknesses identified in the context of activity-based management (see paragraphs 1.68 to 1.74).

Information and communication

1.84. The 'information and communication' element concerns all the procedures designed to provide the necessary data for the reports on the implementation of the budget and management plans. Only half the directorates-general satisfied the minimum requirements for management charts in relation to management information (Internal control standard 12).

Control activities

1.85. This area covers the very wide spectrum of activities that provide the Commission's authorising officers by delegation with reasonable assurance that objectives have been achieved and risks brought under control. This is the area that is still posing the most problems. Whereas directorates-general usually considered that they had made good progress as regards the segregation of duties (Internal control standard 16), around two thirds of them have not yet implemented the minimum requirements laid down as regards Internal control standards 17, 'Supervision', and 19, 'Continuity of operations'. Progress was even less (20 %) in the case of Internal control standard 15, 'Documentation of procedures'.

Audit and evaluation

1.86. Since an internal control system must provide those responsible with reasonable assurance that activities are being carried out, in accordance with their instructions, the results of independent audits cannot be ignored.

1.87. Only five directorates-general said that they had not met the baseline standards for audit reports and the follow-up of them (Internal control standard 21). The Court's work nevertheless showed that this area still calls for further effort (see paragraphs 5.44 to 5.52 and 6.61 to 6.64).

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1.88. As regards the systems for recording and correcting internal control weaknesses (Internal control standard 20), half the directorates-general said they met the baseline standards. The level of progress declared for the annual review of internal control (Internal control standard 24) is better. However, the Court's review still showed problems with the application of this standard (see paragraphs 5.10 to 5.14, 6.5 to 6.19, 7.35 to 7.39, 9.24 to 9.27).

Declarations of the directors-general

1.89. The declaration annexed to the annual activity report is an affirmation by the director-general that the internal controls introduced in the departments in question offer reasonable assurance that the underlying transactions are legal and regular. In their declarations directors-general may highlight internal control weaknesses, or even the existence of irregularities. In such cases they issue reservations and draw up an action plan which includes deadlines for implementation.

1.90. The explanations given by the Commission in order to clarify the concept of materiality include the use of reservations to improve consistency. The explanations provided have had a positive impact, especially for the directorates-general that are responsible for implementing research policy (see paragraphs 6.9 and 6.10). However, the scope of the reservations and the formulation of the corrective action envisaged could be further improved (see paragraphs 4.16 to 4.21, 5.10, 6.19, 7.39 and 8.32 to 8.37).

1.91. In order to facilitate assessment of the actual scope of the reservations the guidelines set the materiality threshold as a function of the budget for the activity in question ⁽⁴⁹⁾. Directors-general may deviate from this

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1.88. Internal control standard 24 states that 'each directorate-general shall conduct an annual review of its internal control arrangements to act as a basis for the directorates-general statement on internal control in the annual activity report'. All directorates-general did this review.

1.90. Clearer guidelines and a peer review of potential reservations carried out at several levels have made it possible to achieve the increased consistency the Court refers to. Room for further improvement still exists, as recognised in the 2002 Synthesis (section 4.4.). Accordingly, the guidelines on 2003 Annual activity reports will seek to obtain a standard format for the reservations made by the Directorates-General, including information such as concrete evidence, impact on the assurance (even though reservations will not always have a monetary impact), the materiality criterion used and the corrective action envisaged.

1.91. This issue will be raised again in the updated guidelines for the 2003 Annual activity report and closely followed up during the peer review of potential reservations.

⁽⁴⁹⁾ The materiality threshold has only been expressed in financial terms. Three other criteria were adopted: the extent to which internal control standards have been put in place, the Commission's credit and the questions raised by the Court of Auditors and the internal audit capability (see Communication from the Commission, 'The 2002 review of the implementation of activity-based management in the Commission, including clarification of the methodology for the establishment of annual activity reports', COM(2003) 28 final of 21 January 2003).

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threshold if they think the context makes this necessary. In that case the reasons for the choice of a new threshold or other materiality criterion must be documented in the activity report. Only four directors-general specified the references adopted.

1.92. 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 put in place ensured that the underlying transactions were legal and regular. For 22 of the 36 declarations there are reservations limiting the assurance given by the directors-general. For example, as in the previous year, the Director-General for Budgets issued two reservations concerning imperfections in the Commission's accounting systems. The reservations concern both the principles governing them and the IT systems that support them.

1.93. The guidelines draw attention to the fact that the reservations must not make the declarations meaningless and that, in extreme circumstances ⁽⁵⁰⁾, it may not be possible for a director-general to give the required assurance. For 2002 the extent of the noted weaknesses is, in several instances, difficult to reconcile with the assurance expressed while, in several cases, it is not possible to assess the true impact of the reservations expressed (see paragraphs 5.10, 5.13 and 6.19).

1.94. Reservations become meaningless if they do not give a clear view of the impact of any material weaknesses identified in the activities of the directorate-general. The reservations must, therefore, be precise in terms of monetary value or scope. The Court noted several cases where these conditions were not satisfied (see paragraphs 4.19, 5.10, 5.13, 6.19 and 7.39).

THE COMMISSION'S REPLIES

1.92. *On the subject of the reservations of the director-general for the Budget, see the reply in paragraph 1.8.*

1.93-1.94. *The guidelines on the 2002 annual activity report did not specify in which cases reservations would lead the authorising officer by delegation to no longer be able to give the required assurance. By definition, reservations expressed limit such assurance, but the scope and the impact of a reservation have to be cautiously evaluated. For example, it is important to distinguish between the portion of the budget administered by a directorate-general that is covered by a reservation and the actual financial impact of that portion, which is a function of the underlying operations that are affected by shortcomings. The financial impact cannot always be quantified in financial terms. Consequently, the Commission considers that the size of the amounts covered by a reservation is not in itself grounds for questioning the assurance given in the declarations by the directors-general. Nevertheless, experience over the years and further guidance, starting from the guidelines for the 2003 annual activity reports, will help the authorising officers by delegation to assess in an ever more consistent way the conclusions to be drawn from the weaknesses disclosed in their declarations.*

⁽⁵⁰⁾ For example, where the reservations have a significant impact on the directorate-general's budget.

THE COURT'S OBSERVATIONS

1.95. Several directors-general stated that they had obtained reasonable assurance that the control procedures provided them with assurance regarding the legality and regularity of the underlying transactions, but also declared that they did not have the requisite information regarding the operation of certain management or supervisory systems. On several occasions they explained that there were serious weaknesses in these systems (see paragraphs 4.17, 5.10 to 5.13, 6.19 and 8.36).

1.96. Many directorates-general have not yet met the baseline standard for all the internal control standards that are supposed to guarantee the legality and regularity of the underlying transactions (see **table 1.3** and paragraphs 1.81 to 1.88). The shortcomings highlighted were the subject sometimes of a reservation, sometimes of a simple observation or comment, without it being possible to perceive the extent of the problems encountered (see paragraphs 4.21, 5.7 and 5.8, 6.13 to 6.16, 7.38 and 7.39, 9.26 and 9.27).

1.97. For operations under shared management or decentralised management (see paragraph 1.64) the directors-general added reservations to their declarations ⁽⁵¹⁾. Those reservations concerned the following:

- (a) the fact that the Commission services had not all completed their analyses of the systems introduced in the Member States (e.g. Directorate-General for Employment and Social Affairs, Directorate-General for Fisheries and Directorate-General for Regional Policy);
- (b) weaknesses in the operation of some management systems in Member States (Directorate-General for Agriculture, Directorate-General for Employment and Social Affairs and Directorate-General for Regional Policy).

THE COMMISSION'S REPLIES

1.95. *The existence of weaknesses in the control systems can indeed 'limit' the scope of the reasonable assurance without making it meaningless. It is the aim of the reservations to document potential weaknesses to take into account in the context of the assurance expressed in the declaration (See Commission's reply at points 1.93-1.94 for further details). The concept of underlying operations should be refined by identifying operations performed directly by the Directorates-General and those carried out at national or local level.*

1.96. *A shortcoming related to the implementation of the internal control standards does not necessarily lead to a reservation in the declaration. Its impact on the required assurance can be limited. Moreover, such a weakness can be compensated by other aspects of the control systems put in place. Similar deficiencies may lead either to a reservation or to a comment in the body of the report, according to the situation of each Directorate-General and the appreciation of the authorising officer by delegation. A more uniform approach may be expected when all actors have gained experience and when the peer review practice consolidates.*

⁽⁵¹⁾ Directorate-General for Agriculture, Directorate-General for Regional Policy, Directorate-General for Fisheries, Directorate-General for Employment and Social Affairs and Directorate-General for Enlargement.

THE COURT'S OBSERVATIONS

1.98. The Court's audits in their turn showed that the supervisory systems and controls of the different directorates-general needed to be strengthened or better utilised (see paragraphs 4.12(e), 4.50 to 4.52, 5.53 to 5.54, 8.32 to 8.37 and 8.45 to 8.49). Moreover, the declaration of the Director-General of the Directorate-General for Agriculture is not based on a review of transactions relating to 2002 (see paragraph 4.18).

The Commission's Synthesis report for 2002

1.99. The Commission adopted the Synthesis of annual activity reports 2002 on 9 July 2003 ⁽⁵²⁾. The purpose of the synthesis is to enable the Commission to:

- (a) take note of the main results achieved by its services, focusing on the delivery of the annual policy strategy for 2002;
- (b) take stock of the reform of its internal control system;
- (c) in the light of the progress recorded, propose the necessary corrective action;
- (d) report to the other institutions.

The observations that follow are confined to matters relating to financial management in the wider sense of the term.

1.100. The Commission emphasised that 'assessment of the overview from the directorates-general (...) shows good progress in the implementation of the Reform as well as improvements regarding issues identified in last year's Synthesis. However, a number of teething problems need to be addressed, and a better anchoring of the new working methods put in place' ⁽⁵³⁾. The Court shares the Commission's view and considers that implementation of the internal control standards still requires close attention.

THE COMMISSION'S REPLIES

1.98. *The 2001 Synthesis action 12 has been achieved and will be complemented by concrete steps to promote a convergence of audit methodologies and an analysis to identify possible improvements in terms of shared management responsibilities (2002 Synthesis action 5.3.3.). (See also points 1.44 and 1.47 to 1.49).*

1.100. *The Commission recognises the particular importance of internal control standards and has made them the subject of an action under Synthesis 2002 (see section 5.4.5.). All Commission directorates-general, assisted by the central services, are making serious efforts to implement the baseline requirements of the standards by December 2003.*

⁽⁵²⁾ See COM(2003) 391 of 9 July 2003.

⁽⁵³⁾ See COM(2003) 391 of 9 July 2003, p. 4.

THE COURT'S OBSERVATIONS

1.101. In several cases the Commission is looking ahead. In fact:

- (a) in the context of activity-based management, the annual reports of the directorates-general do not yet provide full and comparable information on their priorities, resources and indicators by activity. Similarly the audit of the legality and regularity of underlying transactions is not always covered explicitly (see paragraphs 1.68 to 1.74);
- (b) as regards the accounts, the Commission offers assurance regarding the consistency of the 2002 data. However, in view of the volume of data that is recorded in listings, there is still a risk as regards the completeness of the data appearing in the balance sheet (see paragraph 1.7).

1.102. In order to remedy the shortcomings that were found, the Commission has introduced a new scheme comprising 25 actions to supplement the action plans announced by the directors-general in their annual activity reports. Areas that call for immediate action include:

- (a) implementation of baseline internal control standards by all directorates-general before the end of 2003;
- (b) clarification of the respective responsibilities of the Commission and the Member States in areas of shared management;
- (c) the introduction of flat-rate elements in the calculation of grants;
- (d) evaluation of the devolution process in the area of external relations;
- (e) coordination, as well as the organisation and working methods followed by the Commission's various internal audit capabilities;
- (f) the inclusion of action plans in the annual management plans of the directorates-general.

THE COMMISSION'S REPLIES

1.101.

- (a) *Although they are as complete as possible, the management plans contain aggregated information. They were not designed with a view to controlling the legality and regularity of operations. However, the Commission will look into the possibility of using the management plans as an operational tool in conjunction with the internal control systems. In addition, the efforts at clarification that are currently under way should make it possible to achieve the comparability sought by the Court. (See points 1.72 and 1.74 above).*
- (b) *The Commission guarantees the consistency of the 2002 data through an extensive reconciliation process. Additionally, the situation described by the ECA should be corrected once and for all as from 2005, when, in accordance with the new financial regulation and the accounting modernisation project all financial statements have to be established by an integrated system in accordance with the principle of accrual accounting.*

THE COURT'S OBSERVATIONS

1.103. There is a timetabling problem as regards many of these actions, in that there appears to be insufficient time available between the adoption of the Synthesis report (July 2003) and the deadlines set in the action plan. For example the new 'Internal control standards' action provides that all directorates-general should have drawn up an action plan before the end of September 2003 and should aim to achieve compliance with the baseline requirements before the end of the 2003 year.

1.104. The overlap between actions advocated by the 2002 synthesis report, actions in Chapter V of the White Paper, those in the 2001 synthesis report and those provided for in other Commission decisions ⁽⁵⁴⁾ makes it difficult to carry out a specific assessment of the progress already achieved and the action still to be undertaken by the Commission (see paragraphs 1.66 and 1.67).

1.105. The report does not consider various problems in sufficient depth. They include:

- (a) the general conclusion concerning the assurance that, taken as a whole, the control procedures that have been put in place ensure that the underlying transactions are legal and regular, especially those that have cross-cutting implications for the Commission and whose importance the internal auditor highlighted in his annual report;

THE COMMISSION'S REPLIES

1.103. *The ambitious timetable for the Synthesis 2002 actions is an indication of the importance and urgency the Commission attaches to their implementation. The timetable was drawn up to ensure the implementation of the actions under the conditions anticipated at the time the Synthesis was adopted. The same applies to the action planned under Section 5.4.5. of the Synthesis, for which the Commission carried out a 'Readiness assessment' in September 2003 to identify specific problems outstanding and to achieve the maximum possible compliance with the baseline requirements of all 24 Internal Control Standards by the end of 2003. (See points 1.81 and 1.100).*

1.104. *Regular progress reports on the action plan of the White Paper have been issued since 2000. The most recent Reform progress review was produced in January 2003 (see point 1.67.). Synthesis 2002 also contains a review of the actions of the previous Synthesis. Actions still ongoing have been carried over into the new Synthesis, where necessary with amendments or updates (see sections 5.2 and 5.3 of Synthesis 2002).*

The Commission believes that the reference framework referred to above is appropriate for ensuring coherent monitoring of these actions. It is, however, prepared to examine the feasibility and added value of the Court's suggestion (point 1.108) of grouping all the action plans in a single document.

1.105.

- (a) *The Commission fully assumes its responsibility under Article 274 of the EC Treaty. Under the current system the internal reporting by the authorising officers by delegation (annual activity report and declarations of the Directors-General) and the external assurance as to the legality and regularity of the underlying operations (Article 248 of the EC Treaty) contribute to this objective. The Commission is prepared to consider any potential improvement in the framework laid down by the legislature.*

⁽⁵⁴⁾ See 'Overall assessment of the readiness of the Commission services for integrating the new Financial Regulation in their internal control systems', SEC(2002) 1362 final of 17 December 2002, and 'Commission action plan pursuant to the recommendations of the Court of Auditors in its Annual Report relating to the 2001 budgetary year', SEC(2002) 1378 final of 20 December 2002.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

- (b) the White Paper actions that are linked to fraud control, and the specialist group on financial irregularities in particular, 'the imperviousness of legislation and contract management to fraud' and optimisation of the early-warning system.

Conclusion

Follow-up of the annual activity reports and the synthesis of them in the DAS context

1.106. The annual activity reports and declarations of the directors-general, together with the Commission's Synthesis of them, are management representations and the Court cannot disregard them in the statement of assurance context. The lodging of these declarations is thus an advance that will probably affect the Court's audit approach. It is therefore important for their scope to be free of ambiguity as regards the treatment of material deficiencies at the level of Member States, non-member countries and final beneficiaries. In addition, the procedures leading up to the declarations must be sufficiently transparent to allow an examination of their validity ⁽⁵⁵⁾.

1.107. For the 2002 financial year, the procedure for preparing the annual activity reports and declarations was reinforced and the guidelines were improved. There has nevertheless been an increase in the number of reservations that are due to the risk exposure and the extent of them, all too often, remains imprecise. As a result, it is still difficult to form a reasoned judgment of the Commission's management as a whole. For that reason the annual activity reports and declarations of the directors-general are not yet such that the Court could consider them to be a cornerstone of its own declaration of assurance.

The ongoing reform of the internal control system

1.108. With its Synthesis report, the Commission is continuing the effort towards openness as far as accountability for its management is concerned ⁽⁵⁶⁾. However, new actions were introduced when the reform of the internal control system was put into effect in order to cover issues that had not been taken into consideration in the White Paper, and some of the actions and

1.106-1.107. *The 2002 annual report exercise has been improved compared to the previous and first exercise for year 2001. For the next exercise, services will be required to always support their reservations by concrete evidence and to properly explain their impact on the specific assurances required in the declaration.*

The Commission shares the Court's objective that the annual activity reports and the synthesis will form a solid basis for the Court's annual statement of assurance.

1.108. *An up-date of the White Paper action plan implementation is provided on a regular basis and widely disseminated (see paragraph 1.67 above). The last reform progress review has been produced in January 2003 and the 2002 Synthesis adopted on 9 July 2003 present also an overview of the main reform achievements realised in 2002.*

⁽⁵⁵⁾ See Annual report concerning the 2001 financial year, paragraphs 9.53 and 9.71.

⁽⁵⁶⁾ See Annual report concerning the 2001 financial year, paragraph 9.98.

THE COURT'S OBSERVATIONS

objectives initially specified were changed. The resultant situation is very patchy and follow-up of it has proved particularly complex. Under these circumstances it would be much easier to study the progress of the reform if all the action plans and updates of the White Paper actions could be consolidated within a single document and kept up to date.

1.109. Implementing the reform of the internal control system will take time. Despite the substantial progress that has been made in less than two years, the impact of the reform is only just beginning to be felt. As regards the actions that concern the regulatory framework (introduction of the new Financial Regulation and the procedures for implementing it, adoption of various communications concerning audit, management and financial control), the progress achieved can be considered satisfactory, but problems still persist where actions require services to change their habits or necessitate the introduction of new activities (e.g. the application of internal control standards, the functioning of the accounting system or management of recoveries of unduly paid funds). These aspects continue to require a special effort, as the Commission's internal auditors pointed out in their annual report for 2002.

1.110. In this respect, activity-based management should be used as a means of monitoring and adjusting priorities in order to achieve a balance between, on the one hand, investing resources in supervisory systems and controls in order to provide reasonable assurance that the underlying transactions are legal and regular and, on the other, strengthening the policy-making and policy-implementation capabilities, policy-making and implementation being the main function of the Commission.

THE COMMISSION'S REPLIES

The Commission believes that the reference framework referred to above is appropriate for ensuring coherent monitoring of these actions. It is, however, prepared to examine the feasibility and added value of the Court's suggestion of grouping all the action plans in a single document.

1.109. *As recognised in the 2002 Synthesis, the Commission is conscious that the impact of the reform on its functioning is in progress and will further consolidate in the next exercises. As explained under 1.78 above, a great effort is being deployed to make available the resources needed to thoroughly implement the reform, in particular through the Annual Policy Strategy exercises.*

1.110. *As to the balance in using the limited resources allocated to the Commission to perform all the different tasks entrusted to it, the ABM instruments (directorates-general annual management plans — see 1.72 above and the Job Information System — see 1.73 above) are, and will even more become, major tools in assessing and monitoring the achievement of the objectives set according to the Commission's priorities and the resources needed to this purpose.*

CHAPTER 2

Budgetary management

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GENERAL OBSERVATIONS

Introduction

2.1. The annual budget of the European Union is set by the budgetary authority (Council and Parliament) on the basis of proposals presented by the Commission. The implementation of the budget is the responsibility of the Commission. The use of more than 80 % of the available funds depends on requests from Member or beneficiary States to finance EU programmes.

2.2. The purpose of the Court's observations is to provide an overview of the issues at both a general level and by individual revenue and expenditure areas, to identify problems and to make recommendations for improvement.

2.3. More detailed information can be obtained from the Commission document entitled 'Report on budgetary and financial management — Financial year 2002' ⁽¹⁾. The Commission's report constitutes a considerable improvement on the analyses prepared in previous years. It is logically structured, comprehensive and contains for the most part ⁽²⁾ a consistent and coherent level of detail.

2.4. The 2002 payments appropriations increased by 2 % compared with 2001, with agriculture and preaccession aid receiving the major share of the additional appropriations. The commitment and payments appropriations remained, by respectively 2 204 million euro and 4 590 million euro, below their financial perspective ceilings, which set the overall limit for expenditure for a particular year.

⁽¹⁾ To be published by 30 November 2003 in the *Official Journal of the European Union* with the annual accounts of the European Communities.

⁽²⁾ There remain some areas where additional analysis and explanation are needed, for example in the area of external actions, and concerning the use of administrative appropriations in the operating part of the budget (the so-called 'BA' lines).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

2.5. **Table 2.1** gives an overview of the budgetary out-turn for the 2002 financial year for both commitments and payments. This shows an overall implementation rate of 98 % for commitment appropriations (2001: 97 %) and 86 % for payment appropriations (2001: 82 %). The implementation of commitments for the year raises no material observations on the part of the Court, so the remainder of this text is almost exclusively devoted to payments.

Table 2.1 — Implementation of the 2002 budget by financial perspective heading

(million euro and %)

Financial perspective heading	Financial perspective ceiling	Budget		Implementation of the budget					
		Initial appropriations ⁽¹⁾	Final appropriations ⁽²⁾	Commitments and payments made	Implementation rate %	Appropriations carried over to 2003	% of final appropriations available	Appropriations cancelled	% of final appropriations available
	(a)	(b)	(c)	(d)	(e) = (d)/(c)	(f)	(g) = (f)/(c)	(h)	(i) = (h)/(c)
<i>Commitment appropriations</i>									
1. Common agricultural policy	46 587	44 255,1	44 354,1	43 217,0	97,4	83,9	0,2	1 053,2	2,4
2. Structural operations	32 768	33 838,0	34 017,4	34 011,7	100,0	1,4	0,0	4,2	0,0
3. Internal policies	6 558	6 557,8	7 973,7	7 614,0	95,5	213,2	2,7	146,5	1,8
4. External action	4 873	4 803,0	5 207,3	5 085,3	97,7	71,4	1,4	50,5	1,0
5. Administrative expenditure	5 012	5 175,6	5 381,5	5 272,3	98,0	74,3	1,4	34,9	0,6
6. Reserves	676	676,0	510,8	170,5	33,4	8,8	1,7	331,5	64,9
7. Pre-accession aid	3 328	3 328,0	3 531,9	3 503,9	99,2	21,9	0,6	6,2	0,2
Total	99 802	98 633,5	100 976,6	98 874,7	97,9	474,9	0,5	1 627,0	1,6
<i>Payment appropriations</i>									
1. Common agricultural policy		44 255,1	44 940,0	43 520,6	96,8	315,1	0,7	1 104,4	2,5
2. Structural operations		32 129,0	31 603,3	23 499,0	74,4	3 254,3	10,3	4 849,9	15,3
3. Internal policies		6 157,4	7 956,8	6 566,7	82,5	749,6	9,4	640,6	8,1
4. External action		4 665,4	4 969,8	4 423,7	89,0	68,3	1,4	477,8	9,6
5. Administrative expenditure		5 175,6	5 856,6	5 211,6	89,0	548,0	9,4	97,0	1,7
6. Reserves		676,0	651,8	170,5	26,2	8,8	1,4	472,5	72,5
7. Pre-accession aid		2 595,1	2 600,9	1 752,4	67,4	50,5	1,9	798,0	30,7
Total	100 078	95 653,5	98 579,3 ⁽³⁾	85 144,5	86,4	4 994,5 ⁽³⁾	5,1	8 440,3	8,6

⁽¹⁾ Budget finally adopted by the European Parliament on 13 December 2001 (OJ L 29, 31.1.2002).

⁽²⁾ Budget appropriations amended after taking into account supplementary and amending budgets and transfers, and including appropriations carried over from 2001, appropriations resulting from the contributions by third parties and other revenue corresponding to a defined purpose, and appropriations made available again.

⁽³⁾ Column total does not agree with sum of individual entries for reasons of rounding.

Source: 2002 revenue and expenditure account.

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Surplus

2.6. As in the previous two years, there was a significant, albeit smaller, surplus of revenue over expenditure (see **Table 2.2**) ⁽³⁾. For 2002 the surplus amounted to 7 422 million euro, compared with 15 014 million euro in 2001 and 11 619 million euro in 2000. Surpluses arise when the Commission is unable to carry out all of the budgeted expenditure and does not make a corresponding reduction in the revenue for the year ⁽⁴⁾. This means that, as the calls for GNP resources from Member States are made in accordance with the decision of the budgetary authority on the level of expenditure when adopting the budget, more such resources are called up than are needed to cover the actual level of expenditure.

2.7. As the Treaty does not allow the EU budget to be in deficit, a small surplus may always be expected, particularly as it is unlikely that the appropriations will all be spent for a particular year. Indeed, a surplus may result from sound management of funds to the extent that expenditure is only incurred when appropriate processes and procedures are in place and adequately prepared projects and programmes have been accepted for financing. However, there is a need for a policy of more active management of emerging surpluses and a faster response when they are identified. The surplus for 2002, while less than previous years, is still very high.

2.6. *The procedure for the calls for GNP resources from Member States means that the Commission does not have leeway to adjust the calls in line with the level of realised expenditure. In principle, an adjustment could be done with a supplementary and amending budget (SAB), but as discussed in point 2.10, it is normally not a practical option. Accordingly, the adjustment is done in the year $n + 1$ with an SAB regarding the surplus of the previous year. Another possibility is a letter of amendment at the end of year n reducing the Member State contributions from 1 January $n + 1$. The latter was done in 2003 for an amount of EUR 1 billion.*

⁽³⁾ The presentation of the figures leading to the surplus in Table 2.2 follows a different approach from that of the Commission. The resulting surplus is the same as that of the Commission. The Court's presentation is based on the budget implementation data in Table 2.1 and Diagrams I and IV in Annex I. The Commission's presentation follows the requirements of Article 15 of Council Regulation (EC, Euratom) No 1150/2000 of 22 May 2000 implementing Decision 94/728/EC, Euratom on the system of the Communities' own resources, and established practice.

⁽⁴⁾ A surplus could also be due to the Commission receiving more revenue than budgeted, due, for example, to higher than expected yields on traditional own resources. This was not, however, the major cause of the very high surpluses of recent years.

THE COURT'S OBSERVATIONS

2.8. As **Table 2.2** shows, the surplus was caused mainly by lower than expected spending on structural measures (4 850 million euro), agriculture (1 104 million euro), internal policies (640 million euro), pre-accession aid (798 million euro) and external actions (478 million euro). In the case of structural measures the lack of demand for funds arose mainly from delays by Member States in making final claims for the 1994 to 1999 programming period, and, to a lesser extent, continuing (but much reduced) delays in implementing the 2000 to 2006 programming period. The final deadline for the closure of the former programming period was 31 March 2003 and Member States did not submit most final claims until shortly before that date. As a result the Commission carried forward 3 254 million euro to 2003 to cover the resulting final payments. This reduced the reported surplus by the same amount. The Court has significant doubts that the Commission will

THE COMMISSION'S REPLIES

2.8. The payment appropriations in the 2003 budget for pre-2000 Structural Fund programmes, including the amounts carried forward from 2002, equal the amounts Member States forecast they would claim at the closure of these programmes, less 5 % of the outstanding commitments (RAL) at the end of 2001, which were entered in the PDB 2004 to cover payments delayed for legal reasons. At the time when the Commission decided on the carryover in mid-February, the gap between the then available forecasts and budget appropriations for 2003 implied a need for a carryover of EUR 3 254 million.

Due to the late arrival in bulk of closure documents just before the deadline of 31 March 2003, the mixed quality of these

Table 2.2 — Composition of surplus 2002 (and 2001)

(million euro)

	2002			2001		
Revenue	<i>Budgeted</i>	<i>Collected</i>	<i>Contribution to surplus</i>	<i>Budgeted</i>	<i>Collected</i>	<i>Contribution to surplus</i>
Own resources	80 926	79 775	– 1 151	81 470	79 736	– 1 734
Other	15 126	15 659	533	12 665	14 553	1 888
Total	96 052	95 434	– 618	94 135	94 289	154
Expenditure	<i>Underspending ⁽¹⁾</i>	<i>Less carryover to 2003 ⁽²⁾</i>		<i>Underspending ⁽¹⁾</i>	<i>Less carryover to 2002 ⁽²⁾</i>	
Agriculture	1 419	– 315	1 104	2 542	– 685	1 857
Structural measures	8 104	– 3 254	4 850	10 539	0	10 539
Internal policies	1 390	– 750	640	1 182	– 707	475
External actions	546	– 68	478	689	– 238	451
Administration	645	– 548	97	652	– 534	118
Reserves	481	– 9	472	669	0	669
Pre-accession aid	849	– 51	798	901	– 24	877
Rounding	1		1	– 1		– 1
Total	13 435	– 4 995	8 440	17 173	– 2 188	14 985
Exchange differences			– 253			73
Other ⁽³⁾			– 147			– 198
Total surplus			7 422			15 014

⁽¹⁾ Includes the cancellation of unused credits brought forward of 309 million euro (1 804 million euro in 2001).

⁽²⁾ Amount carried over includes 684 million euro in respect of third party revenues for which the usual cancellation rules for carryovers do not apply (550 million euro in 2001).

⁽³⁾ Sundry elements mainly related to reused credits carried forward.

Source: 2002 revenue and expenditure account.

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be in a position to use a large part of these appropriations in 2003. See paragraphs 2.25 to 2.26, 5.16 to 5.21, 5.38 to 5.40 and 5.56 for more information.

2.9. If the Commission is to be able to introduce a supplementary and amending budget (SAB) to reduce the amount of revenue to nearer the level of forecast expenditure, and thereby reduce the surplus, it needs to be aware of the risk of excessive underspending sufficiently in advance of the year end. To help it to plan the need for, and use of, funds for structural measures the Commission requests forecasts of spending from Member States. In practice these forecasts significantly and systematically overestimate the need for funds. This also applies when estimates are revised during the year, even when performance to date is behind target.

2.10. During the 2002 budgetary procedure the budgetary authority made a joint declaration requiring the Commission to provide an implementation plan for the 2002 budget. Following an initial plan prepared in June 2002, an updated version was produced in October 2002 based on utilisation to date and revised estimates. This forecast an overall 11 % underspending of payment appropriations, mainly arising from the Structural Funds. Despite this information the Commission did not take the opportunity to propose a SAB to reduce the amount of revenue in line with the reduced need for funds.

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documents and the need for the Commission to make the appropriate checks before final payment, more payments will be delayed into 2004 than those already foreseen in the PDB 2004. The information now available also indicates a significant volume of previously unforeseen decommitments. These will add to the underimplementation in 2003 foreseen by the Court. The Commission will consider making appropriate proposals to the budgetary authority in this regard.

2.9. *Despite the fact that, in global terms, Member States' forecasts have systematically overestimated the need for funds by a significant amount, they remain the best information on payment needs the Commission receives from sources closer to the execution of programmes on the ground. This is the consequence of shared management and there is no real alternative to the bottom-up approach. The Commission is making significant efforts to improve the forecasts in cooperation with the Member States. In view of the inaccurate forecasts received in the past, the Commission has written to the Member States several times reminding them how important it is for it to have high quality implementation forecasts for each programme on time.*

The Commission also endeavours to make good use of the payment appropriations available by carrying out transfers such as the one to the Cohesion Fund (see point 2.16).

2.10. *The forecast underspending was associated with a considerable degree of uncertainty, particularly relating to the Structural Funds, and could not therefore be used as such for an SAB. The Commission, however, acknowledges that the forecast ultimately overestimated the actual implementation.*

The SAB is a rather complicated procedure for reducing revenue as it requires at least one reading in Parliament and the Council and the acceptance of the Ecofin Council. Because of the forecasting uncertainty due to the usual concentration of Member States' payment claims towards the end of the year, an SAB procedure completed before mid-November is risky. If it is adopted after that date, under Article 10(3) of Regulation (EC) No 1150/2000, the readjustments of revenue will apply starting from January $n + 1$. However, the Commission

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is prepared to use an earlier SAB when the under-implementation is sizeable and sufficiently certain to occur.

An alternative solution would be the letter of amendment procedure at the end of October, used mainly for actual EAGGF implementation on 15 October, including an estimation of the balance at the year-end which, after the Council's second reading, will be entered as revenue in Article 3 0 0 in the budget n + 1.

In both cases the reductions are in force only in January n + 1.

Carryover of appropriations

2.11. In its Opinion ⁽⁵⁾ on the new Financial Regulation, the Court stated that the carryover procedure, whereby unused budgetary appropriations are carried forward for use during the following financial year, constitutes an unnecessary complication to both the budgetary process ⁽⁶⁾ and the accounting system. The amounts involved are often low and concern obligations which could be covered by appropriations belonging to the following year, made available, if necessary, through the SAB procedure.

2.11. *The carryover procedure is a part of the regulatory framework. It provides additional budgetary appropriations with a fast and fairly simple procedure, compared to an SAB, provided that certain conditions are fulfilled (mainly that the budgetary appropriations would otherwise be insufficient to meet the Commission's payment obligations). Accordingly, the Commission does not share the Court's view on the drawbacks of the carryover procedure.*

2.12. For 2002 the appropriations brought forward from 2001 totalled 411 million euro for commitments and 1 540 million euro for payments ⁽⁷⁾. In respect of the commitments, the subsequent utilisation was almost total, whereas for payments 309 million euro (or 23 %) was cancelled. The majority (79 %) of the carry-over related to agriculture and administrative expenditure — both non-differentiated appropriations subject to automatic carryovers. However, 65 % of the payment appropriations cancelled related to carryovers for internal policies and external action. Both of these areas were

2.12. *The carryover decisions have to be made as early as in mid-February on the basis of a forecast on the overall need for payment appropriations for the budget headings concerned, in order to cover a possible lack of appropriations. These forecasts are subject to uncertainties. It should also be noted that underimplementation in 2001 does not necessarily imply underimplementation in 2002, but the situation could actually be the reverse, i.e. a need for additional appropriations in order to catch up. The reasons for the overall underutilisation of payment appropriations for internal policies and external action included unforeseen delays of*

⁽⁵⁾ Opinion No 2/2001 (OJ C 162, 5.6.2001).

⁽⁶⁾ For example, separate allocations are used for carryovers in the accounting system, and are subject to separate rules governing their use.

⁽⁷⁾ Excluding 648 million euro of earmarked revenue relating to the research field.

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subject to significant underspending in 2001, and previously, which should have indicated that a carryover was probably not necessary.

2.13. For 2002 the amount carried forward to 2003 was reduced to 145 million euro for commitments, but increased significantly to 4 995 million euro in respect of payments. The main cause of this increase was the 3 254 million euro carried forward within the Structural Funds relating to the closure of the 1994 to 1999 programming period, for which the deadline for the final receipt of claims is March 2003. There is, however, a strong possibility that these carried-over appropriations will not be used ⁽⁸⁾ because of the risk of delays in processing the closure claims.

European Union Solidarity Fund

2.14. As a consequence of the floods in central Europe in the summer of 2002, a supplementary and amending budget was adopted in November 2002 establishing a new financial instrument in the internal policies area: the European Union Solidarity Fund. The Fund is intended to cover expenditure resulting from unexpected disasters and is financed by a new flexibility mechanism which allows up to 1 000 million euro to be made available each year above the financial perspective ceilings. It covers the Member States and candidate countries.

2.15. The amount of 728 million euro granted to Austria, France, Germany and the Czech Republic in 2002 was financed by a transfer of payment appropriations from the Structural Funds. The payments were made to the Member States concerned under budget heading B2-4 0 0 in internal policies (599 million euro), and to the Czech Republic under budget heading B7-0 9 0 in preaccession aid (129 million euro).

⁽⁸⁾ The new Financial Regulation requires the Commission to use the payment appropriations of the year before those carried forward.

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programme and project approvals, resulting in delayed commitments and, consequently, in lower-than-planned advance and other payments.

2.13. *The bulk of payment claims for the Structural Funds was received just before the final deadline for their receipt by the Commission. The Commission is endeavouring to process all acceptable payment claims received as soon as possible. As to the expected under-execution of payment appropriations, the Commission will consider making appropriate proposals to the Budgetary Authority (See also the comment to point 2.8)*

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Own resources

2.16. The amount of traditional own resources (customs and agricultural duties, and sugar levies) made available to the Commission — 11 237 million euro — was 23 % lower than in 2001, mainly due to an increase from 10 % to 25 % in the amount Member States retain by way of collection costs. The underlying total of duties and levies fell by 7,7 %, reflecting both a fall in the value of imports and a decrease in duty rates for certain types of import. The change in collection costs, introduced by a new own resources decision ⁽⁹⁾ that entered into force on 1 March 2002, covered all duties and levies established from 1 January 2001, with retroactive effect. Therefore during 2002 the Commission repaid to Member States a further amount of 2 023 million euro to adjust retentions made at the 10 % rate in 2001.

2.17. The GNP resource increased by 32 % compared with 2001 in order to meet the reduction in customs and agricultural duties, a decrease in the VAT call-up rate from 1 % to 0,75 % following the new own resources decision, and the repayment of 2 023 million euro relating to the adjustment of the traditional own resources collection costs referred to in the previous paragraph. As explained in paragraph 2.10, in the absence of action to reduce the surplus by means of a supplementary and amending budget, the GNP own resource was up to 7 422 million euro greater than needed to cover actual expenditure, representing around 16 % of this resource.

2.17. *As discussed in the Commission's reply under point 2.6, the Commission does not have leeway to adjust the revenues without a decision by the Budgetary Authority on an SAB.*

⁽⁹⁾ Council Decision 2000/597/EC, Euratom of 29 September 2000 on the system of the European Communities' own resources (OJ L 253, 7.10.2000, p. 42).

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Agriculture

2.18. Agricultural expenditure represents the largest proportion of the budget by value. For 2002 the budget provided for expenditure of 44 940 million euro. Final expenditure was 43 521 million euro representing almost 97 % of available payment appropriations ⁽¹⁰⁾.

2.19. Unused payment appropriations amounted to 1 419 million euro, resulting mainly from a 798 million euro underuse of ancillary expenditure (veterinary measures etc.) due to delayed decisions on measures in relation to foot and mouth disease resulting from the lack of reliable information provided by the Member States concerned, and a 345 million euro underuse in rural development. Both of these types of expenditure are of a more discretionary nature than the bulk of agricultural expenditure.

2.20. A new initiative known as modulation was introduced by Council Regulation (EC) No 1259/1999 ⁽¹¹⁾. Member States may decide to reduce the payments granted directly to farmers under support schemes (except rural development) on the understanding that the funds are to be spent on rural development schemes within three years. The funds generated can be used as additional Community aid for those rural development measures that are co-financed by the EAGGF-Guarantee section throughout the Community (early retirement, less favoured areas and areas with environmental restrictions, agri-environment and afforestation). A total of 287 million euro has been retained (2002: 169 million euro; 2001: 118 million euro) and, of this, 260 million euro awaits expenditure on suitable schemes.

2.19. In the case of rural development, the choice of measures and the speed of implementation are largely at the discretion of the Member States, provided they remain within the expenditure ceilings agreed with the Commission. For this reason, it is more difficult for the Commission to ascertain precisely what the outturn will be, and if a margin will remain.

⁽¹⁰⁾ Excluding the monetary reserve intended to cover, if necessary, the impact on agricultural spending of significant movements in the EUR/USD exchange rate compared to the rate used in preparing the budget. It is not included in the agricultural heading of the financial perspective. The reserve was not used in 2002, the last year of its operation.

⁽¹¹⁾ Council Regulation (EC) No 1259/1999 of 17 May 1999 establishing common rules for direct support schemes under the common agricultural policy (OJ L 160, 26.6.1999, p. 113).

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Structural measures

2.21. Structural measures consist of actions to promote socioeconomic development in Member States. The main instruments are the four Structural Funds ⁽¹²⁾ and the Cohesion Fund. The payment appropriations for structural measures payments represented an increase of 1,8 % compared with 2001. This related mostly to an increase of one third for Community initiatives ⁽¹³⁾. The budgetary authority agreed a lower increase than the one proposed by the Commission even though the Commission's was based on estimates by Member States. The subsequent payment implementation rate for Community Initiatives was 25 %, the lowest in the structural measures area.

2.22. The implementation rate for Structural Fund payments was 72 % ⁽¹⁴⁾ of available appropriations, which represents an increase on that for 2001 (69 %) and accounts for the largest proportion (around 65 %) of the overall surplus. Overall underspending amounted to 8 104 million euro (see **Table 2.2**), of which the largest proportion (around 6 100 million euro) related to delays in the receipt of final claims for the 1994 to 1999 programming period. The balance of the underspend comprises the continuing, but much reduced, delays in the implementation of the 2000 to 2006 programming period.

2.23. In contrast to the Structural Funds, payment appropriations were fully spent for the Cohesion Fund, covering both the closure of old projects and payments on new projects. A late transfer of 548 million euro from the Structural Funds was insufficient to meet the needs for additional appropriations and 200 million-euro of claims remained unpaid at the end of the year. This high implementation rate in 2002 was due to a

2.21. *The approval of many Community initiative programmes was delayed more than originally expected, and significantly more than the approval of the mainstream programmes. But even allowing for that, the actual progress in implementing the Community initiatives has indeed been slower than expected. The Commission has already taken this into consideration in its PDB 2004, where the budget for payments for the Community initiatives is only 62 % of the annual instalment of commitments, compared to 80 % for the mainstream programmes.*

2.22. *The bulk of the underspending in the Structural Funds was due to significant delays in the receipt of final claims for the 1994 to 99 programming period. For the new period (2000 to 2006) the implementation of programmes improved relative to 2001, even if not as much as initially expected.*

2.23. *Outstanding commitments (RAL) for the Cohesion Fund (projects from before 2000) were reduced by 36 % (from EUR 2 billion to 1,5 billion) and represents six months of commitment appropriations.*

⁽¹²⁾ European Regional Development (ERDF), European Social Fund (ESF), European Agricultural Guidance and Guarantee Fund (EAGGF-Guidance) and the Financial Instrument for Fisheries Guidance (FIFG). The budget is further divided into three priority areas known as objectives.

⁽¹³⁾ Operations of Community interest carried out at the initiative of the Commission to supplement those implemented under the priority objectives.

⁽¹⁴⁾ There was a significant variation in underspending between the various priority objectives. See Diagram IV of Annex 1.

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diverse mix of circumstances, resulting in many projects being finalised during the year, and may not reflect the trend in future periods.

2.24. As explained in paragraph 2.9, underspending on the Structural Funds largely arises from inaccurate forecasting by Member States. In 2002 the procedure was improved with an initial plan prepared by the Commission in June 2002, and an amended plan issued in October 2002 based on a revision of the estimates. The quality of the plan depends on the quality of the forecasts provided by Member States of their expected use of funds. These have proved to be significantly, and consistently inaccurate. For 2002 the average overestimate was 73 %, up from 38 % in 2001. The lowest overestimate was one quarter higher than actual needs, and six Member States overestimated needs by between two and six times the sums finally needed. The nature of estimates is that actual performance is likely to differ from the estimate, either above or below. However, in all cases the Member States overestimated the funds required, which indicates a systematic and structural, rather than random, problem with the procedure.

2.25. As mentioned in paragraph 2.8, the final deadline for submitting final claims for the 1994 to 1999 programmes was 31 March 2003. Many Member States concentrated on meeting this deadline and as a consequence did not submit claims on programmes until after the end of 2002. In order to cover part of the large number of payments expected in 2003, 3 254 million euro was carried forward to 2003.

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2.24. *It is true that Member States' forecasts have consistently shown a significant overestimation bias on average. They have also been erratic, i.e. the average forecasting error of each Member State is quite volatile.*

Despite their poor quality, they remain the best information on payment needs the Commission receives from sources closer to the execution of programmes on the ground.

Thus the Commission is making significant efforts to improve the forecasts in cooperation with the Member States. So far, due to their overestimation bias, the forecasts have been of limited value for budgeting (except in specific circumstances, such as the ones mentioned in the reply to point 2.9), but the potential value of the forecasts justifies continued efforts towards their improvement. The Commission uses its own analysis besides Member States' forecasts for budgeting purposes.

In any event, the Commission appraises the forecasts received from Member States in the light of its own information. For 2004 the amounts in the budget are smaller than those returned by the Member States in their forecasts.

See also point 2.9.

2.25. *In all Member States a significant cause of the delays was the time taken to complete the audits of the programmes required before closure.*

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2.26. However, the Commission expects that many of the claims will be incomplete and will require significant and time-consuming intervention before they can be closed. This, together with the large volume of transactions involved, means that there is a significant risk that many of the final payments will only be made in 2004. Accordingly, this will have an impact on the expected use of the payment appropriations carried over.

2.27. Underimplementation of the 2000 to 2006 programming period contributed 1 964 million euro to the overall surplus. However, this reflects a spending rate of 91 %, which represents a considerable improvement compared with 2001 (70 %).

2.28. The main risk faced by the Commission is the future effect of the cumulative significant underspending encountered at the beginning of the 2000 to 2006 period. As a result, large volumes of funds will need to be spent at the end of the period in order for the complete budgetary envelope to be implemented. Member States may have difficulties in absorbing the funds.

2.29. One consequence of the accumulated underspending is the high level of outstanding commitments. At 31 December 2002 these totalled 66 731 million euro, a rise from 56 765 million euro at the end of 2001. This increase is partly caused by the low level of payments in 2001 and 2002 referred to above, but is primarily a direct consequence of the new system for commitments and payments in the Structural Funds (see paragraph 5.3).

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2.26. Although the bulk of payment claims was received just before the final deadline for their receipt by the Commission, the Commission is endeavouring to process all acceptable payment claims received as soon as possible, in cooperation with the Member States. As to the expected under-execution of payment appropriations, the Commission will consider making appropriate proposals to the budgetary authority.

2.28. The late adoption of many programmes at the beginning of the period 2000 to 2006 led to a re-budgetisation of uncommitted amounts totalling EUR 6,152 million to later years in the programming period, and to a corresponding revision of the financial perspective. The re-budgetisation has been spread over the period 2002 to 2006 and represents on average an increase of 4 % of the initial amount provided for in the financial perspective, which should not present a specific problem for the absorption of funds.

2.29. Around one third of the outstanding commitments for structural measures concerned pre-2000 programmes. The outstanding commitments for the period 2000 to 2006 represent less than two years of commitments. The Commission feels that this amount is not unreasonable for the implementation of multiannual programmes consisting of heavy investments and for which the Regulation provides for payment within two years of commitment.

In 2002, a great effort was devoted to clearing the oldest RAL. In consequence, the outstanding commitments for the pre-1994 programmes were greatly reduced, from EUR 532 million at the beginning of 2002, to EUR 128 million at the end of the year.

Under the rules for the period 2000 to 2006 commitments are made annually while payments essentially follow the implementation of the programmes until 2008. Outstanding commitments are expected to increase until 2006, as indicated by the Commission, most recently in its

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communication to the European Parliament and to the Council, 'Evolution of budget execution of the Structural Funds, in particular outstanding commitments (RAL)' (COM(2002) 528 final).

2.30. At the end of 2002 some two thirds of the outstanding commitments for the Structural Funds concerned the 2000 to 2006 programming period. A new rule introduced for this programming period requires any part of a commitment which has not given rise to a payment claim by the end of the second year following its establishment to be cancelled automatically. This procedure, which imposes on Member States the risk of losing funds, is intended to encourage implementation of programmes in line with the financial plans (see paragraph 5.36).

2.30. See comment on 2.28.

Internal policies

2.31. Internal policies are mostly directly managed by the Commission and are dominated by research and technological development (RTD) expenditure, which represented 56 % of the payments made in 2002. The implementation rate for internal policy expenditure as a whole remained low, at 82,5 %, which represented a small increase on the 81,8 % achieved in 2001. The underspending of payments contributed 640 million euro to the surplus. The 100 % implementation rate for the new European Union Solidarity Fund (see paragraphs 2.14 and 2.15) contributed to the overall increase in implementation for the area as a whole.

2.31 to 2.33. *The underimplementation of payment appropriations noted by the Court is explained by the structural causes described by the Court at point 2.32. For RTD, underimplementation in 2002, excluding revenue from third parties, came to EUR 854 million minus EUR 684 million (payment appropriations for revenue from third parties), i.e. EUR 170 million. Given the budget of EUR 3 751 million, the rate of under-implementation in this area of internal policies has therefore fallen to 4,5 %.*

2.32. The 2002 budget showed a 5,2 % increase in payment appropriations compared with 2001, RTD expenditure being allocated an additional 3,9 % and education increasing by 22,3 %, to reflect specific Commission priorities. However underspending in RTD (854 million euro) and education (110 million euro) comprised the two main elements (69 % together) of the gross underspending for the area. In both cases the procedure in the Financial Regulation concerning earmarked third party revenue explains the bulk of the underspending. When third countries contribute to Community programmes, the same amount of

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additional appropriations are recorded for both commitments and for payments, even though the need for the payment appropriations may be spread over several years. Unused payment appropriations are carried forward automatically to the following years to enable the actions to which they are earmarked to continue without further calls for funds for the countries concerned. There is, therefore, a structural surplus of payment appropriations in areas such as RTD and education.

2.33. The underimplementation occurred largely (61 %) in shared cost projects for which there are significant inherent delays in planning and implementation of projects once the earmarked revenue has been received. Further reasons are late or incomplete submissions of claims for payment from contractors and delays by the Commission in making legal commitments and organising calls for tender.

External actions

2.34. Expenditure on external actions is in the main directly managed by the Commission and comprises a large number of different headings, the largest being cooperation with the Balkans (17 %). The implementation rate for payments in 2002 was 89 %, which represents an increase on the 86 % achieved in 2001. There were a large number of transfers during the year which were needed to take into account the changing priorities inherent in this type of expenditure, such as responding to the situation in Afghanistan.

2.35. For 2002 the payments appropriations were increased by 6,7 % (294 million euro) compared with the 2001 budget in order to take into account specific priority areas of the Union. Much of this increase was accounted for by an increase for the Mediterranean third countries and the Middle East (225 million euro), together, other major increases in funds being for development aid to Asia (95 million euro), partner countries in Eastern Europe and Central Asia (81 million euro), and development aid to Latin America (66 million euro). The former two achieved near total implementation, whereas the spending rates for the latter two, which received increased funds, were 84 % and 78 % respectively.

2.35. *In the case of Eastern Europe and Central Asia, the increase in payment appropriations was 26 % compared to 2001 and for Latin America the corresponding increase was 18 %. For these two areas the payment appropriations voted by the budgetary authority greatly exceeded the Commission's request.*

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Administrative expenditure

2.36. Administrative expenditure mostly comprises staff and buildings costs. Around two thirds of administrative expenditure is attributable to the Commission, one fifth to Parliament, and the balance to the other institutions and bodies. The appropriations for administrative expenditure increased by 4,8 % compared with 2001, which reflects both normal inflationary increases and preparations for enlargement.

2.37. The implementation rate for payments was 89 %, which is comparable to that for 2001 and is largely consistent across all institutions. Of the overall underimplementation, 369 million euro is attributable to the Commission and mostly concerns decentralised expenditure on support staff and administration (113 million euro) and building and equipment costs (92 million euro). Due to the nature of this expenditure — purchases of goods and services, and reimbursements of meeting and mission costs — these areas have a higher level of automatic carryovers, which are needed to finance, for example, goods and services ordered before the year-end where the receipt and settlement of invoices occurs after the year end. The implementation rate on the carryovers (88 % for those brought forward from 2001) contributes to an effective implementation rate of payment appropriations for any given year of over 98 % by the end of the following year.

Preaccession aid

2.38. Preaccession aid comprises amounts paid to accession and candidate countries to the Union and is a mixture of direct (Commission) and shared management (Commission-beneficiary States) expenditure. The budget for payments was 494 million euro higher than in 2001, an increase of 24 %. The increase in the budget was made despite the severe problems encountered by beneficiary States in absorbing funds in 2001. For 2002, payments made totalled 1 752 million euro, representing 67 % of the available appropriations, up from 61 % in 2001.

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2.39. Payments in respect of Sapard ⁽¹⁵⁾ remained low, despite an increase compared with 2001. In 2002 the Commission transferred 124 million euro (31 million euro in 2001) to administrations in the beneficiary States, which represents 34 % of the amounts available (6,5 % in 2001). In turn the administrations transferred 33,5 million euro ⁽¹⁶⁾ to final beneficiaries (1 million euro in 2001). As such, some three years after the start of the programme only 2 % of available funds have been transferred to final beneficiaries (0,1 % in 2001). Although Sapard is an essential instrument to tackle priority problems in accession States relating to agriculture and rural development, the Court notes that the vast majority of advances so far transferred remain on the Sapard euro accounts.

2.40. Financial implementation of Sapard has been slower than initially anticipated, mainly because it took longer than expected to set up the management and control systems in the accession countries. It was only in the second half of the year that all the conditions were fulfilled for the Commission to approve the conferral of management of Sapard to three countries, representing 70 % of expenditure. However financial implementation was also slow in those countries which had received conferral of management in 2001. This is because some local conditions necessary for implementation were not fulfilled.

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2.39. The 2002 preliminary draft budget was drawn up in early 2001 on the assumption that all countries would secure timely conferral of management decisions. However, only two countries did so, but not including the two largest beneficiaries. It was also assumed that the initial payment on account for Sapard would be paid at the ceiling of 49 % of the first annual allocation (AFA 2000, about EUR 260 million) in the relevant legislation. In May 2001 the Commission decided that initial payments on account would be limited to 50 % of this ceiling. This policy continued in 2002, reducing payments by over EUR 100 million. A policy change was considered but rejected on the grounds that greater priority should be given to firm management of appropriations rather than to more complete budget execution. Payments on account are only made after the approval of the conferral decisions. Consequently, the bulk of these payments in 2002 (EUR 89,1 million) was paid only from July 2002 onwards into the Sapard euro accounts of the candidate countries.

Payments to final beneficiaries are made only when they have incurred eligible expenditure, generally several months after the beneficiary has been selected.

2.40. Two countries, Bulgaria and Estonia, carried out most of the work to set up their management and control systems in 2000 or early 2001. Hence, the Commission does not consider the conferral of management to have been slow for these two countries. For most of the beneficiary countries and for a variety of reasons, including 'local conditions', it took longer to set up their management and control systems.

On the issue of implementation, after the conferral of management there is inevitably an interval between that and payments being made to final beneficiaries. Even though such disbursements were limited, the Commission does not consider that implementation has been slow.

As the Commission has stated in the Sapard annual report for 2001, there is a risk that assessing the instrument on the basis of disbursement of budget resources may give it a distorted image. The Commission still considers this point to be valid.

⁽¹⁵⁾ Instrument supporting sustainable agricultural and rural development in the central and eastern Europe applicant countries during the preaccession period.

⁽¹⁶⁾ Representing 13,7 million euro charged to the 2002 budget and 19,6 million euro to be charged to the 2003 budget.

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2.41. Most beneficiary countries have indicated that one of the bottlenecks is that beneficiaries are sometimes unable to prefinance project expenditure due to difficulties with access to credit, with land reform, or with the property market. As indicated in the Court's annual report for 2001 ⁽¹⁷⁾, the Commission should analyse the reasons for the slow implementation and ensure that appropriate action is taken, either by the Commission or the candidate countries.

2.42. For ISPA ⁽¹⁸⁾ the implementation rate for payments was 79 %, which constitutes a rise from 58 % in 2001. The low implementation results from a concentration of commitments at the year end.

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2.41. *The issue of slow implementation is complex and is related, amongst other things, to access to credit. Even when credit is available, some beneficiaries are reluctant to take out mortgages on property, and other matters of unclear title of ownership, in particular of land, also play a part.*

To alleviate problems of financing, the Community does not require a project to be completed before any aid may be granted. Aid may be granted in instalments, but — for reasons of sound financial management — based on costs actually borne by the beneficiary. Despite this, only few beneficiary countries have chosen not to require project completion before any aid is granted. This action reduces the administrative burden (and risks of the project not being completed) but places an inevitable burden on beneficiaries in terms of the prefinancing of expenditure.

The Commission has also encouraged the Sapard agencies to shorten the interval between eligible expenditures being incurred and aid being paid.

In order to seek to mitigate problems linked with access to credit availability, the Commission, with the aid of Phare funds, is supporting a project to improve access to credit for SMEs in candidate countries. The Commission is further examining ways of ensuring that this facility is taken up more widely.

2.42. *This increase is a result of the Commission's efforts to strengthen the administrative capacity of candidate countries to implement ISPA projects, in particular in the field of public procurement. It is true that the concentration of commitments at year end had a negative impact on spending. Moreover, such projects require a certain lead time for preparatory work, including tendering, so as to ensure efficient and proper project implementation. Consequently, it takes some time until payments can flow, but this flow accelerated between 2001 and 2002, as noted by the Court.*

⁽¹⁷⁾ Paragraph 6.30.

⁽¹⁸⁾ Instrument supporting economic and social cohesion in the applicant countries of central and eastern Europe, particularly in the fields of environment and transport.

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2.43. During the period the spending rate for Phare ⁽¹⁹⁾ funds (which represent around 60 % of the preaccession area appropriations) fell from 79 % in 2001 to 69 % in 2002. This was caused by a move away from traditional infrastructure-type projects towards support for institution-building. The change in emphasis requires significantly different types of projects which, in turn, need additional preparation and implementation time.

CONCLUSIONS AND RECOMMENDATIONS

2.44. The Commission's report on budgetary and financial management for 2002 is a well prepared and useful document, and constitutes a considerable improvement on previous years. The Court recommends that in future it be completed by the inclusion of a section on own resources. With regard to the administrative budget headings included in the operating part of the budget, the introduction from 2004 of activity-based budgeting will require the report to analyse the administrative expenditure allocated to the various policy areas. The findings of the document should be used in future budget-setting procedures in order to reduce the risk of similar weaknesses recurring.

2.45. In some cases underspending was caused by increases in budgetary appropriations compared with 2001 which the Commission was then unable to implement (i.e., internal policies and external actions). In other cases (i.e., preaccession aid, the Community initiatives of structural measures) the budgetary authority reduced increases proposed by the Commission, which had the effect of reducing underspending. The Court recommends that increases in budgetary appropriations should only be proposed when there are realistic plans for their full use. Specific attention is needed when spending in the previous year has been low.

2.44. *In future the Commission will include a section on own resources in the report, starting from Report 2003. The administrative expenditure allocated to the various policy areas will be analysed after the introduction from 2004 of activity-based budgeting.*

The Commission shares the view that the analyses of the budget implementation should be used in future budget-setting procedures.

2.45. *The Commission aims at realistic budgeting of payment appropriations. The best method is a careful assessment of the need for payment appropriations by budget headings, taking into account all foreseeable circumstances affecting budget implementation (e.g. the likely schedules for programme and project approvals, progress on the ground in project implementation as a prior condition for payments, control procedures and administrative constraints).*

Continued emphasis on the budget implementation plan exercise regarding the current budget year, comprising monitoring, reporting and revisions integrated into the budget decision procedure, can also be expected gradually to improve budget forecasting for the PDB. This also comprises an assessment of whether low spending in the past implies lower budgeting (or the reverse).

⁽¹⁹⁾ Instrument to assist applicant countries of central and eastern Europe in preparing for enlargement, particularly institution building and convergence of legislation.

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2.46. The large surplus is mostly caused by underspending in the expenditure areas, particularly Structural Funds. Member State forecasts were grossly inaccurate in their expected use of funds, and the Commission took no action to reduce revenue even when its own estimate showed a significant expected underimplementation at the year end. The Court recommends that further measures should be taken, both to improve the quality of the forecast information provided by Member States and to undertake the necessary steps to reduce revenue when significant levels of underspending are forecast.

2.47. In itself, underspending does not necessarily constitute weak budget management, indeed it may reflect firm management of the appropriations. Efforts to increase utilisation rates simply to use up the funds (and prevent future cuts) increase the risk of inappropriate or irregular expenditure. However, the delaying of expenditure to the end of the current programming period for Structural Funds is likely to cause significant absorption difficulties and commensurate problems in managing the aid. Furthermore, the low implementation of preaccession funds means that priority problems are not being dealt with in a timely manner in the countries concerned. The Court recommends that sufficient appropriate action be taken to deal with these problems in a manner that safeguards the financial interests of the current and future citizens of Europe but does not compromise the delivery of EU grant-aided projects.

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2.46. The Commission has consistently proposed appropriations below Member States' forecasts, based on its best available knowledge at the time of budgeting. The Commission shares fully the Court's concern regarding the importance of improving the quality of Member States' forecasts and has already taken a number of steps to this end. It has conducted a survey amongst Member States on the procedure and improved it in the light of the replies received. It now sends the requests for information to Member States and informs the programme management authorities at the same time. It has streamlined the systems used to collect and analyse the data. It produces annually a widely disseminated report on the quality of the forecasts. The Commission will continue cooperating with Member States to improve the quality of the forecasts.

As to the Court's recommendation to undertake necessary steps to reduce revenue, the Commission is prepared to use an SAB when the underimplementation is sizeable and sufficiently certain to occur. In other circumstances however, the Commission prefers to use the surplus SAB procedure in year $n + 1$.

The unused revenues remain on special Commission accounts held by Member States.

2.47. For the Structural Funds the 'n + 2' rule imposes constant financial discipline and is intended to avoid the problems resulting from underimplementation of the programmes being concentrated at the end of the period. Regarding ISPA, the increase in payments between 2001 and 2002 is a result of combined efforts undertaken by the Commission and candidate countries to set up proper implementation structures and to strengthen the administrative capacity of national authorities, in particular in the field of public procurement. Ensuring compliance with Community procurement principles (transparency, fairness, soundness) is leading in some cases to delays in the implementation of ISPA projects, but the Commission cannot accelerate implementation to the detriment of these principles.

Sapard has contributed to the building of systems that are capable of managing aid to foster structural adaptation of agriculture in the countries concerned. The Commission considers that adequate control systems have to be in place prior to any funds being released. After conferral of management,

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2.48. The Court continues to maintain that the use of carryovers of appropriations unnecessarily complicates the process of budgetary management and the accounting system. They distort the view of overall implementation, with the 3 254 million euro carryover of payment appropriations in respect of the Structural Funds having the effect of reducing the reported surplus by the same amount. In line with its opinion on the new Financial Regulation, the Court continues to recommend that this procedure be abolished and any shortfall in funds met through a more open and transparent method, such as supplementary and amending budgets.

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there is inevitably an interval between that and payments being made to final beneficiaries.

2.48. *The carryover instrument is part of the established regime for budgetary management. Its main purpose is to cover insufficient payment appropriations that can already be foreseen in the beginning of the financial year, provided that the conditions for a carryover in the Financial Regulations are met (i.e. forecast of insufficient appropriations for the next year). It has the advantage of being an instrument that is procedurally fairly simple and fast compared to amending budgets. The earmarking in the accounts of appropriations carried over and the separate rules governing their use are both justified and technically necessary, as appropriations carried over can be used only after the ordinary budgetary appropriations have been exhausted on the budget heading in question.*

The use of an amending budget to cover possible shortfalls of payment appropriations is mainly intended to cover unforeseen additional needs for appropriations during the financial year that cannot be met with the transfer instrument.

The Commission does not share the Court's view that the use of carryovers unnecessarily complicates the process of budgetary management and the accounting system. The use of the instrument has clear advantages and is fully transparent. The difference between the carryover and the SAB instrument is, in the Commission's view, less about transparency and complication than about different decision-making procedures.

CHAPTER 3

Own resources

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INTRODUCTION

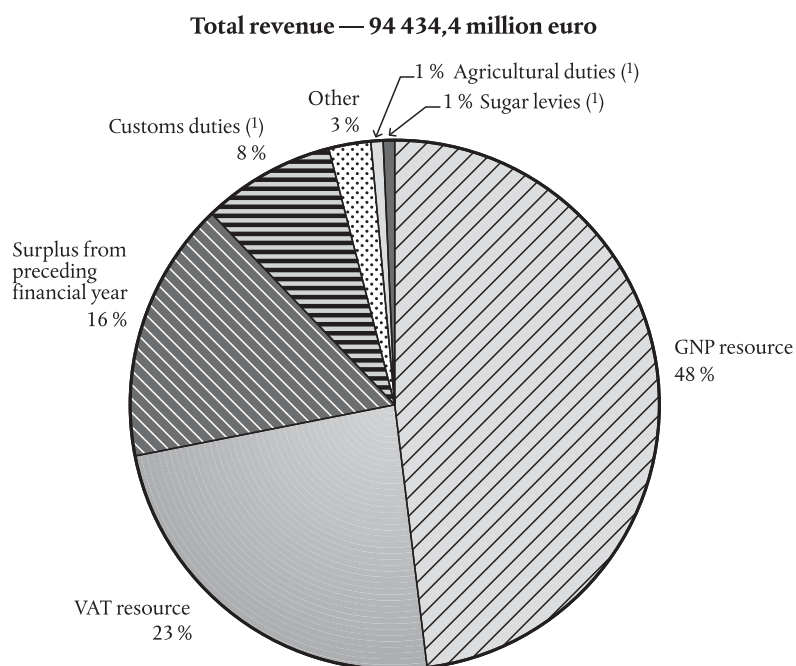
3.1. The revenue of the budget of the European Union consists of own resources and other revenue. The own resources are by far the main source of financing for budgetary expenditure, as is shown by **Table 3.1** as well as **Graph 3.1** and **Graph 3.2**. There are three categories of own resources: traditional own resources (agricultural duties, sugar levies and customs duties), own resources calculated on the basis of value added tax collected by Member States and own resources derived from the Member States' gross national product. In the last three years the share of the other revenue, consisting of the surplus from the previous financial year, has been much greater than previously (see paragraphs 2.6 to 2.10 of this report).

Table 3.1 — Revenue for the financial years 2001 and 2002

(million euro)

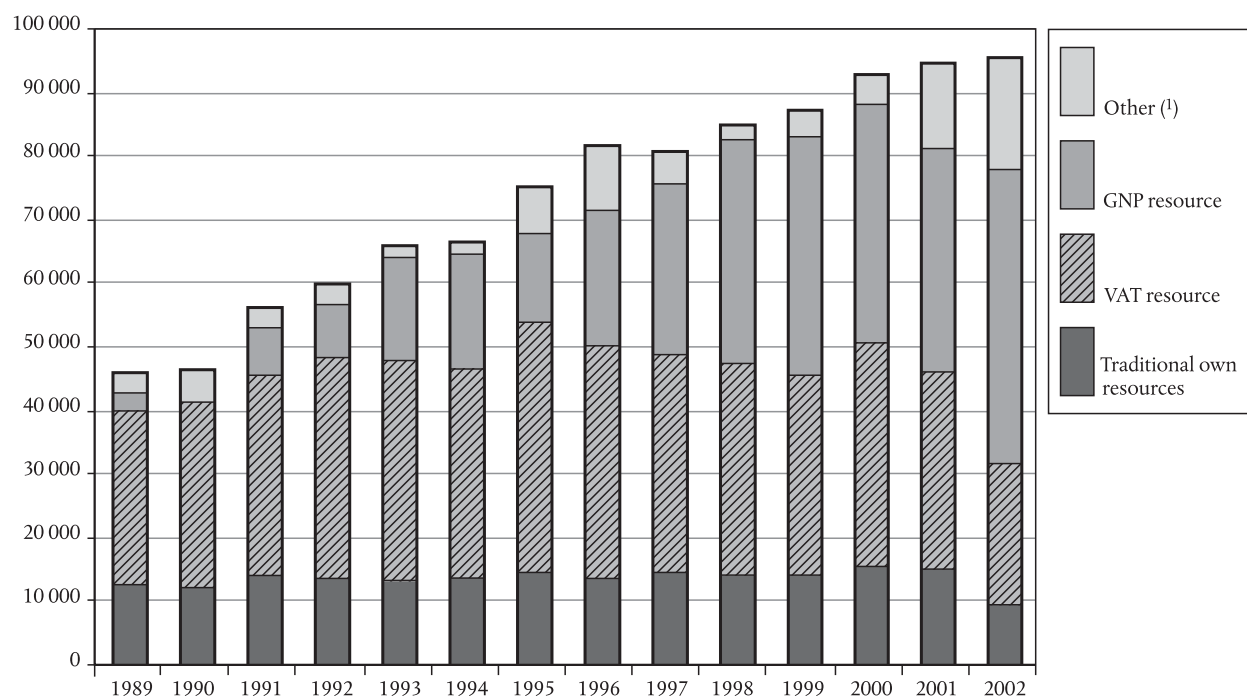
Type of revenue and corresponding budget heading	Actual revenue in 2001	Development of the 2002 budget		Actual revenue in 2002	% change (2001 to 2002)
		Initial budget	Final budget		
	(a)	(b)	(c)	(d)	e = [(d) - (a)]/(a)
1. <i>Traditional own resources</i>	14 589,2	15 892,7	9 682,2	9 214,0	- 36,8 %
— Agricultural duties (Chapter 1 0)	1 132,9	1 121,7	1 121,7	1 180,3	4,2 %
— Sugar and isoglucose levies (Chapter 1 1)	840,0	770,9	770,9	864,8	2,9 %
— Customs duties (Chapter 1 2)	14 237,4	15 765,9	13 734,2	12 917,5	- 9,3 %
— Collection expenses (Chapter 1 9)	- 1 621,0	- 1 765,9	- 3 906,7	- 3 725,6	129,8 %
— Collection expenses (Chapter 2 0)		0,0	- 2 037,9	- 2 023,0	
2. <i>VAT resources</i>	31 320,3	36 603,9	22 601,2	22 388,2	- 28,5 %
— VAT resource from the current financial year (Chapter 1 3)	30 695,4	36 603,9	22 601,2	22 539,0	
— Balances from previous years (Chapter 3 1)	624,9	0,0	0,0	- 150,8	
3. <i>GNP resource</i>	34 878,8	41 147,6	46 605,0	45 947,6	31,7 %
— GNP resource from the current financial year (Chapter 1 4)	34 460,2	41 147,6	46 605,0	45 850,3	
— Balances from previous years (Chapter 3 2)	418,6	0,0	0,0	97,3	
4. <i>Budgetary imbalances</i>	- 70,3	0,0	0,0	148,2	- 310,8 %
— UK correction (Chapter 1 5)	- 72,5	0,0	0,0	149,0	
— Final calculation of UK correction (Chapter 3 5)	2,2	0,0	0,0	- 0,8	
5. <i>Other revenue</i>	13 571,2	2 010,6	17 163,8	17 736,4	30,7 %
— Surplus from previous financial year (Chapter 3 0)	11 612,7	1 200,0	15 375,0	15 375,0	32,4 %
— Miscellaneous revenues (Titles 4 to 9)	1 958,5	810,6	1 788,8	2 361,4	20,6 %
Grand total	94 289,3	95 654,8	96 052,0	95 434,4	1,2 %

Source: 2002 revenue and expenditure account.

Graph 3.1 — Breakdown of actual revenue in 2002

(1) Customs and agricultural duties and sugar levies are shown after deduction of the collection costs of 2002 and of the repayment, made in 2002, of collection costs of 2001 (see paragraph 2.16)

Source: 2002 revenue and expenditure account.

Graph 3.2 — Evolution of sources of actual revenue 1989 to 2002

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

Source: 2002 revenue and expenditure account.

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3.2. In the area of traditional own resources, the Court's audit concentrated on the systems for recording established duties, and particular attention was paid to the system of customs surveillance of the arrival of goods at airports.

3.3. For the VAT and GNP own resources, the Court's audit concentrated on the setting of the budget and its implementation in respect of these resources, with specific attention to the balances and adjustments to balances deriving from these resources and the refunds to Member States. The audit also covered the collection of VAT in Member States in respect of the VAT-related own resource and an examination of the GNP questionnaire procedure, which constitutes the basis for the calculation of the GNP-related own resource.

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Traditional own resources

Accounting for traditional own resources

3.4. The traditional own resources are established by Member States' customs authorities or other designated authorities and are first entered in national accounting systems. They are allocated (at the latest at the time when the amounts must be made available) either to the so-called A account, or, while they remain unpaid and unsecured, or are secured and are under appeal, to the so-called B account ⁽¹⁾.

Audit work done

3.5. The Court examined the Commission's accounts for traditional own resources, analysed the flow of duties from all Member States, and examined the underlying

⁽¹⁾ Article 6 of Council Regulation (EC, Euratom) No 1150/2000 of 22 May 2000 implementing Decision 94/728/EC, Euratom on the system of the Communities' own resources (OJ L 130, 31.5.2000, p. 1).

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national accounting systems in 11 Member States ⁽²⁾ which together were responsible for 96 % of the import duties collected in 2002. It also audited a sample of customs declarations at airports and all major monthly receipts of own resources established by Member States and entered in the Commission's accounts. The Court must stress that its audit cannot cover imports which have not been declared or which have escaped customs surveillance and remained unrecovered.

Reporting amounts to be made available to the Commission

3.6. Commission Decision 97/245/EC ⁽³⁾ sets out the requirements for completing the statements for the A and B accounts that Member States send to the Commission to show the amounts of import duty established.

3.7. Some Member States (Belgium, Denmark, France, Netherlands, Finland, Sweden and the United Kingdom) do not fully conform to the requirements for completing A- and/or B-account statements, and one (Greece) frequently fails to submit any A-account statement, sending only a letter which contains summary information. Although this does not affect the amounts made available, it restricts the Commission's ability to monitor and analyse the data as they develop during the year.

3.7. During the last three years, the Commission has taken action to improve Member States' statements of A and B accounts. At the Advisory Committee on Own Resources (ACOR) on 7 December 2000, the Commission addressed the weaknesses observed in Member States' statements. Subsequently individual follow-up was made with those Member States still not complying. As a result, the overall quality of the statements is improving. The Commission will continue its monitoring action.

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

3.8. 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'.

⁽²⁾ Belgium, Denmark, Germany, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Sweden and the United Kingdom.

⁽³⁾ As amended by Commission Decision 2002/235/EC of 13 March 2002 (OJ L 79, 22.3.2002, p. 61).

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3.9. At 31 December 2002, the gross balance for the B accounts standing in the Commission's books, namely 2 321,2 million euro, was 1,4 % less than the equivalent figure at 31 December 2001 (2 354,9 million euro) ⁽⁴⁾. For the year 2001 the balances in the B accounts had increased by 2,7 %. The reduction in the total at 31 December 2002 is the result of applying the exchange rate at the balance-sheet date ⁽⁵⁾; without the exchange rate effect, the total of the underlying entries in Member States' B accounts increased by 0,4 %.

3.10. The B-account balance includes some long-standing entries for which full recovery must now be regarded as very doubtful. In order to take account of this problem the Commission has entered a value correction in its balance sheet which reduces the total B-account balance by 65 %. 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 not likely to be recovered, and that amendments to the regulation, already proposed by the Commission ⁽⁶⁾; should be made accordingly. As long as the Council does not adopt such amendments, the B-account balance will contain an increasing sum made up of amounts which may never be recovered.

3.11. The B-account totals after deducting collection costs were 2 119,4 million euro at 31 December 2001 and 1 740,9 million euro at 31 December 2002, a decrease of 18 %. This reflects the coming into effect of Council Decision 2000/597/EC, Euratom, on the system of the European Communities' own resources, under which the collection costs for duties established after 31 December 2000 were raised from 10 % to 25 %. The 25 % rate has been applied to the entire outstanding B-account balance, which means that the balance is understated, since a large part (at least 50 %) of the balance dates from before 1 January 2001 and should be subject only to the 10 % deduction.

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3.10. On 1 July 2003, the Commission tabled a new proposal to amend Regulation (EC, Euratom) No 1150/2000, incorporating the 1997 proposal for an improved management of the amounts entered in the B account (COM(2003) 366 final).

3.11. To ensure a convergent interpretation of both Articles 2(3) and 10(2)(c) of the Own Resources Decision 2000/597/EC, Euratom, the Commission interprets Article 10(2)(c) as not covering entitlements established before 1 January 2001 that could be credited to the account of the Commission, in conformity with the Community rules, after 28 February 2001. Consequently the 25 % deduction rate is applied to all amounts correctly entered into the B account as they need only be made available after their recovery.

⁽⁴⁾ Figures given are before deduction of collection costs.

⁽⁵⁾ For Member States (Denmark, Sweden, the United Kingdom) not using the euro.

⁽⁶⁾ Amended proposal for a Council Regulation (EC, Euratom), submitted by the Commission on 3 April 1998, amending Council Regulation (EEC, Euratom) No 1552/89 implementing Decision 94/728/EC, Euratom on the system of the Communities' own resources (OJ C 150, 16.5.1998, p. 20).

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3.12. In 2002, as in previous years, problems were found with the maintenance of the B accounts in several Member States. In Germany, which accounts for 26 % of the total B-account figure for the European Union, it is still impossible to confirm the balance, because the database used does not provide an analysis of the individual entries. The Court identified systematic mistakes in the procedures applied to maintain the B accounts in Italy. Furthermore, the reports on the Commission's inspections in 2002 (see paragraphs 3.15 to 3.16 below) refer to problems in keeping B accounts in Greece, where there was inadequate control over the B accounts at two customs offices and organisational problems prevented full application of Community rules on write-offs. These reports also refer to systematic shortcomings and errors in keeping B accounts in Belgium, Denmark, the Netherlands and the United Kingdom.

3.13. Several anomalies were noted in reporting the B account balances to the Commission (Denmark, Ireland, Italy, the Netherlands, Sweden and the United Kingdom). For some Member States, the amounts shown as recovered on the B-account statements did not match the corresponding figures on the A-account statements (Germany, Ireland, Italy and the United Kingdom). These discrepancies, which might indicate that amounts due to the Commission were not made available or were made available late, were not systematically analysed, nor were A- and B-account statements always reviewed to ensure their completeness.

THE COMMISSION'S REPLIES

3.12. Problems with the maintenance of the B account by Member States are indeed ongoing. Therefore the Commission frequently checks this in Member States. The lack of an audit trail in the German B account was first drawn to the German authorities' attention in a Commission report of an inspection made in 2000. The Commission will be checking what progress has been made in late 2003 as part of a wide-ranging check of accounting procedures in Germany. The Commission has asked the Italian authorities to regularise the situation regarding belated and potentially incomplete accounting for payments obtained for debts in the B account. The Commission is ensuring the follow-up to the results of its inspections with the Member States concerned to obtain remedial measures.

3.13. As a part of its ongoing risk-assessment-based control activities, the Commission checks the completeness of A- and B-account statements and follow-up is given to remedy anomalies in the reporting requirements (see comments for point 3.7). As experience has shown that differences between A- and B-account statements arise almost always from Member States' difficulties in providing accurate B-account data and not from problems in making recovered amounts available, the anomalies referred to by the Court had not yet been followed up at the time of the Court's audit. The Commission is currently giving appropriate follow-up to these discrepancies.

Commission supervisory systems and controls

3.14. Under Article 18 of Council Regulation (EC, Euratom) No 1150/2000, the Commission may request that Member States 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. 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

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Resources. An overall report on the functioning of the inspections is drawn up every three years and presented to the budgetary authority ⁽⁷⁾.

3.15. The Court has reviewed the work of the Commission unit that carried out these inspections, including the criteria used to select themes for inspection, and its methodology and documentation. The unit's methodology is supported by a well established audit manual. Audit work is increasingly done in the context of a joint audit initiative that involves functionally independent internal audit units of customs. The unit visits every Member State at least once a year. Its choice of themes to cover reflects a risk analysis process.

3.16. The reports issued by the unit are clear and properly evidenced. In 2002 they covered the operation of small and medium-sized customs offices, customs clearance of cereals, and B accounts (see paragraph 3.12). In the small and medium-sized customs offices the Commission found that compliance with Community regulations was generally satisfactory. As regards cereals, it was found that in several Member States the procedures in use were not fully compliant with Community regulations. In respect of both themes, a number of shortcomings in the system for making own resources available were identified.

3.17. It is not the unit's role to give overall assurance that the accounting is correct and that all duties due are identified and established. The results of the unit's work, however, are taken into account by the Court in reaching its conclusion on the Statement of Assurance.

THE COMMISSION'S REPLIES

3.15. *The Commission strongly endorses the joint audit arrangements. Audits under these arrangements continue to be successfully performed in Austria, Denmark and the Netherlands. Three further Member States have expressed interest in joining in the near to medium term. In addition, some accession States have already similarly expressed interest and the Commission will actively pursue their participation provided the necessary conditions are fulfilled.*

⁽⁷⁾ The latest is document COM(2003) 345 final, fourth report from the Commission on the operation of the inspection arrangements for traditional own resources (2000 to 2002).

Customs surveillance of arrivals of goods at airports

3.18. Control over goods entering the EU customs territory by air transport is based on the following control (sub-)systems:

- (a) controls of arriving aircraft and unloading of cargo;
- (b) controls over temporary storage or warehousing of goods ⁽⁸⁾ awaiting a further customs destination;
- (c) controls of goods declared for free circulation or other customs regimes or destinations.

3.19. The Court examined customs clearance through airports in 11 Member States (see footnote 2) where import duty collected constitutes a major revenue stream representing, at national level, between 4 and 30 % of duty collected. The audit concentrated on an evaluation of the customs surveillance and control procedures applied which are intended to ensure that all goods are declared properly and in good time and that import duties are correctly established.

Control plans

3.20. Community legislation does not generally prescribe either particular methods or the level of customs control, this being at the discretion of the Member States. Control strategies for airports need to minimise risks to revenue, by ensuring that goods arriving at airports are under continuous customs surveillance until they are either released for free circulation or a customs-approved treatment is assigned to them.

⁽⁸⁾ A warehouse is a customs regime where, subject to certain rules, goods can be stored without time limits. Temporary storage provides for the possibility of storing goods prior to a customs-approved treatment for a maximum period of 20 days.

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3.21. A particular characteristic of air cargo is the high volume of parcels and the simplified procedure, where the manifest ⁽⁹⁾ is regarded as a summary declaration on which the status of the goods is indicated either with a 'C' for Community goods or a 'T' for third country goods.

3.22. The above elements should be the basis for deciding on the level and type of control, usually a mix of physical spot checks of goods, reviews of inventory and stock records and checks on declarations.

3.23. In five of the Member States visited (Belgium, France, Denmark, Netherlands and United Kingdom) the airport customs had devised specific control plans taking into account the above mentioned risks and control activities related to temporary storage and warehousing.

Controls on aircraft arrivals and entry of unloaded goods into temporary storage

3.24. In all Member States visited the system of surveillance of the arrival of goods is largely based on what is considered to be a self-controlling system by private operators from the unloading of an aircraft to the disposal of goods. An effective system for reporting on differences between cargo items listed on cargo manifests and entered in temporary storage or a customs warehouse regime, and for the follow-up to such differences, constitutes an indispensable element of such a surveillance system.

3.25. In France, customs' information about arrivals is insufficient to enable them to check that all goods are in fact presented. In Austria, Spain and Sweden there are no clear procedures for reporting differences.

3.25. *The Commission is examining closely the procedures for presenting goods to customs at French and Spanish airports. Similarly, it is analysing the procedures used in Sweden and Austria for reporting differences. Appropriate follow-up is being given by the Commission.*

⁽⁹⁾ Commercial document listing all cargo carried by aircraft.

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3.26. Only two of the Member States visited (Belgium and the Netherlands) use traditional customs controls such as routine reconciliation between the number of arriving aircraft and the manifests lodged, and supervision of the unloading of aircraft. The main reason for this is that only in a few Member States do the customs authorities have direct access to the computer system operated by the airport authorities ⁽¹⁰⁾.

Temporary storage and warehousing

3.27. Cargo arriving by air can be put in temporary storage for a maximum of 20 days before it is assigned to a customs-approved treatment or use. Some Member States authorise goods to be placed directly under a customs warehouse regime instead of in temporary storage, which gets round the 20-day deadline and allows cargo to be stored without any time limits. Apart from differences in control practices ⁽¹¹⁾, the Court identified some weaknesses in the control arrangements. In Germany customs relied entirely on an electronic clearance system and no customs checks on temporary storage facilities were carried out. In Austria, the frequency and scope of controls on warehouse operations were insufficient. In Germany the 20-day period for temporary storage was frequently exceeded. As appeared from a built-in control feature in the IT system. In the United Kingdom, some similar differences were not promptly followed up.

3.27. *The anomalies found in the various Members States concerning temporary storage and warehousing referred to by the Court are being followed up by the Commission so as to ensure compliance with the rules. Corrective action will be taken, where appropriate.*

Control of the status of goods under simplified procedure (transit)

3.28. An airline company may be authorised to use a manifest as a transit declaration, which uses the identification 'T' for third-country goods and 'C' for goods whose Community status can be demonstrated.

⁽¹⁰⁾ It is noted that in some countries (Netherlands, Italy, Denmark and Sweden) the customs only get information related to third-country flights. However, Community flights may carry non-Community goods in transit (see paragraph 3.28).

⁽¹¹⁾ Certain Member States (for example Spain and Italy) prescribe control frequency and methods at national level; others (for example the Netherlands and the United Kingdom) establish central guidelines but delegate implementation decisions to regional or local level.

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3.29. According to Article 445(4) of Commission Regulation (EEC) No 2454/93 as last amended by Regulation (EC) No 1335/2003, the customs authorities at the airport of destination should transmit to the customs at the airport of departure details of manifests for verification, if considered necessary. Only at three airports visited (Austria, Belgium and Denmark) had such subsequent verifications been carried out in a consistent manner. In one control operation it was found that out of 41 shipments indicating 'C', 10 were in fact third-country goods. At the other airports visited, this check had either never or rarely been undertaken.

Customs clearance by fast couriers

3.30. Certain airports have granted special facilities to fast courier companies in order to ensure that the goods are cleared rapidly. In one Member State (Sweden) import declarations for high-value goods (>22 euro) could be handed in up to 11 days after the goods had left storage, which means that goods can leave storage without controls and without all the necessary documentation (for example invoices or preference certificates) being present.

3.31. Low-value goods (≤ 22 euro) can be considered a special risk, as no customs duty is charged. Few Member States had undertaken special control actions in this area but those that had done so (Denmark and the United Kingdom), identified a significant rate of irregularity.

Transfer of goods between airports

3.32. Goods can be moved by road between airports under a transit system. In one Member State (France), frequent movements of goods take place without the customs procedures of the transit system being respected (absence of customs stamps by office of departure and arrival and no indication that the goods had been sealed during transport).

THE COMMISSION'S REPLIES

3.29. Under the joint audit initiative Austria, Denmark and the Netherlands all examined the control of transit movements by air. All found areas of concern. Since those audits were carried out the regulatory requirements have changed. The Commission took note of those findings and included them in its risk analysis when selecting themes for control in 2003. The Court's comments will also be included in the process for 2004.

3.30. The Commission will ensure the follow-up to the remarks made by the Court and corrective actions will be taken when appropriate.

3.31. The Commission will consider taking steps to check whether Member States have adequate control mechanisms to cover these risks.

3.32. The Commission is examining the point relating to transit procedure between airports in France. Action will be taken, if appropriate.

Conclusions and recommendations

3.33. Taking into account the scope of the audit (see paragraph 3.5) and with the exception of the B accounts matters noted in paragraph 3.12, the checks and systems analysis carried out by the Court gave satisfactory overall results concerning the reliability of the accounts used for recording traditional own resources.

3.34. The audit work carried out on the systems and related transactions which underly the accounts has also given satisfactory overall results as far as the legality and regularity of the underlying transactions is concerned (see also indicators in Annexes 1 and 2). However, there is scope for Member States to improve the national instructions in respect of the control regime for airports so that the special risks at airports (e.g. value and status of goods and differences between cargo declared and unloaded) are covered. Customs authorities should also have knowledge of all flight arrivals in advance so they can better plan the control to be undertaken.

3.34. *With regard to special risks at airports, the Commission will draw the attention of the Member States to these risks at the next meeting of the Advisory Committee.*

VAT/GNP own resources

3.35. In contrast to the EU's revenue from traditional own resources, the VAT and GNP own resources reflect macroeconomic statistics whose underlying data cannot be tested directly. Therefore, the VAT/GNP audit takes as its starting point, the receipt by the Commission from the Member States of the macroeconomic aggregates (either as forecasts or as real figures) and seeks to assess the Commission's system for handling the data until they are ultimately reflected in the final accounts. The Court looks at the difficult question of the quality of the macroeconomic data separately in special reports, such as Special Report No 17/2000 ⁽¹²⁾.

⁽¹²⁾ Special Report No 17/2000 on the Commission's control of the reliability and comparability of the Member States' GNP data (OJ C 336, 27.11.2000).

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Commission supervisory systems and controls

3.36. The Commission's inspection activities ⁽¹³⁾, carried out in cooperation with the Member States, constitute an important element of the control system for VAT/GNP related own resources. The Court has reviewed the work of the units carrying out these inspections.

3.37. In respect of the VAT-related own resources, the Commission's on-the-spot inspections have proved to be of great value as they have given rise to many reservations (85 still valid at the end of 2002), several of which relate to the amount of net VAT collected. These observations cast doubt on the accuracy and reliability of the VAT statements produced by Member States ⁽¹⁴⁾.

3.38. The preparation and the reporting on these inspections, which are centred on the Member States' VAT statements as well as the follow-up of the audit observations, are of good quality. However, the Court notes that inspection activities related to the collection of VAT in Member States have been limited and that the abovementioned reservations have not yet been quantified.

3.38. Article 11(1) of Council Regulation (EEC, Euratom) No 1553/89 of 29 May 1989 on the definitive uniform arrangements for the collection of own resources accruing from value added tax requires the Commission to ensure in particular that operations to centralise the assessment base and to determine the weighted average rate and the total net VAT collected have been performed correctly, and also to verify the data and calculations used for corrections and compensations. The collection of VAT is explicitly referred to in Article 12 of the Regulation, which requires the Commission to examine this matter and to consider possible improvements in a triennial report ⁽¹⁾. When reservations concern cases where tax has not been charged, where no data have been provided or where the Commission questions data used by a Member State, it is usually very difficult for the Commission to quantify the impact on the base at the time when the reservation is made. Quantification normally requires subsequent discussions with the Member State concerned.

⁽¹³⁾ The inspection visits are based on Council Regulation (EEC, Euratom) No 1553/89 of 29 May 1989 on the definitive uniform arrangements for the collection of own resources accruing from value added tax (OJ L 155, 7.6.1989, p. 9) and Council Regulation (EC, Euratom) No 1150/2000 of 22 May 2000 implementing Decision 94/728/EC, Euratom on the system of the Communities' own resources (OJ L 130, 31.5.2000, p. 1).

⁽¹⁴⁾ The VAT statement is a document drawn up by the Member States which must contain the data used to determine the VAT base, which constitute the basis for the calculation of the VAT own resource and which are required for the Commission's control (Articles 7 and 11 of Council Regulation (EC, Euratom) No 1553/89) (OJ L 155, 7.6.1989, p. 9).

⁽¹⁾ The 5th such report is now in preparation and will be published in 2004.

THE COURT'S OBSERVATIONS

3.39. Before 31 July the Member States must send the Commission the so-called VAT statement for the previous calendar year, which contains all the data necessary for the calculation of the VAT own resource. Greece sent its VAT statement for 2001 five months overdue and Portugal's VAT statement for 2001 is still outstanding, which is hampering the Commission's inspection activities, as outlined above.

3.40. Concerning the GNP-related own resource, the Court has found that the Commission directs much of its GNP inspections activities to methodological issues (ESA 95 inventories ⁽¹⁵⁾). GNP control missions in Member States do not generally check whether the output from the GNP questionnaires ⁽¹⁶⁾ corresponds to the applicable methodology.

3.41. Controls on the GNP questionnaires are essentially based on the expertise of the desk officers for the countries in question and there exist no specific check-lists to ensure standardised procedures for verifying GNP data.

VAT collection in Member States

3.42. In addition to the audit work related to the Commission's accounts for the VAT own resource, the Court examined the collection of VAT ⁽¹⁷⁾ in seven Member States ⁽¹⁸⁾ and reviewed the role of the Commission in its capacity as authority with management responsibility for the correct application of EU legislation, concerning the VAT-based own resource.

THE COMMISSION'S REPLIES

3.39. Although Greece's final VAT statement was indeed received late, a provisional summary of the forthcoming statement was received before the deadline. The Commission accepts that Portugal has completely failed to meet its obligations as regards the transmission of its VAT statement for 2001 and is preparing legal proceedings against the Member State on this matter.

3.40. The checks by the Commission are grounded in a thorough analysis of the procedures used by Member States to compile their GNP, based on inventories of sources and methods that are thoroughly analysed by the Commission and discussed in missions to the countries. These inventories normally include a numerical illustration for one year (usually 1995) of the transition from basic data to the data included in the GNP questionnaire for that year.

3.41. See response to point 3.51.

⁽¹⁵⁾ The inventory is a document produced by each Member State that lays down the specific methods to calculate the GNP figures based on the European system of accounts (ESA 95).

⁽¹⁶⁾ The questionnaire is the document based on a common model by which the national statistical offices communicate the GNP figures to Eurostat each year.

⁽¹⁷⁾ The collection of VAT in Member States constitutes one of the key factors in the calculation of the VAT own resource.

⁽¹⁸⁾ Germany, Belgium, Denmark, Italy, Luxembourg, Austria and Sweden.

THE COURT'S OBSERVATIONS

3.43. From this work the following conclusions can be drawn. Calculations of the data and figures underlying the figures presented in part I of the Member States' VAT statements and the build-up of the net VAT collected figure in this statement sometimes show differences in respect of presentation and terminology, which could render the control and comparison of this part of the VAT statement difficult.

3.44. Not all Member States' accounting systems for VAT receipts show, for a specific fiscal year, the amount of VAT due to be paid by taxpayers, the amount collected, the amount outstanding, the amount subject to enforcement procedures and the amount of VAT collected after enforcement. Neither did all Member States' accounting systems for recording and centralising VAT payments include an audit trail which allows the tracking of (individual) VAT amounts due and the payment thereof via the centralisation of these amounts to their inclusion in the amount of net VAT collected that is mentioned in the Member States' VAT statements.

3.45. Although precise and comparable data for all Member States are not available ⁽¹⁹⁾, there exist wide-ranging differences between Member States' enforcement procedures which affect the collection of VAT, and thus the calculations of VAT own resources in Member States.

THE COMMISSION'S REPLIES

3.43. Community legislation does not provide for a standard format for annual VAT statements, nor does it confer implementing powers on the Commission or on the ACOR, to adopt measures to this end. Where the presentation poses a problem, the Commission requests suitable changes in future statements. The move to electronic transmission of statements and their accompanying data and documentation since 2001 (statements for 2000), together with the publication of the documents on the Commission's CIRCA Intranet, as well as the regular methodological discussions held in the ACOR, have all encouraged greater standardisation and transparency. The Commission will continue to examine to what extent further standardisation and transparency are achievable.

3.44. Article 7 (1) of Regulation (EEC, Euratom) No 1553/89 obliges Member States to send the Commission a statement of the total amount of the VAT resources base for a given year, calculated in accordance with Article 3 of the Regulation. Article 3 mentions only the total net revenue collected by a Member State during the year in question. It does not refer to the other amounts listed by the Court. Nevertheless, at the next meeting of the ACOR, the Commission will ask Member States whether they might provide this information. The Commission will also encourage Member States to take all necessary measures to ensure that effective audit trails exist.

3.45. The Commission consistently uses the available instruments to increase awareness of solutions and encourage the adoption of best practice in the field of enforcement. The Fiscalis programme and successive reports pursuant to Article 12 of Regulation (EEC, Euratom) No 1553/89 and Article 14 of Council Regulation (EEC) No 218/92 of 27 January 1992 on administrative cooperation in the field of indirect taxation (VAT) ⁽²⁾ are of particular importance in this respect. Any actions aimed at achieving greater harmonisation in this area would have to take account of the principle of subsidiarity. At the present time the Member States do not generally see a need for harmonised procedures.

⁽¹⁹⁾ The Sector has requested Member States to produce, for the years 2000 and 2001, data in respect of the amounts sent to enforcement and their collection.

⁽²⁾ OJ L 24, 1.2.1992, p. 1.

THE COURT'S OBSERVATIONS

3.46. From a review of Commission inspections in Member States ⁽²⁰⁾ carried out in the period 2000 to 2002 (see paragraph 3.37), the following observations related to the collection of VAT were noted:

- in Germany, the Commission's auditors accepted, for the years 1998 and 1999, the figure for net VAT collected that was shown in the annual VAT statement though these amounts could not be reconciled with the amounts in the annual accounts of the German State,
- in Portugal it was not possible to reconcile the net VAT receipts with the State accounts for the year 1998; the Commission has put a reservation on this,
- in France, receipts related to fines and default interest for Metropolitan France and the receipts for the overseas departments for the years 1999 and 2000 were incorrectly entered in the VAT statements and had to be recalculated,
- in Italy, documentation in support of the amount of refunds deducted from the gross receipts in the VAT statement for the year 1998 could not be produced.

THE COMMISSION'S REPLIES

3.46. *The problem of reconciliation in Germany was subject to a Commission reservation for several years. The German authorities have explained why the differences arise and the Commission accepted the figures in the annual statements despite the apparent discrepancies. The Commission has asked the German federal authorities to improve their accounting practices in order to eliminate the divergences. The Commission maintained a reservation against Italy on the point mentioned by the Court, until the Italian authorities produced the evidence required.*

Annual GNP procedure and the related controls

3.47. National GNP questionnaires (containing macro-economic aggregates) are the main instrument by which the GNP data are communicated to the Commission. After their consolidation into a single GNP questionnaire, and once checks have been carried out by the Commission and an opinion has been given by the GNP Committee ⁽²¹⁾, the data are sent to DG Budget for calculating the GNP-related own resource.

⁽²⁰⁾ These inspections were carried out on the basis of Regulation (EEC, Euratom) No 1553/89, Article 11 on the definitive uniform arrangements for the collection of own resources accruing from value added tax.

⁽²¹⁾ Liaison between the Commission and the Member States is institutionalised through the GNP committee. The committee consists of representatives of the Member States and of the Commission. The chairman of the committee is a representative of the Commission. The GNP committee examines Member States' calculations of their GNP at market prices and related methodological problems, in accordance with Council Directive 89/130/EEC, Euratom of 13 February 1989.

THE COURT'S OBSERVATIONS

3.48. The Court examined the role of the Member States, the Commission and the GNP Committee in the annual GNP procedure as well as the Commission's verification activities in respect of selected figures ⁽²²⁾ within the GNP questionnaire for 2002.

3.49. The Commission's verification of selected figures from the GNP questionnaire was tested for six Member States ⁽²³⁾ but several observations apply, in the Court's view, to the Commission's work on all Member States.

3.50. With regard to the procedures for the transmission of GNP data for own resources purposes, the process is, on the whole, sufficiently flexible and robust and the results of the checks carried out by the Commission are well documented. The checks have produced results in the form of changes to the GNP figures.

3.51. However, the procedures for checking the data in the GNP questionnaires are of an ad hoc character, and the exact nature of the checks carried out beyond the simple initial arithmetical test is unclear. There are no specific guidelines for the desk officers to follow, which could lead to the nature of the checks performed varying from one country to another. The effectiveness of the checks carried out thus depends largely on the expertise of the desk officer concerned.

3.52. There is little direct verification by the Commission of the figures presented in the GNP questionnaire, e.g. by examining the data used by the National Statistical Offices (NSO) when producing the questionnaires.

THE COMMISSION'S REPLIES

3.51. *Incoming GNP data are thoroughly checked in two stages. The first stage is spreadsheet based and comprises a number of standardised consistency checks and a systematic revision analysis. The second stage is carried out by the desk officers who are highly experienced national accountants with specific knowledge of the countries they are responsible for. That expertise allows them to target known problem areas specific to the country. The Commission will make an effort to further standardise this second stage of checks. Additionally of course the Commission checks that the value of GNP and its main components corresponds to the equivalent figure in the regular national accounts publications in the Member States.*

3.52. *The Commission does little direct verification of data in the GNP questionnaires in the sense indicated by the Court. Some direct verification takes place in the context of the analysis of Member states inventories. The Commission is prepared to examine the possibility of doing more direct verifications in the future.*

⁽²²⁾ Line 4, taxes on products (identified as D.21 in the ESA 95) in particular VAT (D.211).

⁽²³⁾ Belgium, Spain, Luxembourg, Austria, Sweden and the United Kingdom.

THE COURT'S OBSERVATIONS

3.53. As far as the quality control of GNP is concerned, the Commission directs much of its control operations towards the methodological issues laid down in the inventories, the current priority being the changeover to ESA 95 and the analysis of new inventories.

3.54. Although the Commission has developed both a standard structure for the new inventories to follow and an assessment questionnaire to ensure a systematic and fair analysis of the inventories, the audit showed that discrepancies between inventories do exist, and that the standardised structure, although respected by all countries (who have provided an inventory) in principle, differed widely in practice in both content and presentation. France and Luxembourg have not yet provided inventories, which means that the Commission cannot verify the correctness of their GNPs and thus the calculations of the related own resource.

Conclusions and recommendations

3.55. In relation to the scope of the audit, as set out in paragraph 3.35, the Court found that the VAT and GNP resources were being correctly calculated by the Commission and entered in the Community accounts. However, the audit of VAT collection in Member States has identified certain problems related to collection which, as well as the reservations mentioned in paragraph 3.37, cast some doubts on the accuracy and reliability of the VAT statements produced by the Member States and provided to the Commission.

3.56. To address this situation the Court recommends that the Commission should take the following actions:

- (a) implement a standard layout for the presentation in the VAT statement of at least the figure of net VAT collected;
- (b) explore the possibility of including in the VAT statements the amount of VAT assessed as to be paid for the year in question;
- (c) request Member States to provide an audit trail for the collection of VAT;

THE COMMISSION'S REPLIES

3.54. *The content and presentation of the inventories do indeed vary. Often the information is included in another section of the inventory. Where this is not the case, the Commission has requested supplementary information. The Commission confirms that the absence of inventories for France and Luxembourg does hinder their verifications of GNP.*

3.56.

- (a) *As noted in the reply to point 3.43, Community legislation does not provide for a standard layout but the Commission will nonetheless continue to encourage greater standardisation and transparency.*
- (b) *The Commission will, at the next ACOR meeting, invite Member States to provide this information.*
- (c) *The Commission will raise with Member States, at the next ACOR meeting, the need to ensure the best possible quality of audit trails for the collection of VAT.*

THE COURT'S OBSERVATIONS

- (d) encourage Member States to use best practice in respect of enforcement procedures;
- (e) expand its control activities on the collection of VAT by Member States.

THE COMMISSION'S REPLIES

- (d) *The Commission will continue to use the available instruments to increase awareness of solutions and encourage the adoption of best practice in the field of enforcement.*
- (e) *The Commission considers that it must strike a balance between respect for the right of Member States to organise the collection of VAT, over 95 % of which accrues to national treasuries, in the most appropriate way, and the need to ensure that own resources are adequately protected. It therefore prefers to use the reports required by Article 12 of Regulation (EEC, Euratom) No 1553/89 to comment on the collection of VAT by Member States in the context of own resources.*

3.57. In respect of the GNP-related own resource, the Court recommends that the Commission increases its control activities on the correctness and reliability of the data given in the GNP questionnaire, in addition to the important checks which are at present carried out in respect of the methodology, in order to increase the reliability of the calculation of the most important own resource (see also indicators in Annex 2).

3.57. Detailed responses are given in the points above.

ANNEX 1

Own resources — Development of key observations

Observations	Measures taken	Measures to be taken
Making available of own resources		
<i>Delays in making available of traditional own resources</i>		
The Court's examinations of the accounting and centralisation procedures for traditional own resources have from time to time shown that certain established entitlements were not made available to the Commission or were made available with significant delays.	<p>The Commission unit charged with the inspection activities provided for in the Regulation (Council Regulation (EC, Euratom) No 1150/2000) acts on all cases of delay, and Member States are invited to pay default interest when appropriate.</p> <p>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.</p>	The Commission's actions are satisfactory.
Amounts established but not yet made available		
<i>Content of the accounts</i>		
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 (EC, Euratom) 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/GNP resources

Aspects of the Commission supervisory system	Traditional own resources	VAT	GNP
Conception	A	A	A
Practical transposition in procedural stages: — compliance with standards — taking into account of experience	A	A	A
Actual operation: — compliance with standards — taking into account of experience	A	A	B
Results: — remedial effect — preventive effect	A	A	A
Overall assessment	A	A	A

A Works well, few or minor improvements required.

B Works but improvements necessary: more direct verification of GNP data and standardisation of checks required. It is also noted that there exists a general reservation for all GNP data for the years since 1995 and that France and Luxembourg have failed to provide inventories.

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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THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

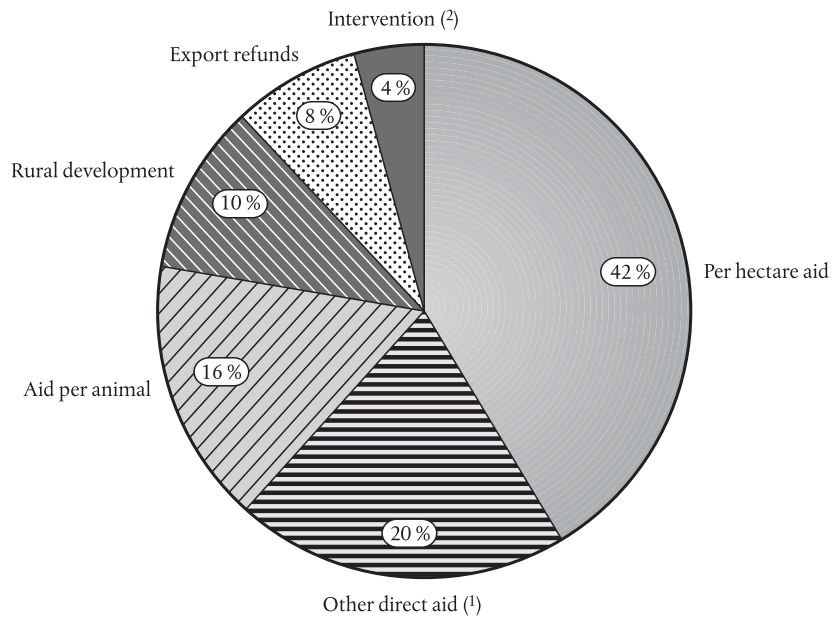
INTRODUCTION

4.1. Expenditure in 2002 on the common agricultural policy (CAP), i.e. the European Agricultural Guidance and Guarantee Fund (EAGGF Guarantee Section), totalled 43 521 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, 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) the Commission pays a cash advance to the paying agency;
- (d) the paying agency pays claimants, and reports expenditure made to the Commission;
- (e) 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;
- (f) 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;

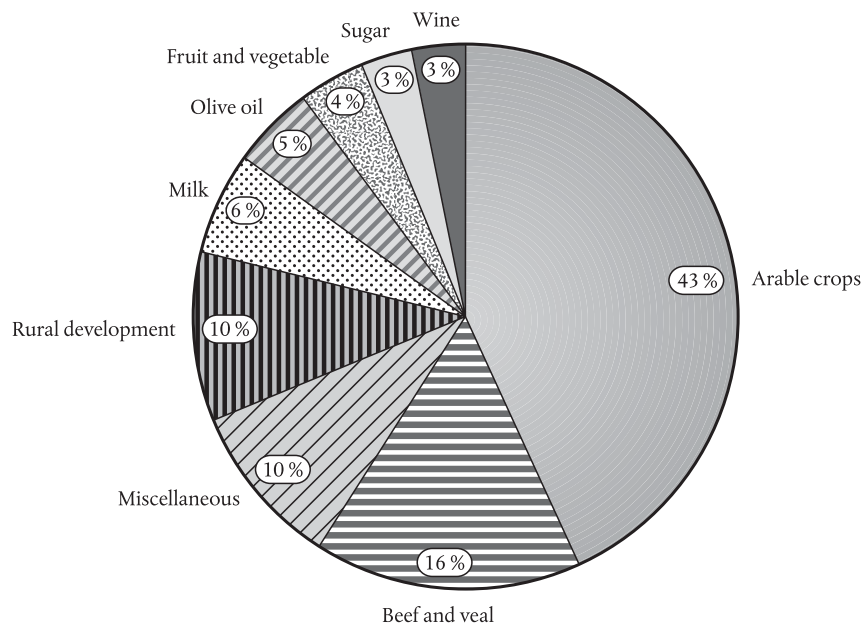
Graph 4.1. — Breakdown of EAGGF-Guarantee expenditure by economic type — financial year 2002

⁽¹⁾ Other direct aid: production as well as processing or consumption aid paid to producers or organisations of producers or processors.

⁽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).

Source: The Commission's annual accounts for 2002 — Volume II — Gross data.

Graph 4.2 — Breakdown of EAGGF-Guarantee expenditure by sector — financial year 2002

Source: The Commission's annual accounts for 2002 — Volume II.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

- (g) 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 (see paragraph 4.59).

4.4. The Commission's Director-General for Agriculture produces each year an activity report (AAR) on the Directorate-General's 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 certified accounts of the paying agencies (see paragraphs 4.7 and 4.8 for conclusions relevant to the Statement of Assurance);
- (b) evaluated IACS inspection and reporting procedures (see paragraphs 4.9 to 4.13);
- (c) tested transactions directly (see paragraphs 4.14 to 4.15);
- (d) examined the report and declaration by the Director-General for Agriculture (see paragraphs 4.16 to 4.21).

4.6. Paragraphs 4.22 to 4.48 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 to 1.12, 1.14 to 1.16 and 1.30 to 1.31.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Certification of paying agencies' accounts

4.7. As explained in paragraph 4.3 above, there is an annual 'financial clearance' decision in which the Commission decides whether to accept the CAP paying agencies certified accounts for the preceding budgetary year. Paragraphs 4.54 to 4.58 set out the Court's detailed comments on the Commission's financial clearance decision for 2002.

4.8. The following observations and conclusions on the paying agencies certified accounts are of relevance to the Statement of Assurance:

- (a) certifying bodies' audits cover the accuracy of financial information provided by the paying agencies to the Commission. They can also provide assurance that information supplied by farmers, processors and exporters has been correctly processed by the paying agencies;
- (b) the certifying bodies have signalled some significant problems (described in paragraph 4.55) in the way transactions are dealt with by the paying agencies. Qualifications by the certifying bodies affect expenditure of 300 million euro, and the Commission and the Court have identified some other paying agency accounts which contain a material level of error not mentioned in the associated certificates. The Commission has not accepted the accounts in respect of one quarter of the total amount declared pending receipt of further information or the completion of additional audit work;
- (c) on the other hand, the work of the certifying bodies has contributed to improvements in the work of the paying agencies and provides valuable assurance on the reliability of financial information supplied by paying agencies to the Commission. On balance, the Court is able to place significant reliance on the work of the certifying bodies in respect of the accuracy of the paying agencies' accounts;
- (d) the certifying bodies' audits do not, however, provide assurance that the information supplied to paying agencies by claimants under CAP schemes is correct. For the legality and regularity of payments to claimants, only limited reliance can thus be placed upon their work.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Operation of IACS checks

4.9. Each Member State is required to have in place an integrated administration and control system (IACS). It comprises a computerised database of holdings and aid applications, systems for identifying parcels of agricultural land and identifying and registering animals, and an integrated system of administrative controls and on-the-spot inspections.

4.10. Approximately 58 % of CAP expenditure was subject to these procedures and systems in 2002. The aid schemes concerned, principally area and headage aids paid to farmers, are managed by the Member States' paying agencies, which are responsible for carrying out the administrative checks (intended to ensure that claims are eligible, that payments are made correctly and that there are no double payments) and on-the-spot inspections (intended to check the accuracy of claims and thus their compliance with regulations). In addition, areas sown with crops subsidised on the basis of the quantity of production (see paragraphs 4.34 to 4.37) are also reported through the IACS declarations and subject to the same checks as cultivated areas.

4.11. The Court last examined the implementation of IACS in 1999/2000 ⁽¹⁾. It has now carried out a further audit, examining the way in which 15 paying agencies in 10 Member States dealt with applications which led to payments in 2002 ⁽²⁾. The audit:

- (a) reviewed the paying agencies' administrative control and on-the-spot inspection systems and procedures;
- (b) re-inspected 90 claims inspected by the paying agencies;
- (c) assessed the Commission's monitoring of IACS.

4.10. *In accordance with Article 9a of Council Regulation (EEC) No 3508/92 (IACS) as amended by Regulation (EC) No 1593/2000, and although not compulsory until 1 January 2003 at the latest, most Member States ensured in respect of a whole series of Community aid schemes also during 2002 that their administration and control systems were compatible with IACS. This compatibility related to the computerised database, the parcel and animal identification systems and administrative checks.*

⁽¹⁾ Special Report No 4/2001 (OJ C 214, 31.7.2001).

⁽²⁾ Fifty-five of the 86 paying agencies are involved in processing IACS transactions.

THE COURT'S OBSERVATIONS

4.12. The main findings of the Court's audit are as follows:

- (a) administrative procedures and checks to ensure correct payments are generally good or satisfactory;
- (b) arrangements for carrying out inspections and for reporting individual results are also generally good to satisfactory, though less reliance can be placed on the results of inspections in respect of animal premiums than in respect of arable aid payments;
- (c) preparation and reliability of statistics necessary for monitoring overall performance of IACS are satisfactory in most cases;
- (d) risk analysis and selection procedures for inspections, important for the surveillance of the legality and regularity of aid entitlements while meeting the minimum requirements of Community legislation, are generally the weakest aspect of Member States' implementation of IACS, being mostly just adequate;
- (e) there is scope to continue to improve guidance to Member States on the application of IACS and the use of information from the system.

Annex 2 sets out further details of the Court's findings.

4.13. For those Member States which have satisfactorily implemented IACS (paragraph 4.17(c)), IACS inspection results represent an important source of evidence on the legality and regularity of CAP transactions.

THE COMMISSION'S REPLIES

4.12.

- (b) *The Court's remark concerning animal premiums is agreed, for which reason the Commission services have laid even more emphasis over several years to scrutinising inspection statistics supplied by Member States, resulting in many clearance of accounts procedures, which in turn have been verified as soundly based by the Court.*
- (d) *The Commission services have been making recommendations over many years in line with those of the Court, and amended the IACS legislation accordingly. Indeed, IACS legislation was improved in respect of risk analysis in 2001.*
- (e) *Over the years the Commission considers that given the limited number of staff it has established the correct balance of resources to adequately cover both aspects raised by the Court.*

The Commission points to the complete recasting during 2001 of the IACS Regulation with entry into force for claim year 2002, followed by a whole series of working documents and clarifications dedicated to ensuring correct and uniform implementation by Member States. Information received from Member States has been and is used to good effect.

4.13. *Even in Member States where improvements in implementation are needed, the Commission considers IACS inspection results to provide important information.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

The Court's sample of transactions

4.14. The Court examined a representative sample of 232 payments drawn from the accounts of 25 paying agencies (responsible for 70 % of CAP expenditure) in 12 Member States. Each payment was examined at the level of the paying agency and the final beneficiary. These tests provide direct evidence on the basis for the claims made by farmers, of the accuracy of financial information, and the application of Community legislation.

4.15. The Court's audit indicates that, as in previous years, CAP expenditure was materially affected by error ⁽³⁾. A large number of the transactions examined by the Court were subject to errors, most often at the level of the final beneficiary.

Annual activity report and declaration by the Director-General for Agriculture

4.16. The activity report for 2002 prepared by the Commission's Director-General for Agriculture describes what the Directorate-General has done during 2002. It includes a declaration by the Director-General that, subject to five reservations (three of which are relevant to the EAGGF Guarantee Section), he has reasonable assurance that:

- (a) the resources allocated to the activities described in the report have been used for the intended purposes and in accordance with the principles of sound financial management; and
- (b) the Directorate-General's internal monitoring and control procedures are adequate to guarantee the legality and regularity of the underlying transactions.

⁽³⁾ As explained in paragraphs 4.22 to 4.48 which draw on all the sources of evidence available to the Court, different areas of the CAP are subject to different degrees of risk, e.g. expenditure on arable crops appears to be the lowest risk category of CAP spending.

THE COURT'S OBSERVATIONS

4.17. The reservations that are relevant to the EAGGF Guarantee Section concern:

- (a) a continuing risk of fraud through the re-import into the Union of subsidised agricultural products;
- (b) continuing weaknesses in the management of the International Olive Oil Council;

- (c) insufficient implementation of IACS in Greece.

4.18. For EAGGF expenditure whose management is shared with the Member States (over 99 % of the total) the basis for the Director-General's declaration is:

- (a) the financial clearance decision for 2001 (not 2002);
- (b) conformity decisions (see paragraph 4.59) taken during 2002, which do not include corrections in respect of 2002. (Conformity decisions on expenditure in 2002 will be taken in future years.)

In other words, the declaration is relevant to transactions undertaken in years previous to 2002.

4.19. It is unclear from the annual activity report whether the Director-General relied on other control procedures for his declaration. This, coupled with the failure of the Commission to clarify the scope of the responsibilities of the authorising officers in the areas of shared management (action 12 of the Commission's action plan), raises further doubts as to the basis of the Director-General's declaration.

4.20. The Court is therefore of the opinion that the contents of the Director-General's declaration do not constitute a useful basis for the Court's Statement of Assurance in respect of agricultural expenditure in 2002.

THE COMMISSION'S REPLIES

4.17.

(a) and (b) *The two reservations concerning risk of 'carousel' and the International Olive Oil Council were carried-over from the Director-General's declaration for 2001. For both reservations, action plans were set up in 2002 in order to address the weaknesses identified. The implementation of these action plans progressed substantially during 2002 and will be completed in 2003.*

(c) *The insufficient implementation of the IACS in Greece has been addressed by the Commission both through legal proceedings and financial corrections imposed within the clearance of accounts procedure. The Commission has in 2003 put in place a particular follow-up of the implementation of the IACS in Greece to support the effort made by the Greek paying agency (Opekepe) to rectify the situation.*

4.18 to 4.20. *Article 53(5) of the new Financial Regulation provides that '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 final responsibility for the implementation of the budget in accordance with Article 274 of the EC Treaty and Article 179 of the Euratom Treaty'.*

Thus, the assurance on the EAGGF-Guarantee can be based on the existence of an effective clearance of accounts procedure. The fact that corrections are decided some years after the year of the expenditure concerned is an integral part of the clearance procedure. The correction mechanism is completed by the assurance which can be gained from the accreditation of paying agencies, the annual certification procedure and the IACS, which permit a great deal of reliance on the control over the expenditure declared.

In the Annual Activity Report 2003 DG Agriculture will present in more detail the functioning of the clearance procedure and of the control systems related to the transactions of the financial year for which assurance is given

THE COURT'S OBSERVATIONS

4.21. The Court notes that six of the 24 internal control standards (ICS) have only been partially implemented in the Directorate-General for Agriculture. Of particular concern are those related to supervision, to the recording of exceptions and to the recording and correction of internal control weaknesses.

*The Court's assessment of areas of CAP spending***Area aid schemes**

4.22. Expenditure on arable crops paid on an area aid basis amounted to 18 226 million euro in 2002, 42 % of CAP expenditure. All of this expenditure is covered by IACS.

4.23. The IACS inspection results for 2001 (i.e. in respect of claims paid in 2002) are set out in **table 4.1**. These results cover arable crops (81,2 % of the total area inspected) but also forage areas and crops which are not subsidised on the basis of the area cultivated. The overall rate of error in the 14 Member States which have implemented IACS (not Greece) was 1,2 %, as compared with 2,4 % in the previous year. This primarily reflects the lower rate of error found in Italy. 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. The overall results cannot therefore be considered to provide a fair estimate of the average level of errors.

4.24. Overall, the 14 Member States concerned checked just under 10 % of claims, representing 11,75 % of the area for which claims were made. The two Member States which checked claims most extensively were Italy (16,8 % of claims and 25,7 % of the area declared)

THE COMMISSION'S REPLIES

4.21. In the area of financial management the Directorate-General for Agriculture respected the requirements of the standards. The Directorate-General for Agriculture received Financial Control's annual award 2002 as the authorising officer of the year. In some non-financial areas the Directorate-General is still in the process of ensuring full respect of the standards.

The internal control standards were set up in 2001 in order to monitor progress in the implementation of all parts of the internal reforms in the Commission. They require significant administrative changes within all services, which inevitably take a certain time.

4.23. In spite of the inherent difficulties in compiling and interpreting statistics from 15 Member States, the Commission believes that the lower error rate is due to the further implementation of IACS, more effective control and sanctioning by Member States, and the audit and clearance of accounts supervision undertaken by its agricultural audit service.

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.

4.24. The Court's remark relates exclusively to on-the-spot checks. It is emphasised that annually all (i.e. 100 %) aid applications are checked administratively, incorporating documentary checks on completeness and coherence of documents and information, and cross-checks against independent data

Table 4.1 — Area aid, forage areas and other crops. Results of IACS field inspection and remote sensing in 2001, relating to claims paid in 2002

Member State	Applications submitted			Applications checked			Error detected in application checked		
	Number	Area (ha)	Average size (ha)	Number	%	Area (ha)	%	Area (ha)	%
Austria	131 856	2 490 280	19	7 384	5,6	195 281	7,8	1 773	0,9
Belgium	42 171	1 009 857	24	4 412	10,5	159 930	15,8	861	0,5
Denmark	53 238	2 307 858	43	2 886	5,4	139 602	6,0	571	0,4
Finland	71 213	2 063 262	29	5 256	7,4	157 230	7,6	1 277	0,8
France	428 885	23 660 186	55	29 817	7,0	2 340 944	9,9	11 534	0,5
Germany	328 307	13 939 230	42	25 901	7,9	1 135 507	8,1	5 989	0,5
Greece	(¹)	(¹)	(¹)	(¹)		(¹)		(¹)	
Ireland	128 233	4 669 301	36	8 387	6,5	333 640	7,1	1 583	0,5
Italy	618 502	7 257 549	12	104 072	16,8	1 866 674	25,7	23 851	1,3
Luxembourg	2 079	164 198	79	175	8,4	14 999	9,1	253	1,7
Portugal	142 231	2 547 815	18	16 064	11,3	1 571 344	61,7	30 149	1,9
Spain	449 831	18 025 706	40	42 347	9,4	2 176 783	12,1	46 314	2,1
Sweden	61 139	2 723 268	45	4 593	7,5	260 488	9,6	4 780	1,8
The Netherlands	47 377	618 376	13	4 662	9,8	76 062	12,3	2 295	3,0
United Kingdom	134 169	14 105 850	105	7 538	5,6	812 818	9,6	3 210	0,4
Total 2001	2 639 231	95 582 736	36	263 494	10,0	11 241 302	11,8	134 440	1,2
Total 2000 (²)	2 973 806	96 176 722	32	330 906	11,1	11 594 185	12,1	274 119	2,4
Total 1999 (²)	3 052 592	96 038 049	31	364 947	12,0	12 132 991	12,6	372 717	3,1

(¹) Data not sent to the Commission.(²) 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: Differences in percentage of errors detected may be explained both by differences in the number of inaccurate claims submitted and differences in the efficiency of detection.

Source: DG AGRI — IACS 2001 Statistics, summarising inspection results provided by the Member States.

THE COURT'S OBSERVATIONS

and Portugal (11,3 % of claims and 61,7 % of the area declared). Both made extensive use of aerial and/or satellite photography to check declarations. Four Member States found errors in more than half of the claims checked, Luxembourg finding an error on nearly 90 % of the claims checked (with little impact on the amount claimed). Ireland, Italy and Denmark, however, found less than 15 % of claims to contain error (see **graph 4.3**). Detected errors had the greatest impact on the area claimed in the Netherlands, where they amounted to more than 3 % of the area checked (see **graph 4.4**).

4.25. For some Member States the significant difference between the average size of claim submitted and the average size of claim checked may have an impact on the rates of error revealed. For example, in Portugal (where the greatest divergence is apparent), an average claim was for 18 hectares, but the average size of claim checked was 98 hectares (see **table 4.1**). Finland and Germany came closest to representativity on this measure (average area claimed 29 ha and 42 ha, average area selected for inspection 30 ha and 44 ha respectively).

4.26. Irregular expenditure in this area is most likely to arise in the following circumstances:

- (a) farmers claim for more land than they cultivate;
- (b) farmers claim for a crop receiving a higher premium when they in fact cultivate a crop which receives a lower subsidy, or is not subsidised through an area aid payment;
- (c) in exceptional cases, farmers claim for land which was not cultivated prior to the introduction of area aid payments in 1992, and is therefore not eligible.

THE COMMISSION'S REPLIES

to verify existence of the parcel and claimant, eligibility for aid and cross-checks on parcels and claimants to avoid undue multiple payments.

The number of claims checked on the spot represents almost double the minimum regulatory requirement.

Both administrative and on-the-spot checks are executed prior to payment, thereby avoiding undue charge on the Fund, which in any case would have been minimal as only 1,2 % of the area checked was actually revealed as non-eligible.

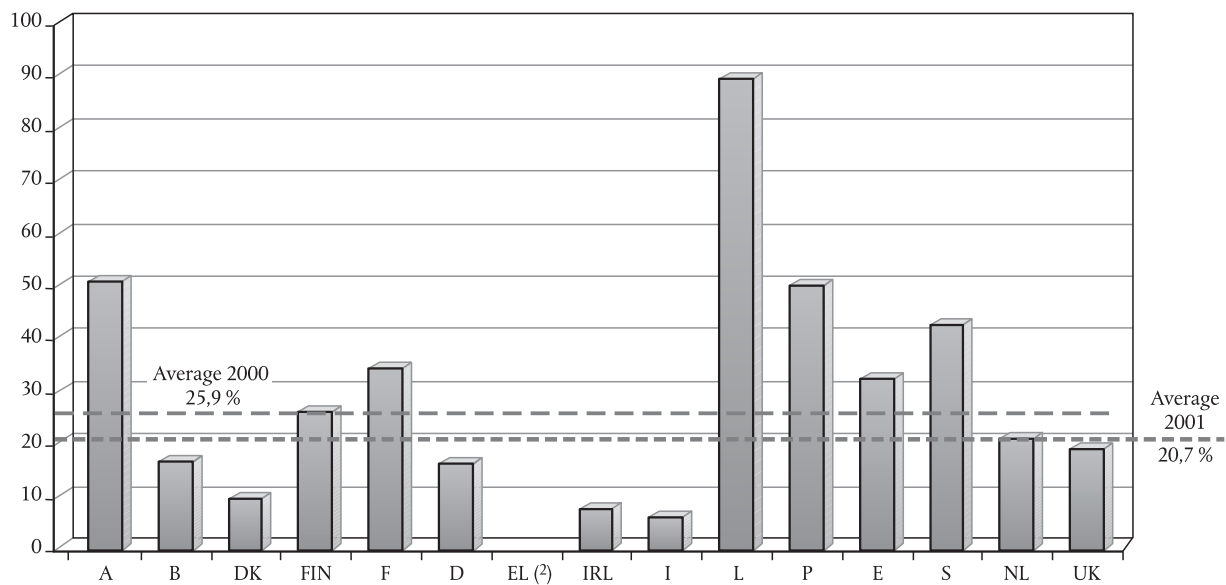
The Commission has the permanent and continuous task of monitoring IACS implementation and does not find it necessary to examine annually and in depth the variations in results for a particular year. Instead the Commission considers it more opportune to examine and rectify the underlying reasons for potential differences and to take the appropriate action under the clearance of accounts procedure.

4.25. *IACS legislation has always envisaged an element of representativity, which was further reinforced as from 2002 to provide that between 20 % and 25 % of on-the-spot checks must be selected at random.*

As concerns Portugal, as the Court mentions in its previous observation, on-the-spot checks were more than double the regulatory minimum in number and covered almost 62 % of declared surfaces.

4.26. *The Court's presumed risks to the Community budget are agreed and form part of the basis for the Commission's own risk analysis for its own audit program. However, it should be emphasised that in a Member State with a properly performing IACS all appropriate controls are executed pre-payment and so, ideally, such potential undue payments are avoided.*

Graph 4.3 — Area aid. Results of IACS field inspections: percentage of applications inspected which were overstated ⁽¹⁾

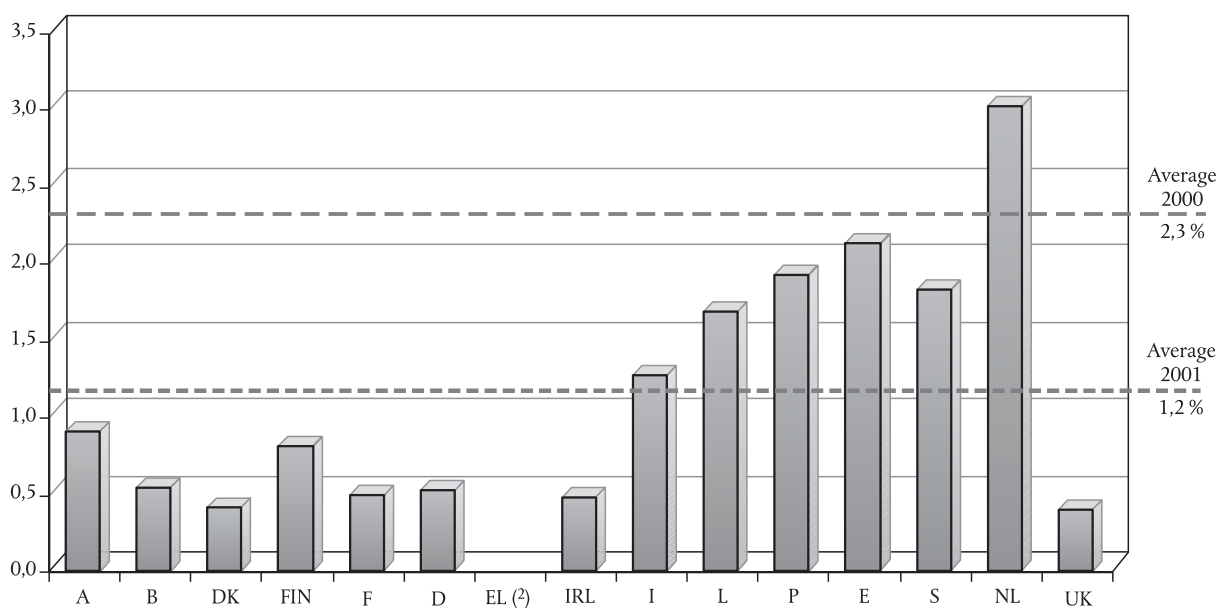


⁽¹⁾ 54 542 applications were overstated, i.e. 20,7 % of the total number of applications inspected by Member States. This represents a reduction of nearly 27 % compared with the year 2000.

⁽²⁾ Greece: data not sent to the Commission.

Source: DG AGRI — IACS 2001 Statistics relating to claims paid in 2002.

Graph 4.4 — Area aid. Results of IACS field inspections: average overstatement ⁽¹⁾ in claims inspected



⁽¹⁾ Total overstatement amounted to 134 440 ha, i.e. 1,2 % of the total area checked by the Member States. This represents a reduction of nearly 50 % compared with the year 2000. Italy alone explains 78,5 % of this reduction.

⁽²⁾ Greece: data not sent to the Commission.

Source: DG AGRI — IACS 2001 Statistics relating to claims paid in 2002.

THE COURT'S OBSERVATIONS

4.27. Comparison between the results of the Court's audit and the inspections carried out under IACS is difficult. So far as comparison is possible, the Court's audit indicates a somewhat higher rate of error than do the IACS results. However the Court's work tends to confirm that underlying error rates are falling. Several factors may explain this:

- (a) administrative checks are becoming more effective, and make better use of information from aerial photographs, land registry maps and previous claims;
- (b) reductions in some subsidies (such as oil seeds) reduce incentives for farmers to grow one crop, and claim the subsidy for another;
- (c) an ever increasing share of farmers (particularly larger farmers) have been the subject of field inspection in previous years.

4.28. The Court's audit included 73 transactions involving arable crop subsidy payments (in which 17 errors were found), and 41 set-aside payments (for which 20 errors were found). As in previous years, most of the errors identified by the Court involved discrepancies between the arable area declared by farmers and the area found when parcels were measured in the presence of auditors. Nearly half of the discrepancies were of less than 3 % of the declared area. A similar number of discrepancies related to errors of between 3 % and 20 % of the area declared. ⁽⁴⁾The audit identified only two payments where the error exceeded 20 % of the area claimed, one in France and one in Greece.

Animal premium schemes

4.29. Aid to livestock producers amounted to 7 164 million euro in 2002, 16 % of CAP expenditure. More than 90 % of this sum subsidises the production of beef and veal, the remainder subsidising the production of sheep and goats. Typically, producers are paid

THE COMMISSION'S REPLIES

4.27. *The Commission believes that error rates are falling, and generally agrees the causes, but would add to the list the significantly improved quality of source material (i.e. photographs, satellite images and maps). Furthermore, the Commission would also claim credit for the generally improved situation due to its very active guidance of Member States, especially noticeable since the late 1990s, and the very effective clearance of accounts procedure that has proved useful as both a preventive and corrective tool.*

⁽⁴⁾ Under IACS rules, errors of less than 3 % of the declared area are corrected but not penalised. Errors of between 3 % and 20 % are corrected, and subject to a penalty. Errors exceeding 20 % of the area declared lead to refusal of the claim.

THE COURT'S OBSERVATIONS

on the basis of the number of animals kept for a specified 'retention period', subject to the observance of quota limits and of maximum stocking densities.

4.30. IACS inspection result statistics for animal premiums, provided by the Member States to the Commission, show the number of animals missing or disallowed. For the most important scheme, the suckler cow premium (see **table 4.2 and graph 4.5**), 6,4 % of animals selected for on-site inspection in 2001 (i.e. in respect of claims paid in 2002) were disallowed. Error rates were high in Portugal (50,2 %) and in Italy (31,2 %) where inspections covered respectively 22 and 30 % of aid applications. In the other Member States, the reported error rate was below 10 % and in 10 Member States it was below 2 %. While 98 % of claims were inspected the number of animals missing or disallowed in Greece was very low (0,9 %). For the special beef premium the percentage of animals missing or disallowed was 2,9 % in 2001, for the extensification premium 1,6 %, for the slaughter premiums 3,1 % and for the sheep and goat premiums 10,6 %.

4.31. For all animal premium schemes the overall percentage of errors in IACS statistics is to a large extent influenced by exceptionally high error rates in one or two Member States where unusually large numbers of animals have been inspected. In most Member States, the error rate is below 2 % for all animal premiums. 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 (see **graph 4.5**).

4.32. The direct testing performed by the Court revealed:

- (a) over-declarations of livestock (United Kingdom, Spain and Italy);
- (b) an overestimate of the forage area when calculating the density factor affecting entitlement to the special beef premium (United Kingdom);
- (c) the absence of a farm register with which to check that the statutory 'retention' period had been observed (Netherlands);

THE COMMISSION'S REPLIES

4.30. *The figures cited in respect of Greece, Italy and Portugal are known to be insufficiently accurate. For Greece, the weaknesses in the bovine identification and registration system renders the figure for ineligible animals especially imprecise, whilst for Italy and Portugal the suckler cow premium figures are perhaps confused due to the inclusion of animals excluded as being in excess of quota. A similar problem has been noted in respect of the ewe and goat premium schemes.*

4.31. *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.*

2001 was the first year in which most Member States were able to fully utilise their bovine databases to detect irregularities.

4.32. *The findings are fairly typical of those established over several years in these and other Member States by the Commission's agricultural audit service.*

Table 4.2 — IACS inspections for suckler cow premiums. Results of on-the-spot checks in 2001, relating to claims paid in 2002

Member State	Total number of claims submitted	Claims inspected		Inspected claims partially rejected		Inspected claims fully rejected		Total number of animals claimed	Animals inspected		Inspected animals rejected	
		Number	%	Number	%	Number	%		Number	%	Number	%
Austria	82 269	8 806	10,7	851	9,7	31	0,4	363 640	56 878	15,6	1 442	2,5
Belgium	16 907	2 210	13,1	51	2,3	8	0,4	404 224	86 362	21,4	192	0,2
Denmark	9 478	761	8,0	76	10,0	6	0,8	108 413	13 889	12,8	169	1,2
Germany ⁽¹⁾	35 060	6 253	17,8	588	9,4	93	1,5	622 970	165 229	26,5	11 614	7,0
Greece	13 003	12 758	98,1	128	1,0	121	0,9	198 809	195 433	98,3	1 850	0,9
Spain ⁽¹⁾	70 715	7 882	11,1	462	5,9	38	0,5	1 706 896	335 755	19,7	3 736	1,1
France ⁽²⁾	133 636	17 393	13,0	4 509	25,9	249	1,4	4 170 745	697 050	16,7	10 267	1,5
Ireland	66 832	7 904	11,8	610	7,7	19	0,2	1 111 386	174 745	15,7	1 329	0,8
Italy	59 500	11 004	18,5	2 359	21,4	458	4,2	752 580	228 649	30,4	71 388	31,2
Luxembourg	523	35	6,7	13	37,1	0	0,0	21 729	1 720	7,9	140	8,1
The Netherlands	4 996	761	15,2	81	10,6	9	1,2	59 603	19 196	32,2	252	1,3
Portugal	28 824	3 444	11,9	492	14,3	20	0,6	305 924	65 961	21,6	33 143	50,2
Finland	1 452	181	12,5	17	9,4	2	1,1	28 094	3 696	13,2	65	1,8
Sweden	10 631	801	7,5	68	8,5	2	0,2	153 744	14 530	9,5	112	0,8
United Kingdom ⁽³⁾	47 467	1 720	3,6	164	9,5	2	0,1	1 687 513	56 485	3,3	431	0,8
Total	581 293	81 913	14,1	10 469	12,8	1 058	1,3	11 696 270	2 115 578	18,1	136 130	6,4
<i>Total 2000</i>	<i>596 148</i>	<i>67 522</i>	<i>11,3</i>	<i>5 855</i>	<i>8,7</i>	<i>756</i>	<i>1,1</i>	<i>11 176 703</i>	<i>2 161 009</i>	<i>19,3</i>	<i>333 841</i>	<i>15,4</i>

⁽¹⁾ Germany and Spain: summary table at paying agency level.⁽²⁾ France: data of claims rejected include sanctions following both administrative and on-the-spot controls.⁽³⁾ United Kingdom: summary table of England, Northern Ireland, Wales and Scotland.

NB 1: Differences in percentage of errors detected may be explained both by differences in the number of inaccurate claims submitted and differences in the efficiency of detection.

NB 2: A claim is fully rejected when a difference higher 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.

Source: DG AGRI — IACS 2001 Statistics, summarising inspection results provided by the Member States.

THE COURT'S OBSERVATIONS

- (d) shortcomings in the management of sheep premiums, either because checks were inadequate or because files took too long to process, resulting in delays in payment (Italy);
- (e) non-observance of the statutory conditions, in particular neglect in the keeping of compulsory registers of animals and in the handling of their 'passports' and ear tags.

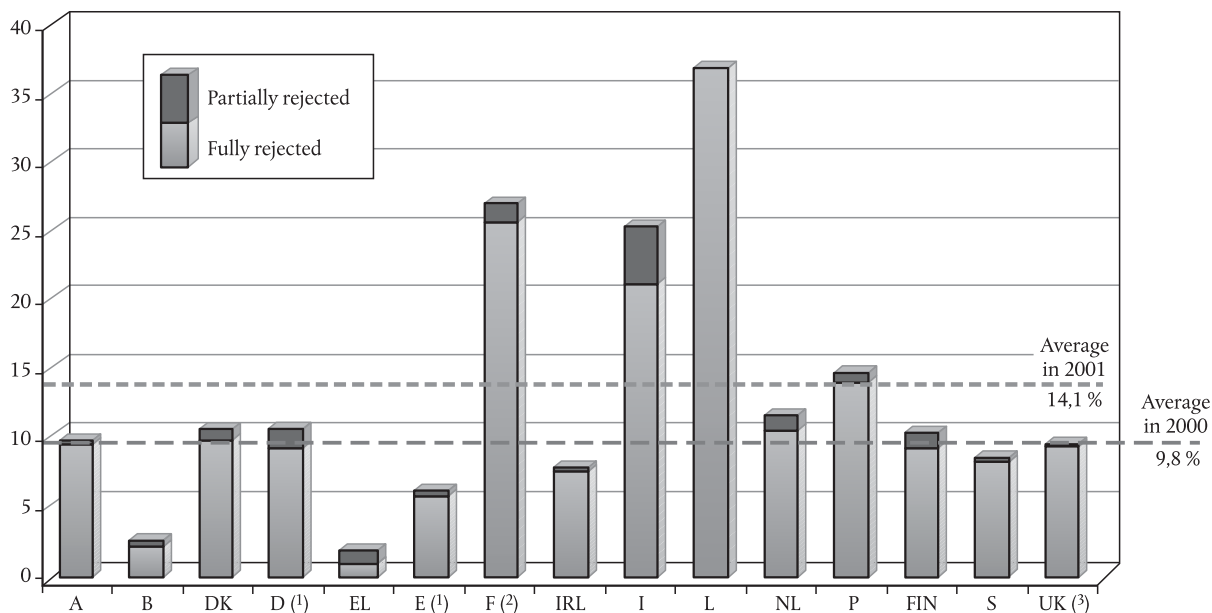
4.33. Frequent animal movements and the complex conditions of the animal premium schemes are the main reasons why the results of IACS checks in the animal sector show higher error rates than for arable crops. Both the results of IACS testing and the direct work of the Court indicate that there is significant risk in this area.

THE COMMISSION'S REPLIES

4.33. The majority of Member States have a properly functioning bovine identification and registration database, which in conjunction with properly executed (pre-payment) IACS checks, mitigates the risk of irregular claims.

If the Commission accepts the Court's opinion of higher risk in respect of the animal premium schemes, it has to be stressed that financial corrections in the context of the clearance-of-accounts procedure are applied for those Member States whose deficient systems have caused a risk to the Community budget.

Graph 4.5 — Suckler Cow Premium. Percentage of claims inspected with errors



(1) Germany and Spain: summary table at paying agency level.

(2) France: data for claims rejected include sanctions following both administrative and on-the-spot controls.

(3) United Kingdom: summary table of England, Northern Ireland, Wales and Scotland.

NB 1: Differences in percentage of errors detected may be explained both by differences in the number of inaccurate claims submitted and differences in the efficiency of detection.

NB 2: A claim is fully rejected when a difference higher 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.

Source: DG AGRI — IACS 2001 Statistics, relating to claims paid in 2002

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Subsidies paid on the basis of quantity produced

4.34. Subsidies for the production of olive oil, cotton, tobacco and dried fodder (5 316 million euro, 12 % of CAP expenditure in 2002) are paid on the basis of the quantity produced rather than the area cultivated. Two risks are apparent here:

- (a) 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;
- (b) 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).

4.35. To deal with these risks, Community legislation provides for a number of control mechanisms. One such system applies to the olive oil sector, through the checks performed by specialist agencies. These exist in Greece, Italy, Portugal and Spain. They are required to perform checks on individual producers, mills (at least 30 % of authorised mills) and producer associations. Work performed at the level of mills forms the most significant element of their work programme: checks made in 2001 (affecting 2002 expenditure) led the agencies to propose the withdrawal of authorisation from more than one in eight of the mills examined (see **table 4.3**). Checks cover only a small proportion of producers (less than half a per cent — see **table 4.4**). Work in 2001 (affecting 2002 expenditure) led the agencies to propose the reduction or refusal of payments to more than one in 15 of the producers examined. Both in the case of authorisation of mills and in the case of the reduction or refusal of payments to producers there were marked differences among the Member States concerned. The specialist agency in Italy noted that the total weight of olives declared by pressing mills exceeded the production estimates of the Italian statistical agency (ISTAT) by, on average, 7 % for the period 1984 to 2001, and by 7,5 % in 2001.

4.36. Discrepancies and control weaknesses noted by the Court in the area of production-based subsidies paid in 2002 include:

- (a) a quantity of pressed olives incompatible with the final production figure for olive oil (Greece);

4.34. *Each of the schemes referred to by the Court became compulsorily IACS-compatible as from 1 January 2003, from which time the Commission expects that control mechanisms will be significantly enhanced.*

- (a) *In the case of tobacco, the Regulation specifically provides for a penalty in the event of under-declaration of the area, precisely to avoid the risk highlighted by the Court.*

4.36. *With one exception, each of the Court's observations relates to the unsatisfactory situation in Greece regarding a number of Community aid schemes. As concerns the cases mentioned in respect of the olive oil and cotton sectors, financial corrections have been proposed annually under the clearance of accounts procedure, demonstrating that the*

THE COURT'S OBSERVATIONS

- (b) in the same country, in one case it was impossible, even applying the most favourable yield, for the farmer to have produced the quantity of cotton claimed without having used areas declared as sown with durum wheat and therefore benefiting from premiums for that crop;
- (c) olive grove density declarations were not updated (Greece);
- (d) the nature, frequency and rotation of checks were generally unreliable in the olive oil sector (Greece and Spain) and the tobacco sector (Greece).

THE COMMISSION'S REPLIES

weaknesses referred to by the Court are properly dealt with by the Commission.

(d) In the case of tobacco, the Commission has found no evidence of the general unreliability of inspections to which the Court refers.

Table 4.3 — Olive oil inspection agencies: checks on mills (2000 and 2001), relating to claims paid in 2002

Member State	No. of mills ⁽¹⁾	Mills checked						Proposals to withdraw authorisation	
		Total		in depth		summary		No	% of mills checked
		No	%	No	%	No	%		
Greece	2 264	1 399	61,8	939	41,5	460	20,3	217	15,5
Spain	1 684	1 032	61,3	928	55,1	104	6,2	59	5,7
Italy	5 744	3 020	52,6	1 811	31,5	1 209	21,0	382	12,6
Portugal	904	552	61,1	552	61,1	(²)		227	41,1
Total	10 596	6 003	56,7	4 230	39,9	1 773	16,7	885	14,7

⁽¹⁾ Total of authorised mills with declared activity.

⁽²⁾ ACACSA does not carry out summary checks.

Source: Annual reports for 2000 and 2001 of the Greek, Spanish, Italian and Portuguese olive oil agencies.

Table 4.4 — Olive oil inspection agencies: checks on producers (2000 and 2001), relating to claims paid in 2002

Member State	No. of producers	Producers checked						Aid payments withdrawn or reduced	
		Total		in site		using documents ⁽²⁾		No	% of producers checked
		No	%	No	%	No	%		
Greece ⁽¹⁾	874 290	5 100	0,6	2 910	0,3	2 190	0,3	27	1,2
Spain	439 097	1 229	0,3	708	0,2	521	0,1	83	15,9
Italy	922 223	1 787	0,2	269	0,0	1 518	0,2	17	1,1
Portugal	138 690	2 576	1,9	1 678	1,2	898	0,6	214	23,8
Total	2 374 300	10 692	0,5	5 565	0,2	5 127	0,2	341	6,7

⁽¹⁾ The number of payments withdrawn or reduced does not include 952 crop declarations, which were disallowed.

⁽²⁾ Controls using documents are performed during relevant field and cross controls.

Source: Annual reports for 2000 and 2001 of the Greek, Spanish, Italian and Portuguese olive oil agencies.

THE COURT'S OBSERVATIONS

4.37. The observation at paragraph 4.36(b) appears to form part of a general problem. Greek authorities have told the Commission that up to 8 % of areas actually planted with cotton had been declared as planted with another crop, enabling producers also to claim an area aid subsidy, as did the producer examined by the Court ⁽⁵⁾.

Rural development

4.38. Rural development expenditure amounted to 4 349 million euro in 2002, 10 % of CAP schemes. The most important schemes cover agrienvironmental measures, the 'less favoured areas' (including more than 50 % of the agricultural area of the EU) and forestry. Other schemes cover investments, support for early retirement, and for young farmers. Expenditure is based upon rural development plans drawn up by the Member States and approved by the Commission.

4.39. Typically, schemes of this kind have eligibility conditions which are more complex and difficult to verify than payments to farmers for arable crops or animal premiums. Frequent conditions include adherence to 'good farming practices' and minimum standards for environmental impact, hygiene and animal welfare. Member States have significant discretion in the choice of areas to fund and in the design of appropriate control systems.

4.40. As in previous years, certifying bodies expressed concerns about this expenditure, and the certifying bodies for the French, Portuguese and Bavarian agencies again qualified their audit opinion.

THE COMMISSION'S REPLIES

4.37. *The Commission's service responsible for the audit of agricultural expenditure is continuing enquiries in the sectors concerned in the framework of the clearance of accounts procedure. Naturally, any weaknesses identified with regard to (in this case) Greece's control systems are dealt with under the clearance of accounts procedure.*

4.39. *One of the purposes of Agenda 2000 was to allow the CAP to better adapt to local circumstances or priorities. Thus, insofar as rural development measures are concerned, the criteria for good farming practice (GFP) minimum standards and areas to be supported are set at national or regional level. The relevant verifiable indicators are also set at the appropriate national and regional levels.*

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.

4.40. *In the framework of the clearance of accounts of EAGGF-Guarantee, examination is made of the relevant findings made in the reports of the certifying bodies.*

⁽⁵⁾ The Commission's response was to introduce new legislation (Commission Regulation (EC) No 1486/2002) amending the stabiliser mechanism for cotton. This Regulation does not address the risk of excessive expenditure on other crops.

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Other expenditure

4.41. Other expenditure amounts to 8 466 million euro, almost 20 % of CAP spending in 2002. This includes many 'intervention' measures to support agricultural markets, such as export refunds, purchase of agricultural stocks and aid for private storage, as well as subsidies for the production and disposal of fruit and vegetables and the restructuring and conversion of vineyards.

4.42. The Court finds serious errors in this area. In 2002 errors affected, notably, payments for the storage of grape must, and subsidies for bananas and dried currants. Subsidies for replanting vineyards involve particular risks.

4.42.

1. *For the storage of grape must the Commission considers this case to be serious and is following it up within the clearance procedure.*
2. *For bananas, the Commission services are well aware of the non-conformity in the French national legislation. The subject has been discussed with the French authorities in the framework of the clearance of accounts procedure; a financial correction will be proposed.*
3. *For dried grapes, as a result of recent missions, the Commission has made and will continue to propose financial corrections.*
4. *While there is a risk that restructuring/conversion may increase the potential for vine-growing production, it can be identified only when the vineyard becomes productive, i.e. many years after replanting and at national level.*

4.43. Some of this expenditure is covered by monitoring systems which operate at Community level. The most significant examples are:

- (a) a posteriori checks ⁽⁶⁾, typically that a subsidy paid is supported and confirmed by commercial documentation held by a processor, exporter or other intermediary. These checks are carried out by Member States' authorities and they cover all subsidies involving the processing and transformation of agricultural products, consumption aids and export refunds;

⁽⁶⁾ These are provided for by Council Regulation (EEC) No 4045/89 (OJ L 388, 30.12.1989, p. 18).

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- (b) physical and documentary checks that goods benefiting from export refunds are correctly described on claim forms ⁽⁷⁾. These are carried out by Member States' customs services at the time of export. For most products Member States are required by Community legislation to carry out physical checks on at least 5 % of subsidised exports unless a risk analysis is applied.

4.44. The Commission has identified numerous weaknesses in the way a posteriori checks are performed and planned and errors recorded and corrected, notably in Italy, the Netherlands, Spain and the United Kingdom.

4.45. Based on the audits it has carried out, the Commission considers that, in general, physical and documentary checks carried out at the time goods are placed under customs control are of an acceptable standard. It has, however, noted some deficiencies in the way they are performed, in Greece, Italy and the United Kingdom. Although it has not followed up these deficiencies since 2000 the Commission has carried out numerous audits concerning other key controls over export refund transactions.

4.46. Given that the Commission identified the weaknesses in a posteriori checks in early 2001 and that there has been no follow-up, the Court cannot base its assessment of the validity and effectiveness of the checks on the Commission's conclusions.

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4.45. *The deficiencies mentioned by the Court were found by the Commission services 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.

4.46. *As far as a posteriori checks under Regulation (EEC) No 4045/89 are concerned, it has to be underlined that, by analysing and giving feedback on reports received from the national competent services of the Member States, the Commission services monitor the standards of implementation of the relevant regulation, and contribute to solving the identified deficiencies and to improving the quality of the controls carried out. The scope of the audits realised by the Commission's services concerning export refunds in general also cover aspects of the a posteriori checks under regulation (EEC) No 4045/89.*

These elements enable the Commission to reach appropriate conclusions on the application of the regulation (EEC) No 4045/89.

⁽⁷⁾ These are provided for by Council Regulation (EEC) No 386/90 (OJ L 42, 16.2.1990, p. 6).

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4.47. Member States are required by regulation to inform the Commission each year of the number of export declarations submitted, the number subjected to physical check and the number of irregularities detected. However, the Commission is unable to provide information on the value of transactions tested, and the value of irregularities detected, as this is not a legal requirement. The Commission does not have complete and up-to-date management information on the value of transactions subjected to a posteriori checks and on the value of irregularities detected.

4.48. The declaration of the Director-General for Agriculture states that assurance cannot be given on the possible impact of 'carousel' fraud involving the re-import of goods whose export is subsidised.

Conclusion

4.49. As in previous years, the Court found that CAP expenditure, viewed as a whole, 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 have 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) 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) other categories of expenditure pose greater risks and are subject to less effective control systems.

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4.47. *Regarding the financial value of irregularities detected, Member States provide information to the Commission concerning irregularities of more than EUR 4 000; such information is part of their annual report pursuant to Article 9a of Regulation (EC) No 2221/95. This regulation does not require them to state the value of the transactions tested.*

As far as a posteriori checks under Regulation (EEC) No 4045/89 are concerned, such analysis will be carried out before the end of 2003.

4.48. *The Commission has studied the various market sectors to identify possible risks and monitors trade patterns for any evidence that such risks have materialised. One of the actions taken in the sugar sector was the withdrawal of refunds for exports to the Balkans.*

Taking into account the reserve in the Director-General's report, a compliance audit is being carried out on the origin rules for export refunds. This addresses the equivalent carousel risk involving the re-export with subsidy of goods that do not meet these rules.

4.49. *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 taxpayers' interests.*

- (c) *For the other categories of expenditure, the Commission has imposed, wherever appropriate, compatibility with IACS thus allowing cross-checks. Dissuasive sanction systems have been introduced in many schemes (fruit and vegetables, tobacco, dried grapes, etc.).*

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Recommendations

4.50. The Court recommends that the Commission seek further improvements in the way the results of supervisory checks are compiled and presented, in particular:

- (a) IACS statistics should provide more detailed information about the categories of transactions tested, for example by beneficiaries or by crop;
- (b) for the olive oil agencies, the Commission should ensure that inspections and results are classified on a consistent basis;
- (c) 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.

4.51. The Court also recommends that the Commission investigate the reasons why, for IACS checks on areas, tests performed on a random basis show a higher rate of error than those selected on the basis of an analysis of risk.

4.50.

- (a) *The tables used by the Member States are reviewed and improved regularly. However, the Commission must also take account of Member States' requests for the simplification and streamlining of procedures. The Commission considers that the information currently received is sufficient to fulfil its obligations.*
- (b) *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.*
- (c) *Annual statistics on physical controls (comprising information as mentioned in paragraph 4.49) are made available to the Commission by Member States by 1 May each year. These statistics are closely monitored by the responsible services and also give rise to a follow-up within the clearance-of-accounts procedure in the event, for instance, minimum control rates established by the regulation not being respected by Member States. Nevertheless, the Commission is open to suggestions aiming to improve the quality and consistency of statistics on physical checks and will consider how best the additional information requested by the Court could be obtained. For other schemes, statistics about controls are also a vital instrument but not systematically compiled by clearance of accounts for all Member States. Indeed, the number of schemes would not allow such an overall but only a case to case approach.*

4.51. *The Commission is aware of several reasons for the situation outlined by the Court, not 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. Remote sensing is used extensively and is normally randomly based, albeit with some element of risk assessment. This makes it difficult to distinguish clearly between the results of risk- and randomly- based checks.*

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The Commission will renew its efforts to alert Member States to the need for annual analysis of risk criteria and results with a view to enhancing techniques.

4.52. The Court considers that a summary of the results of these checks should be included in the annual activity report of the Director-General for Agriculture.

4.52. *The Commission considers that the inclusion of statistics concerning the performance of controls by Member States would not be consistent with its objective that the annual activity reports provide only summarised information for the relevant year.*

CLEARANCE OF ACCOUNTS

Introduction

4.53. Clearance of accounts consists of two elements in the sequence of decisions set out in paragraph 4.3:

- (a) the annual 'financial clearance' decision, in which the Commission decides whether to accept the CAP paying agencies' accounts for the preceding budgetary year;
- (b) 'conformity decisions' under which the Commission decides whether to 'disallow' expenditure and make corrections. Such decisions may relate to several EAGGF years. In most cases, disallowance takes place because the Commission has identified weaknesses in Member States' management systems, and the Commission applies a scale of flat-rate corrections based on the seriousness of the management failure.

Financial clearance decision for 2002

4.54. 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 (see paragraph 4.14). In addition, the Court examined any other reports for which a qualified certificate was given and those for the new regional paying agencies in Italy. The Court reviewed the use of statistical sampling as reported by all of the certifying bodies and the work of the Commission in preparing the financial clearance decision.

Table 4.5 — Paying agencies by expenditure declared in 2002

No	Member State	Paying agency	Amounts declared in million euro	% of total	qualified accounts	disjoined accounts ⁽¹⁾
1	Italy	AGEA	5 307,5	12,39	✓	
2	France	ONIC	4 382,7	10,23	✓	
3	Greece	Opekepe	2 646,2	6,18	✓	✓
4	United Kingdom	RPA	2 447,9	5,72		
5	Spain	Andalucia	1 697,4	3,96		
6	Ireland	DAF	1 662,6	3,88		
7	Denmark	EU-direktoratet	1 223,0	2,86		
8	France	Oniol	1 129,2	2,64		
9	France	Ofival	1 027,2	2,40		
10	Germany	Bayern, Landwirtschaft	1 026,8	2,40	✓	✓
11	Sweden	SJV	820,8	1,92		
12	Spain	Castilla — La Mancha	763,0	1,78		
13	Portugal	INGA	610,5	1,43		
14	Spain	FEGA	602,8	1,41		
15	Germany	Mecklenburg-Vorpommern	521,4	1,22	✓	
16	Germany	BLE	505,8	1,18		
17	United Kingdom	SERAD	458,6	1,07		
18	Germany	Baden-Württemberg	430,0	1,00	✓	✓
19	Netherlands	LASER	417,7	0,98		
20	Belgium	Min. of Agr.- DG3	378,1	0,88		
21	Netherlands	PZ	349,2	0,82		
22	Spain	Cataluña	320,1	0,75		
23	Netherlands	HPA	300,5	0,70		
24	Italy	SAISA (ex DCCC)	254,7	0,59		
25	France	Odeadom	108,8	0,25	✓	✓
subtotal ⁽²⁾			29 392,5	68,63		
26	Austria	AMA	969,7	2,26		
27	Germany	Niedersachsen	937,3	2,19		
28	France	ACCT/SDE	909,9	2,12	✓	✓
29	Finland	MMM	838,0	1,96		
30	Spain	Castilla — León	790,9	1,85		
31	France	CNASEA	675,1	1,58	✓	
32	France	ONILAIT	556,1	1,30	✓	✓
33	Belgium	BIRB	528,3	1,23		
34	Germany	Sachsen-Anhalt	509,5	1,19		
35	Germany	Hamburg-Jonas	501,1	1,17		
36	Spain	Extremadura	500,1	1,17		
37	Germany	Sachsen	447,2	1,04		
38	Spain	Aragón	443,7	1,04		
39	France	FIRS	414,3	0,97	✓	✓
40	Germany	Brandenburg	403,9	0,94		
41	Germany	Nordrhein-Westfalen LWK Bonn	336,5	0,79		
42	Germany	Schleswig-Holstein	319,5	0,75		
43	France	Onivins	309,2	0,72	✓	✓
44	Germany	Thüringen	277,0	0,65		
45	France	Oniflor	254,9	0,60	✓	✓
46	United Kingdom	DARD	225,8	0,53		
47	Germany	Hessen	212,0	0,50		
48	Germany	Rheinland-Pfalz	182,2	0,43		
49	United Kingdom	NAWAD	157,1	0,37		
50	Portugal	Ifadap	148,3	0,35	✓	✓
51	Spain	Canarias	140,5	0,33		
52	Spain	Valencia	129,3	0,30		
53	Spain	Navarra	118,7	0,28		
54	Germany	Nordrhein-Westfalen LWK Münst	118,2	0,28		
55	Spain	Galicía	106,9	0,25		
56	Italy	ENR	89,1	0,21		
57	Spain	Murcia	85,0	0,20		
58	Austria	BMLFUW Präs B10	62,0	0,14		
59	Austria	ZA Salzburg	58,3	0,14		
60	Spain	País Vasco	56,2	0,13		
61	Spain	Asturias	55,7	0,13		
62	Italy	AGREA	52,7	0,12		
63	Spain	Madrid	49,1	0,11		
64	Ireland	DCMNR	48,3	0,11	✓	
65	Luxembourg	Ministère de l'Agriculture	38,7	0,09	✓	
66	Spain	La Rioja	36,0	0,08		✓
67	Netherlands	DLG	35,3	0,08		
68	Italy	Region Lombardia	33,6	0,08		✓
69	Belgium	Vlaamse Gemeenschap	28,9	0,07	✓	
70	Spain	Cantabria	28,5	0,07		
71	Italy	AVEPA	28,2	0,07	✓	
72	Netherlands	PT	28,1	0,07		
73	Netherlands	PVVE	20,5	0,05		
74	Germany	Bayern, Umwelt	19,9	0,05	✓	✓
75	United Kingdom	FC	19,4	0,05		
76	Germany	Saarland	18,9	0,04		
77	Italy	ARTEA	18,6	0,04		✓
78	Spain	Baleares	17,0	0,04		✓
79	Germany	Hamburg	10,7	0,02		
80	Belgium	Région Wallonne	9,9	0,02	✓	
81	France	Ofimer	7,8	0,02		
82	Germany	Nordrhein-Westfalen LfEJ	4,8	0,01		
83	Spain	FROM	3,9	0,01	✓	
84	United Kingdom	CCW	3,0	0,01		
85	Germany	Bremen	1,8	0,00		
86	Germany	Berlin	1,5	0,00		
subtotal			13 432,8	31,37		
TOTAL			42 825,3	100,00	18 896,3	11 469,8

⁽¹⁾ Accounts disjoined from the financial decision taken on 7 May 2003.⁽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 the euro zone: Denmark: 7,4282, Sweden: 9,1458, United Kingdom: 0,6842.

Source: Summary report of the Commission on the financial clearance of the EAGGF Guarantee Section accounts for 2002.

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Audit opinions of certifying bodies

4.55. For the financial year ending 15 October 2002, 64 paying agencies managing 23 929 million euro received a clear audit opinion (see **table 4.5**). The remaining 22 agencies received a qualified or negative opinion because of:

- (a) material levels of error in the accounts of three paying agencies (Ifadap (Portugal), Baden-Württemberg and Bayern Umwelt (Germany));
- (b) breaches of accreditation criteria (which do not have a direct financial impact) and control weaknesses (Opekepe (Greece), Ifadap (Portugal), Flemish Community (Belgium), Bayern Umwelt (Germany), FIRS, ONIC, Odeadom, Onivins (France), Ministry of Agriculture (Luxembourg), AGEA (Italy));
- (c) the inability of some certifying bodies to provide assurance on certain budget headings (amounting in total to 286 million euro) because of specific weaknesses in control systems or difficulties in obtaining information from customs authorities (SDE, Ofival, Oniflhor, Onilait);
- (d) some certifying bodies' inability to give an opinion on the completeness of the debtor's statement (Ifadap and Opekepe).

Shortcomings in the work of certifying bodies

4.56. Most certifying bodies tested a sample of payments made by the paying agencies and then extrapolated the results in order to determine whether there was a material level of error in the accounts. Materiality is defined for these purposes as 1 % of the value of the population from which the sample is taken. Most of the expenditure (36,8 billion euro) declared by 69 paying agencies was subject to statistical sampling (some 23 500 transactions). The Commission concluded that there was also a material level of error for two paying agencies (Walloon region and Rioja) whose accounts had not been qualified. The Commission's guideline No 8 provides elements of guidance in, *inter alia*, calculating the level of error and treating the (different kinds of) errors. Furthermore, the Commission's guideline

4.56. *Where the results of the audit work carried out by the Commission's services has an impact on the valuation of errors noted by the certifying body, appropriate action has been taken, or, in case of audits still ongoing, will be taken.*

The Commission has requested additional information in cases where the information provided by certifying bodies was deemed insufficient in order to appreciate the work done.

The accounts of one paying agency (Rioja) have been disjoined because of various problems including insufficient evidence of the work performed on the valuation of errors. In other cases, the certifying body in its report indicates

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No 7 provides for a standard model of the certification report, which should contain sufficient information on this essential element ⁽⁸⁾. However, contrary to the Commission's guideline, for several paying agencies the reports do not contain sufficient information to verify the certifying bodies calculations of the level of error, while some other certifying bodies' have not treated errors correctly.

Compliance with Commission guidance

4.57. In general, the guidance provided by the Commission provides a sound basis for the audit of the paying agencies and is followed by the certifying bodies. However, the Commission could do more to ensure that this guidance is followed. For example, once again the certifying body for Opekepe (Greece) was appointed late in the year (27 November 2002). Consequently it was unable to attend physical stocktaking checks and could only visit eight out of 55 administrative regions.

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that it will continue to monitor the follow-up of the conformity issue noted by the paying agency concerned. In this case, the conformity issue will be again reported upon in the 2003 certification report. Should this follow-up be considered inadequate, the Commission's services will take appropriate action in the framework of the 2003 certification process.

4.57. *Despite its late appointment, the work of the certifying body of Opekepe has been considered satisfactory. The certifying body's assessment of the procedures and the accounts of the paying agency also relies on the work performed by the internal audit department of the agency and its delegated bodies (where this work is reasonably considered reliable).*

The agency's internal audit service also visited a number of administrative regions, and assisted or took part in the physical stocktaking checks.

The Commission's services will continue to underline the importance of a timely appointment of the certifying body, but unless its work is insufficient or inadequate, it would be difficult to take more severe steps, given that Member States are responsible for such an appointments.

⁽⁸⁾ According to these guidelines, the need and method to extrapolate results depends on the approach adopted in respect of sampling. In line with the Commission's guidelines, certifying bodies can divide the EAGGF transactions into several populations: a population for which the monetary unit sampling technique is appropriate and population(s) for which this technique is not appropriate. In this case extrapolation of the findings is only appropriate in respect of the populations sampled with the monetary unit sampling technique. Results from the other sampling techniques should be taken into account by the certifying bodies in forming their opinion on the populations concerned.

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The Commission's decision

4.58. The Commission took its financial clearance decision on 7 May 2003, after the 30 April deadline laid down in the Regulation. The Commission accepted the accounts of the paying agencies, subject to the following exceptions and conditions:

- (a) the Commission excluded (disjoined) the accounts of 17 paying agencies from the decision, accounting for 11 470 million euro (27 % of the total expenditure declared). The accounts of Opekepe (Greece) and NAWAD (United Kingdom) were not cleared because they had not yet provided the Commission with detailed computer data on payments. For the Balearic Islands and Rioja (Spain), the Commission requested further information. The primary reason for disjoining the eight French paying agencies was that the certifying body did not obtain assurance that the Customs department had adequately applied internal control procedures. Ifadap (Portugal), Baden-Württemberg and Bayern Umwelt (Germany) were disjoined because of a material level of error. The reports for Tuscany and Lombardy were rejected, respectively because of failure to comply with the Commission's guidelines and because not enough audit work had been performed;
- (b) as a sanction against late payments, overshooting expenditure ceilings and failure to collect milk super levy on time, the Commission decided that the advances paid to Member States in 2002 were 89,5 million euro too high;
- (c) the Commission intends to make corrections in conformity decisions for the Walloon region, Bayern Umwelt and Ifadap and for some other paying agencies when the Commission receives the necessary data ⁽⁹⁾.

4.58. *The Commission has made and will continue to make every possible effort to respect the regulatory deadline. Significant improvements have been recorded in respect of the clearance decision in comparison to the financial year 2001. Furthermore the quality of the work carried out was considered more important than the strict respect of the deadline.*

⁽⁹⁾ For example, the Commission requested the certifying body for Baden-Württemberg to complete its audit work and report its findings by 30 June 2003.

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Conformity decisions taken in 2002

4.59. In 2002 the Commission took three conformity decisions in respect of expenditure in 1996 to 2001 ⁽¹⁰⁾, disallowing 301,4 million euro. The Court has examined a sample taken from the three decisions covering 273,8 million euro (91 %) and has sought to establish whether:

- (a) the corrections in the conformity decisions are adequate and well founded;
- (b) corrections are made in good time;
- (c) all significant areas of the budget are satisfactorily considered by the Commission when preparing for conformity decisions.

Adequacy of corrections

4.60. The Court concluded that in respect of 198 million euro of disallowed expenditure the Commission's procedures were well founded and consistent with its normal scale of flat-rate corrections ⁽¹¹⁾.

4.61. In the following cases the Court took the view that a more rigorous application of the Commission's own rules would have been justified:

- (a) olive oil, Italy: correction of 22,7 million euro. The Commission found significant weaknesses in the checks carried out at mills and a lack of rigour in the performance and follow-up of compatibility checks (on the quantities of olive oil produced). The Commission has classified these checks as key controls. A rate of correction of 5 % would have been consistent with the Commission's scale of flat-rate corrections. However, for this measure the Commission applied a correction rate of 2 % of declared expenditure;

4.61.

- (a) *Checks on production aid for olive oil are based on several complementary key checks. Individually, none of them can be considered adequate and risk assessment must look at the inspection system as a whole.*

In Italy, weaknesses have been identified as regards checks on mills and accounting records. However, the risk to the EAGGF is partially offset by the existence of an olive-oil register and computerised records.

The correction rate was therefore set at 2 % to take account of the factors reducing the theoretical risk arising from the poor application of two of the key checks.

⁽¹⁰⁾ Commission Decision 2002/523/EC (OJ L 170, 29.6.2002, p. 73), Commission Decision 2002/524/EC (OJ L 170, 29.6.2002, p. 77) and Commission Decision 2002/881/EC (OJ L 306, 8.11.2002, p. 26).

⁽¹¹⁾ 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.

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- (b) olive oil, Spain: correction of 45,5 million euro. Since 1994 the Commission has applied a 5 % correction to expenditure on olive oil declared by Spain because of inadequacies in the oil register and files. As for previous years the Court maintains its position that a 10 % correction is warranted. This would be in line with the Commission's current proposals to apply higher rates of corrections for recurrent weaknesses ⁽¹²⁾;

- (c) rural development, France: The Commission failed to take account of 3,2 million euro declared retrospectively and netted off by France. Retrospective declaration is not permitted by the relevant regulations. The correction should have been equal to the gross value of the sums overclaimed;

- (d) during 2002 the Commission audited the treatment by 21 paying agencies of advances (e.g. advance payments of export refunds) and securities (provided by beneficiaries in order to obtain advance payments). Common findings in the audits were that paying agencies did not regularly follow up outstanding advances or instigate timely recovery procedures. The Commission disallows expenditure for specific cases of poor administration leading to a financial loss but does not make financial corrections for systems weaknesses.

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- (b) Assessing the risk to the EAGGF takes account of the fact that all olive oil is sold through mills in Spain, which reduces the risk posed by the lack of an olive-oil register and computerised records. That assessment applies to the years to which the Court refers.

The key checks provided for in the case of production aid for olive oil are complementary and the risk posed by the lack of one of them may be at least partially offset by another. A valid assessment is possible only of the system as a whole.

The rate of 5 % applied to Spain may therefore be considered justified.

Increases in the correction rate for recurrent weaknesses should not be automatic but must be based on an overall assessment of the financial risk. In this instance, the other checks which applied may be regarded as adequate to limit the risk to the EAGGF.

- (c) The Commission agrees with the Court and will apply this principle in the future.

- (d) As explained in the reply to the Court's Annual Report for 2001, a system's weakness could lead to a financial correction where a link to a specific identified risk to the Fund can be established.

In some cases, for example, the weakness identified refers to the fact that guarantees are released with an unjustified delay, after all the relevant checks have been performed and no irregularities have been reported. In other cases, the Member State was able to demonstrate the absence of risk to the Fund because, despite the weakness, all the claims were eligible. Of course, in these cases a follow-up of the remedial action taken by the paying agency has been assured.

⁽¹²⁾ 'Communication on recurrent shortcomings', AGRI/61495/2002-final.

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4.62. Stricter application of the Commission's disallowance criteria, on the basis set out above, would have increased the sum disallowed by 83 million euro.

Time taken to reach conformity decisions

4.63. Owing to some of the corrections mentioned above, an inordinate amount of time elapsed between different stages in the procedure for clearance of the accounts. On average, the clearance procedure, starting with the audit visit and ending with the sending of the final letter, takes about two years — or two-and-a-half years with conciliation ⁽¹³⁾. These delays are the result of:

- (a) staff vacancies or high staff turnover;
- (b) delays in reply by Member States;
- (c) the wish to tackle each stage in the procedure simultaneously for all the Member States in an enquiry (this strategy has since been abandoned);
- (d) problems within the Commission in coordinating its inspections;
- (e) the complexity of the cases.

4.64. Two cases corrected in 2002 could have been made earlier. The rural development case involving France (paragraph 4.61(c)) and a similar overclaim which the United Kingdom brought to the attention of the Commission in August 2001 (10 million euro) could have been dealt with in conformity decision No 8 of December 2001 ⁽¹⁴⁾.

THE COMMISSION'S REPLIES

4.62. *The Commission maintains that the rates of financial correction imposed in the above cases were justified. Account was taken not only of the existing correction thresholds, but also of the perceived risks to the Fund.*

4.63. *Delays are still a problem and efforts continue to be undertaken in order to reduce them. As the Court mentions itself the high turnover was one of the problems. The procedure itself can still be improved and in 2003 the Commission has made considerable efforts by launching a project to computerise audit work (procedure). When that instrument is operational, it will improve the real-time monitoring of audit work and so ensure yet stricter supervision.*

- (c) *When an enquiry includes a number of audits on the same aid scheme in different Member States, it is sometimes imperative, in order to have a complete, clear and balanced view of the situation regarding this scheme, to wait for the end of all investigations including the bilateral phase, before finalising the compliance procedure. This has also been confirmed in the communication to the Commission regarding action 98 'Improvement of the EAGGF clearance of accounts procedure.'*

4.64. *The letters from these Member States were received in August, and in view of the internal procedures it was not possible to include them in the Decision No 8. The corrections were therefore applied in Decision No 9.*

⁽¹³⁾ The conciliation body is responsible for trying to reconcile the positions of the Commission and Member States on any proposed corrections referred to it. The conciliation procedure adds around five months to the overall length of the procedure.

⁽¹⁴⁾ Commission Decision 2001/889/EC (OJ L 329, 14.12.2001, p. 68).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Coverage

4.65. As regards the period 1999 to 2002, most of the main budget items have been covered in clearance missions in accordance with the risk level as assessed by the Commission. Only two items which, according to the Commission, have a very high risk level have not given rise to missions: aid for skimmed-milk powder intended for animal feed (253 million euro) and aid for the production of casein (193 million euro). The Court has examined both of these measures in recent years and the Commission decided accordingly not to cover the same ground.

4.66. In addition, there have been no missions by the Commission to cover a number of budget items with a risk level considered average by the Commission. The biggest items of expenditure are for starch and potato starch (232 million euro) and intervention for sugar (227 million euro). Lastly, there have been no missions for a long time in connection with a series of items with low expenditure and risk levels.

4.67. Areas of expenditure accounting for about 4 % of CAP spending in 2002 (1 500 million euro) have not been subject to clearance missions by the Commission in the last four years.

Clearance of accounts decisions in recent years

4.68. The clearance of accounts takes place over a period of years (see paragraphs 4.3 and 4.53). **Table 4.6** and **graphs 4.6 and 4.7** show the results of clearance decisions over several years.

4.69. **Table 4.6** shows the results of the Commission's clearance decisions in respect of 1991 and subsequent years. Clearance has been completed for the years up to and including 1996 but some conformity decisions remain to be taken in respect of subsequent years. The total amounts disallowed represent the Commission's view of the amount of expenditure declared by Member States, which, mainly because of weaknesses in Member States' systems for managing and controlling expenditure, should not be borne by the Community budget.

4.65. *Until and including 2001 the first priority in the milk sector was to address the milk quota problems, especially in Italy. Where the Court established serious weaknesses regarding other measures, these were thoroughly followed up by the Commission.*

4.66. *Risk analysis resulted in more attention being paid to other sectors in 2002. The focusing of clearance work on other sectors was also justified by the Court's audits, which gave rise to no major comments as regards the starch/potato starch and sugar sectors. Furthermore, total expenditure in 2002 in the sugar sector totalled EUR 1 395 million, of which EUR 1 168 million was for export refunds. A specific audit on sugar was not justified in view of the horizontal audits on refunds in recent years and those on procedures in general which also covered sugar refunds.*

4.67. *These measures could perhaps be inspected in the light of a risk analysis.*

Table 4.6 — Corrections in clearance of accounts decisions in respect of budget years 1991 to 2002

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Expenditure declared ⁽¹⁾	31 255,9	30 480,2	34 008,0	33 592,8	35 654,4	39 062,5	40 884,3	38 857,4	40 726,2	40 410,6	41 593,8	42 710,8
Total amount of corrections	-1 504,1	-788,2	-737,0	-307,8	-587,8	-791,1	-480,8	-321,9	-190,8	-108,0	-0,5	0,0
of which:												
(a) milk super levies ⁽²⁾	-979,2	-419,7	-248,0	0,0	-23,3	-215,0	-110,2	0,0	0,0	0,0	0,0	0,0
(b) disallowed expenditure	-524,9	-368,5	-489,0	-307,8	-564,5	-576,1	-370,6	-321,9	-190,8	-108,0	-0,5	0,0
Disallowed expenditure as a percentage of expenditure declared	1,7 %	1,2 %	1,4 %	0,9 %	1,6 %	1,5 %	0,9 %	0,8 %	0,5 %	0,3 %	0,0 %	0,0 %

⁽¹⁾ The difference between the total amount of expenditure declared in this table and the total amount of expenditure in Table 4.5 corresponds to corrections in B1-3 7 0 0. These are not split between the accounts of the paying agencies but taken into account as a whole by the Member State: Spain - 6,6 million euro, France 7,6 million euro (positive correction), Italy - 95,3 million euro and the Netherlands - 20,2 million euro.

⁽²⁾ These corrections reflect non-payment of milk super levies by Member States, rather than incorrect expenditure.

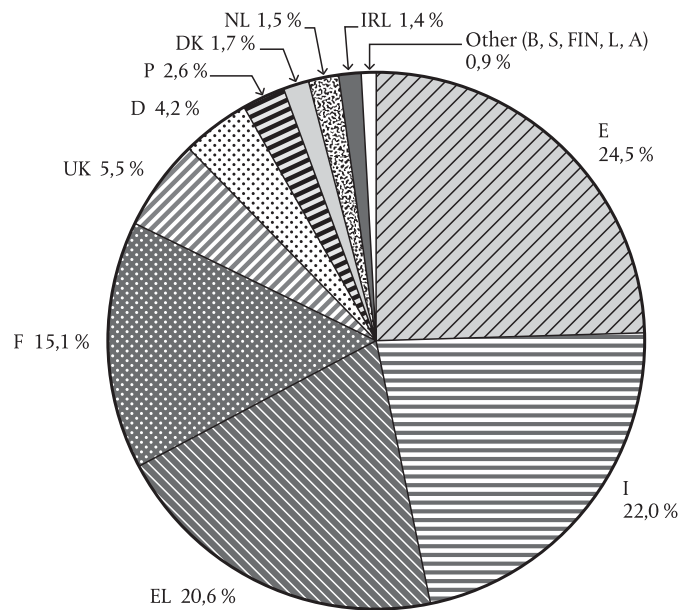
NB: Total amount of corrections per EAGGF year:

There are still conformity decisions to be taken to clear the expenditure of EAGGF years from 1997 onwards.

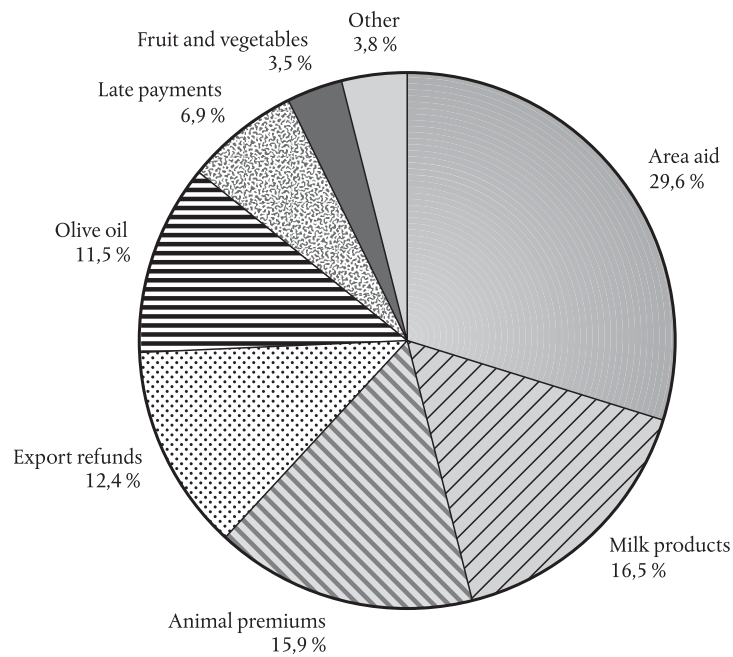
Exchange rates:

Those used by the Commission in its summary reports.

Source: All Commission's clearance of accounts decisions covering EAGGF years 1991 to 2002.

Graph 4.6 — Corrections in conformity decisions (1999 to 2002) per Member State

Source: Clearance of accounts decisions 1 to 11 taken from 1999 to 2002.

Graph 4.7 — Corrections in conformity decisions (1999 to 2002) per market

Source: Clearance of accounts decisions 1 to 11 taken from 1999 to 2002.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

4.70. **Graphs 4.6. and 4.7** set out the distribution of expenditure disallowed in conformity decisions taken by the Commission during the period 1999 to 2002 ⁽¹⁵⁾, by Member State and market sector. These decisions relate to items of expenditure from the Community budget years 1996 to 2001.

Conclusion on clearance of accounts

4.71. Subject to the points discussed in paragraph 4.7 and 4.55, the certifying bodies provide significant assurance on the accuracy of financial information provided by the paying agencies. The Commission has made appropriate use of the reports of the certifying bodies in reaching the financial clearance decision (paragraph 4.58).

4.72. Most of the amounts disallowed in conformity decisions in 2002 were calculated on the basis of the Commission's normal scale of flat-rate corrections (paragraph 4.60). In some cases a higher rate of correction could have been applied (paragraph 4.61). Most budget headings have been considered under the clearance of accounts procedure in the period 1999 to 2002 (paragraph 4.67).

FOLLOW-UP TO PREVIOUS OBSERVATIONS

*Greening the CAP***Main observations of the Court**

4.73. In its Special Report No 14/2000 ⁽¹⁶⁾ the Court concluded that the intensification of agricultural production had created environmental problems which gave cause for concern. The Community had not succeeded in significantly 'greening' agricultural policy.

⁽¹⁵⁾ The year 1999 was the first in which the Commission took conformity decisions under the revised procedure for clearance of accounts introduced in 1996.

⁽¹⁶⁾ Special Report No 14/2000 on 'Greening the CAP' (OJ C 353, 8.12.2000).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

4.74. The Court concluded that:

- (a) the existing optional 'ecoconditionality' rules should have been mandatory throughout the EU;
- (b) the aim of extensifying production was not achieved in the reform of the common organisation of the market (COM) for livestock;
- (c) Community aid continued to support forms of agricultural production which have negative environmental effects, such as fibre flax and artificially dried fodder;
- (d) the Member States' application of the Community's Nitrate Directive was unsatisfactory;
- (e) because of the absence of adequate 'codes of good agricultural practice', European taxpayers are meeting some costs that should be borne by the farmers. This is contrary to the 'polluter pays' principle;
- (f) poor coordination between the various Community schemes adversely affects environmental performance. To secure better coordination a thorough review of all environmentally relevant measures which have an impact on agriculture should be conducted.

The Council recommended that this report be used by the Commission when designing future reform of the CAP ⁽¹⁷⁾.

Actions taken by the Commission

4.75. In its reply to the Special Report, the Commission committed itself to launching several reforms and to preparing proposals for new legislation which would increase the integration of environmental concerns into the CAP.

4.75. *In July 2002 the Commission issued its communication on mid-term review of the Agenda 2000 CAP reform which was further elaborated by the legal proposals in January 2003. On 26 June 2003, EU farm ministers adopted a fundamental reform of the CAP based on these proposals which will help to further increase the integration of environmental concerns into the CAP.*

⁽¹⁷⁾ Council Recommendation on the discharge 1999 (addendum) of 12 March 2001 (SN2089/01).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Proposal for mandatory cross-compliance

4.76. The Commission committed itself to closely monitoring the implementation of Article 3 of Regulation (EC) No 1259/1999 ⁽¹⁸⁾, which stipulates the Member States' obligations to enforce environmental measures.

4.77. In its mid-term review of the CAP, published in 2002 ⁽¹⁹⁾, the Commission proposes that receipt of direct payments should be conditional on respect of statutory standards based on Community environmental legislation, for example the codes for good farming practice under the Nitrate Directive ⁽²⁰⁾ and the designation of Natura 2000 areas under the Habitat Directive ⁽²¹⁾. This is known as cross-compliance.

Reform of the COM for livestock

4.78. In its reply to the Special Report, the Commission claimed that the weaknesses pointed out by the Court concerning the extensification premiums for livestock were rectified in Agenda 2000.

4.79. However, in the mid-term review of the CAP the Commission concludes that the redesign of the extensification premium under Agenda 2000 has not discouraged intensive production systems as much as

4.76. The Commission services, based on the information submitted by the Member States in their annual reporting 2002 and 2003, are preparing a synthesis report on the measures carried out by Member States in relation to Articles 3 and 4 of the common rules Regulation (EC) No 1259/1999. Based on two years of reporting it will be possible for the Commission to give an overview of the application of Article 3 of Regulation No 1259/99 by the Member States.

4.77. With the Agricultural Council conclusions of 26 June 2003, direct payments shall be subject to cross-compliance. For this purpose a priority list of 18 statutory EU standards in the field of environment (including the Nitrate Directive and the designation of Natura 2000 areas under the Habitat Directive), food safety and animal health and welfare has been established in view of sanctioning the non-respect of these standards by cutting direct payments.

4.78. Agenda 2000 introduced new arrangements as regard the extensification payment. The conditions concerning both bovine animals and the forage area to be taken into account for the determination of the stocking density of the holding were more strictly defined than in the previous extensification scheme.

4.79. With the CAP reform a decoupled single farm payment will enter into force as from 1 January 2005 replacing most of the premiums under different common market organisations including the extensification premium.

⁽¹⁸⁾ Council Regulation (EC) No 1259/1999 of 17 May 1999 establishing common rules for direct support schemes under the common agricultural policy (OJ L 160, 26.6.1999, p. 113).

⁽¹⁹⁾ Towards sustainable farming — A mid-term review of the common agricultural policy (COM(2002) 394 final, p. 19).

⁽²⁰⁾ Council Directive 91/676/EEC of 12 December 1991 concerning the protection of waters against pollution caused by nitrates from agricultural sources (OJ L 375, 31.12.1991, p. 1).

⁽²¹⁾ Council Directive 92/43/EEC of 21 May 1992 on the conservation of natural habitats and wild fauna and flora (OJ L 207, 22.7.1992, p. 7).

THE COURT'S OBSERVATIONS

intended. The Commission proposes to abolish the extensification scheme. It argues that decoupling of headage payments and their replacement with a single income payment per farm in combination with reinforced cross-compliance would achieve a better result ⁽²²⁾.

Reforms of the COMs for fibre flax and dried fodder

4.80. In its reply to the Special Report the Commission pointed out that it had recently tabled a proposal for a reform of the flax and hemp common market organisation. Under the mid-term review proposals there would be no separate flax and hemp regime. Farmers in receipt of the proposed single payment would be able to cultivate flax and hemp subject to the cross-compliance requirements (for dried fodder see paragraphs 4.103 to 4.110).

Member States' failure to implement the Nitrate Directive

4.81. Since 1994 the Commission has opened 56 legal cases against Member States for failure to implement the Nitrate Directive ⁽²³⁾. In all 10 cases which have so far reached judgment, the Court of Justice has ruled in favour of the Commission ⁽²⁴⁾. The Commission's synthesis of Member States' reports on implementation of the Nitrate Directive in 2000 shows that most Member States are still involved in at least one infringement case ⁽²⁵⁾.

⁽²²⁾ Commission's written answer to the Court's questionnaire on 12 November 2002, question No 6.

⁽²³⁾ Report from the Commission on the implementation of Council Directive 91/676/EEC concerning the protection of waters against pollution caused by nitrates from agricultural sources. Synthesis of the year 2000 Member States' Reports (COM(2002) 407 final, 17 July 2002).

⁽²⁴⁾ Court Cases: Spain (1 October 1998 and 13 April 2000), Italy (25 February 1999 and 8 November 2001), United Kingdom (7 December 2000), France (8 March 2001 and 27 May 2002), Luxembourg (8 March 2001), Germany (14 March 2002), Netherlands (7 November 2002).

⁽²⁵⁾ Report from the Commission on the implementation of Council Directive 91/676/EEC concerning the protection of waters against pollution caused by nitrates from agricultural sources. Synthesis of the year 2000 Member States' Reports (COM(2002) 407 final, 17 July 2002).

THE COMMISSION'S REPLIES

However, the implementation can be postponed by Member States, if justified by specific agricultural conditions, until 1 January 2007.

4.80. The reform of the CMO for flax and hemp grown for fibres was presented by the Commission in 1999, adopted by the Council in 2000 and has been in force since the 2001/2002 marketing year. The reform consisted basically in two major measures: on the one hand flax and hemp are now integrated into the arable crop regime and, on the other hand, a specific aid is granted to processors who obtain the fibres. Consequently, the provisions resulting from the reform of the CAP will be applicable to the cultivation of flax and hemp. In addition, specific provisions are also provided for the cultivation of hemp.

4.81. In 2000, guidelines were provided on the relationship between the rural development programmes and EU environmental legislation (i.e. Natura 2000 and the Nitrates Directive). With regard to the Nitrates Directive it was required to insert clear and irrevocable commitments in the programming documents to guarantee consistency with the protection of vulnerable zones as provided for under the Nitrates Directive.

Mr. Fischler, on 25 July 2002, in the letter mentioned by the Court requested information from the Member States:

- on the steps taken to complete designation of nitrate vulnerable zones (NVZ),
- on the state of defining mandatory good farming practices and action programmes in NVZ,
- on still ongoing procedures including the timetable in comparison with the programme commitments.

In the meantime the replies of all the Member States concerned have been received and are at present being analysed in a procedure commonly agreed between the Directorate-General for Environment and the Directorate-General for Agriculture with a view to possible further steps concerning these commitments.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

4.82. Several Member States made clear commitments in their rural development plans (RDP) for the programming period 2000 to 2006, to designate nitrate-vulnerable zones, but have failed to do so. The Commission has asked all Member States to submit updated information on the implementation of the Nitrate Directive ⁽²⁶⁾. By January 2003, four of the Member States had still not responded to this request ⁽²⁷⁾.

Enforcement of good farming practices

4.83. The Commission's mid-term review proposal would require the enforcement of good farming practices. Member States would have to define and enforce standards, following a common framework. The Commission launched the work to establish such a framework at the end of 2002 ⁽²⁸⁾. Much will depend on how effectively such a code can be implemented in practice.

Performance of environmental evaluations

4.84. The Commission committed itself to preparing a full evaluation of the forestry policy. This evaluation report was finalised in March 2001 ⁽²⁹⁾.

4.85. The Commission has also set up external *ex post* evaluations on some market policies, which have included questions on environmental impacts ⁽³⁰⁾. The results provided in the market evaluation studies have often been disappointing, because they were compiled in an ad hoc manner and based on desk research and summarising of earlier studies from different Member States which referred to different periods.

4.86. In view of the poor experience so far in market evaluations, there is a plan to include specific horizontal studies to evaluate environmental impacts of market measures in the Directorate-General for Agriculture's evaluation programme.

⁽²⁶⁾ Letter of 27 July 2002 from Mr Fischler, the Commissioner for Agriculture, rural development and fisheries.

⁽²⁷⁾ Interview with the Director-General for Agriculture on 13 January 2003.

⁽²⁸⁾ Towards sustainable farming — A mid-term review of the common agricultural policy. COM(2002) 394 final, p. 19.

⁽²⁹⁾ Evaluation of the Community aid scheme for forestry measures in agriculture of Regulation (EEC) No 2080/92, March 2001.

⁽³⁰⁾ 'Evaluation de l'impact des mesures communautaires concernant le gel des terres — Rapport final Janvier 2002' (Evaluation of the impact of Community set-aside measures — final report, January 2002); Evaluation of the common organisation of the markets in the sheep and goatmeat sector — final report, September 2000.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Conclusion

4.87. There remains considerable scope for further improvements in the balance between environmental and agricultural objectives ⁽³¹⁾.

4.88. Although the Commission has taken steps to address the issues, it should continue to ensure the full implementation of mandatory environmental legislation, such as the Nitrate Directive, in the Member States.

4.89. The Commission's proposal in the mid-term review to introduce mandatory compliance with environmental requirements is in line with most of the Court's recommendations in Special Report No 14/2000 to use ecoconditionality rules.

*Community measures for the disposal of butterfat***The Court's findings**

4.90. The common organisation of the market (COM) in the milk and milk products sector provides for a number of aid measures for disposing of butter surpluses on the Community market by encouraging their use in the manufacture of processed foods (pastry products and ice cream) or stimulating their consumption by non-profit-making bodies or by recipients of public assistance. In 2002, the budgetary expenditure devoted to these measures totalled 459 million euro, i.e. 19,4 % of the expenditure of the COM concerned (2 360 million euro).

4.91. In its Special Report No 8/2000 ⁽³²⁾, the Court examined the management of measures for the disposal of butterfat, especially for pastry products and ice cream (87 % of the expenditure in 1999). The Court came to the conclusion that:

- (a) the existing tendering system does not enable the lowest possible Community aid level to be attained; the current tendering procedures should be revised;

4.88. and 4.89. With the Agricultural Council conclusions of 26 June 2003 direct payments shall be subject to cross-compliance. For this purpose a priority list of 18 statutory EU standards in the field of environment (including the Nitrate Directive and the designation of Natura 2000 areas under the Habitat Directive), food safety and animal health and welfare has been established in view of sanctioning the non-respect of these standards by cutting direct payments.

4.91.

- (a) The application of the tender system is considered by Member States and the Commission to be the best method to manage the aid levels and quantities subsidised under the pastry and ice cream scheme.

The objective is specified in the preamble to the Regulation and the indicator for achievement of the aims set for quantities and expenditures, is directly measurable by comparing the quantities actually subsidised with those forecasted.

⁽³¹⁾ Towards sustainable farming — A mid-term review of the common agricultural policy (COM(2002) 394 final, p. 11).

⁽³²⁾ OJ C 132, 12.5.2000, p. 1.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

The way in which the scheme is managed has, over time, ensured disposal of important quantities of butter fat (in total for all measures 555 000 tonnes in 2002 compared with 532 000 tonnes in 1995 or around 30 % of the total butter consumption) which otherwise, to a great extent, would have ended up in public intervention for butter.

The management has enabled the operators to plan regular supplies and ensure stability to the advantage of all parties concerned. At the same time, it has, through the existing tender system, been possible to reduce the aid under the pastry and ice cream scheme, by 42 % from 146 EUR/100 kg to 85 EUR/100 kg (or from 45 % of the butter intervention price to 26 % of the IP) since 1995.

(b) the Commission should consider structural measures to improve demand for non-subsidised butter or to limit its supply;

(c) the Commission should make a comprehensive evaluation of the disposal measures;

(d) aid should be progressively reduced and concentrated only on quality non-imported butterfats used for products where it is likely that additional demand will in fact be created.

The Council ⁽³³⁾ and the European Parliament ⁽³⁴⁾ have supported the Court's observations and recommended that the regulations be revised.

(b) *The Council Agreement on the reform of the CAP includes the reduction of the butter intervention price by a total of 82 EUR/100 kg (or 25 % of the existing IP) over the next four years starting in 2004. This reduction should enhance the non-subsidised disposal of butter and will be reflected in the level of subsidies applied in the milk sector.*

(c) *In 2002, external experts have carried out an evaluation of the common market organisation for milk and milk products including an examination of the butter disposal measures, as requested by the European Court of Auditors.*

(d) *As indicated above, the Commission has, over time, reduced the aid considerably for all eligible products and will continue to do so.*

The surplus measures are introduced to cope with the surplus of milk fat on the EU-market, in practice present in the form of butter. Lower quality butter and imported butter are not eligible for aid as such, but nevertheless form part of the overall supply. These products can be used to produce high quality butter concentrate, which is eligible for aid under the pastry and ice cream scheme. If lower quality butter and imported butter remain on the market, there is a risk of pushing other first quality EU-produced butter into public intervention and the exclusion of imported butter could put into question the EU's international agreements.

⁽³³⁾ The Council's conclusion of 28 February 2001.

⁽³⁴⁾ Resolution of 13 December 2000 on Special Report No 8/2000 (reference A5-0396/2000).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

At present the Commission is, in the framework of the Milk Management Committee with the participation of competent national and EU experts, in the process of consolidating and simplifying the different butter disposal measures.

Action taken by the Commission

4.92. The only changes the Commission made to the regulations were technical amendments relating to the types of tracer and the conditions for approving the establishments authorised to add tracers.

4.92. *As indicated above, the Commission is carrying out a consolidation and simplification of the different butter disposal measures. See reply to points 4.19 and 4.20.*

4.93. Moreover, the Commission had a study carried out to evaluate the milk and milk products COM and the milk quotas Regulation; the resultant final report was sent to it in March 2002. The main recommendations made in this evaluation report are to:

- (a) revise the regulations governing disposal of the products concerned in order to better target the recipients and the aid;
- (b) improve knowledge of the market in butter for pastry products in order to adapt the forms of aid so as to improve the effectiveness of the measures;
- (c) optimise the systems for fixing the rates of aid.

Conclusion

4.94. The evaluation report confirmed the Court's main conclusions and the discharge authority's recommendations. The Commission should therefore carry out an in-depth analysis of the market and propose the necessary amendments to the regulations to improve the effectiveness of the butterfat disposal measures.

4.94. *At present the Commission is, in the framework of the Milk Management Committee with the participation of competent national and EU experts, in the process of consolidating and simplifying the different butter disposal measures.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

PRINCIPAL OBSERVATIONS IN SPECIAL REPORTS

*Subsidies on exports of agricultural products (export refunds)***Introduction**

4.95. The price of agricultural products in the EU is generally higher than the world market price. The EU therefore pays subsidies to exporters to compensate them for the difference between the internal EU and world prices. The main products involved are bulk sugar and cereals, skimmed and whole-milk powder, butter, cheese and beef. In 2001, 3 394 million euro were paid in the form of export refunds ⁽³⁵⁾.

4.96. The Court has published two reports on this subject during 2003. The first concerned the payment of export subsidies several months before goods are exported — 'prefinancing of export refunds' in EU jargon ⁽³⁶⁾. The Court's audit analysed whether the system met its initial objectives and whether it could be usefully simplified, removed or replaced. The second concerned the mechanics of setting the rates of subsidy ⁽³⁷⁾. The Court's audit here set out to establish whether the Commission fixed refund rates in a sound and transparent way which reflected the difference between EU and world prices and on the basis of reliable, up-to-date market information. The principal findings of the two reports are summarised below.

Prefinancing

4.97. Prefinancing allows an export refund to be paid up to 240 days in advance of the physical export. The system has existed since 1969 and was introduced to help maintain preference for EU products. Around 11 % of export refund payments are prefinanced. The system has proved problematic in the past. The last major review by the Commission, in 1997, resulted in significant amounts being recovered from Member States.

4.97. *The Commission services audit all aspects of EAGGF expenditure, including export refunds, in a continuous way and based on a risk analysis. While they have not carried out an audit of the prefinancing regime per se since 1997, they have been actively examining matters related to export refunds. They have also been following the progress of the Court's audit, which began in 2000 and has taken an approach similar to that of the earlier Commission audit. They have taken account of the Court's findings in the risk analysis used to determine its future work programme.*

As a result of this central risk analysis, three clearance of accounts audits were carried out in 2003 to Member States with material expenditure, presenting the opportunity to follow up the Court's observations.

⁽³⁵⁾ Expenditure amounted to 3 622 million euro in 2002.

⁽³⁶⁾ Special Report No 1/2003 (OJ C 98, 24.4.2003).

⁽³⁷⁾ Special Report No 9/2003 (OJ C 211, 5.9.2003).

THE COURT'S OBSERVATIONS

4.98. The system is complicated, time consuming and expensive to administer and control. Much of this derives from the complex regulatory framework. This has led to differences in the way the Member States apply the system and check payments, which, in turn, makes the audit of certain aspects of the system difficult.

4.99. Where firms process goods under prefinancing prior to export (for example, grain into flour, beef into tinned beef) the system becomes more cumbersome and the records used to monitor the processing were not reliable. Prefinancing now often plays a role very different from that foreseen in 1969. It is used to increase control over beef exports and, in the case of cereals, to extend the period during which exporters can use export licences.

4.100. The Court recommended that the system be reviewed and consideration given to its removal. The Commission agreed to carry out a review of prefinancing.

THE COMMISSION'S REPLIES

4.98. *The Commission shares the Court's opinion concerning the complexity of the refund prefinancing arrangements. The Commission has made an effort to improve the implementation of physical checks in the Member States, (e.g. working papers in 1998 and 2002 explaining how physical checks should be carried out) before setting up a new legal framework which, inter alia, aims to further harmonise checks on products subject to prefinancing (see 4.102).*

4.99. *The Commission would agree, regarding prefinancing of beef, that control procedures for paying agencies are cumbersome and costly. The financial guarantee put up by an exporter cannot be liberated until the paying agency has reconciled the quantity placed under prefinancing with the quantity or quantities exported and placed in free circulation in a third country. This reconciliation is a routine and integral part of paying agency procedures. The introduction of database requirement, plus limitation of number of declarations should make this much simpler.*

For processed goods the use of standard yields will, from the 1 October 2003, no longer be applied which represent a considerable simplification.

4.100. *Having carried out the review promised, the Commission has decided to effectively limit the use of prefinancing to the beef and cereals sectors and non Annex I goods, where it is felt that abolition of the regime would oblige the Commission to create other mechanisms that would complicate matters more. The Commission believes that the new system will provide a suitable balance between controls on, and support for, the operators concerned.*

The Court's observations have been addressed by Regulation (EC) No 444/2003 (horizontal matters) and by Regulations (EC) No 456/2003, (EC) No 500/2003 and (EC) No 740/2003 (specific matters). Key elements of these include a shortening of the prefinancing period, a new minimum rate of physical checks, and the provision of suitable information by Member States.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Fixing of refund rates

4.101. The information used by the Commission for fixing refund rates was not always complete or up to date. There were no guidelines or manuals setting out procedures to be followed nor was there systematic evidence of management checks on the rates set. For some product sectors the difference between the EU and world market price quotations calculated by the Commission could not be systematically linked to the calculation of refund rates actually set. The Commission stated that it was not able to ensure that export subsidies for beef did not exceed the difference between EU and world price quotations. The Commission's analyses of skimmed-milk powder and whole-milk powder price quotations showed that the subsidy exceeded the difference between quoted world and EU prices for significant periods covered by the audit.

4.102. The overall conclusion was that the way the Commission set refund rates was insufficiently clear, particularly for beef, milk products and to a lesser extent cereals. The Court made a number of recommendations designed to make procedures clearer, to improve documentation and to facilitate management control. The Commission has reacted positively and is in the process of implementing most of these.

*Sound financial management of the common organisation of the market in dried fodder***Introduction**

4.103. Dried fodder provides less than 2 % of the EU's total crude protein fed to livestock. Nearly all Member States produce dried fodder but the major producers are Spain, France and Italy.

4.104. Aid is paid for dried fodder that leaves the processor and which meets the required criteria for protein and moisture content. Since 1995 there has been a maximum guaranteed quantity (MGQ) to limit budgetary costs.

4.101. *The fixing of the refund rates are supported by analysis and management checks are part of the standard procedure. All fixings are prepared in a meeting with the Director-General and the opinion of a Management Committee is sought by the Director responsible for the sector concerned.*

The improvements in the working methods in the field of fixing export refunds formalised by the Commission on 10 July 2002 correspond to the recommendations made by the Court.

4.102. *The Commission has introduced a comprehensive action plan in response to the Court's observations. The main elements include the information used to set refund rates, a possible increase in the use of tendering (where feasible), and the documentation of internal procedures.*

4.103. *Even if the provided quantity of protein as such is an important element, the protein composition and other qualities required by the different animal categories must be considered as well.*

4.104. *In February 1995, the Council agreed in an overall compromise on dried fodder for a level of aid within an effective upper limit on the EU budgetary expenditure by the introduction of MGQ.*

THE COURT'S OBSERVATIONS

4.105. The objectives of the audit were to examine whether the rates of aid were determined on a sound basis and the detailed rules and procedures introduced ensured effective control. The audit also examined whether appropriate monitoring had been carried out and the impact of the measures had been evaluated.

Audit findings

4.106. The rate of aid paid for artificially dried fodder is almost double that paid for sun-dried fodder. This encouraged producers to switch from sun-drying and to produce artificially dried fodder to the maximum extent possible. EU production has continued to increase since 1995 and the MGQ has been exceeded since 1998/99. Development of the market has been uneven, with some Member States able to exceed their MGQ by as much as 60 % whereas others have consistently failed to produce up to their MGQ.

4.107. Lack of clarity in regulations created opportunities for different interpretations and the introduction of questionable practices in Member States. In certain Member States, some checks were not being carried out, including cross-checking with the IACS system, reconciliation of financial accounts of processors and aid claims. Verification of plants entering the drying process is not required by the regulations. In one Member State marketing companies wholly owned and managed by processors had been set up to enable them to claim that fodder has left their premises, thereby qualifying for aid sooner than if they were transferring ownership to a real third party.

THE COMMISSION'S REPLIES

4.106. *Since 1995, due to the budgetary stabiliser system, an overshoot of the MGQ does not create any additional expenditure to the Community Budget.*

4.107. *The Commission too is very concerned by the different interpretations of its audits in the clearance of accounts procedure.*

In 1999 it carried out a series of audits of agricultural expenditure on dried fodder in the main producer Member States which revealed weaknesses similar to those noted by the Court. However, in view of the other elements making up the inspection systems in the Member States, it considered the financial risk to the EAGGF was limited, with the exception of a few cases where financial corrections were applied.

The Commission has taken note of the comments by the Court concerning the continuation of these weaknesses and will attend to them in future audits.

With regard to the special case of steps taken to speed up the collection of aid, the Commission cannot regard them as open to criticism in themselves. The criterion of leaving the place of production is intended to ensure the effectiveness of physical checks and is designed mainly to ensure that dried fodder does not receive aid twice.

THE COURT'S OBSERVATIONS

4.108. There has been no specific evaluation of this market. Two other major reviews by the Commission, however, provided an opportunity to examine the market and its development. The first was a review of the options for replacing the processed animal proteins banned as a result of the BSE epidemic, which concluded that the best option would be to increase imports of soya rather than pursue more costly alternatives such as increasing production of dried fodder. Market forces would come into play, however, and a variety of methods would be used, including using additional soya.

4.109. The second was the mid-term review of the CAP. This proposed a transfer of aid from processors to fodder growers as part of the single farm payment scheme and single lower-rate interim aid system for processors which would last four marketing years and then cease. The Council decided in June 2003 to maintain a single rate for processors alongside the aid to growers. It has also asked the Commission to report on the fodder sector by 30 September 2008 on the basis of an evaluation.

Recommendations

4.110. The Court recommended that the Commission take the opportunity of reforming the market organisation to review the rules to be applied by Member States to ensure appropriate control.

Production aid scheme for cotton

4.111. This report contains the Court's findings from a sound financial management audit of the production aid scheme for cotton. This scheme had previously been audited in the early 1990s and the findings published in the Court's 1992 and 1995 Annual Reports.

THE COMMISSION'S REPLIES

4.108. *The Directorate-General for Agriculture had planned in 2001 an evaluation of the dried fodder sector but this was postponed in favour of other market priorities.*

An evaluation of the dried fodder scheme is provided for in the Council Decision and is to be completed in time for the Commission Report to the Council by 30 September 2008. As the Court indicates, it should be noted that the sector was included in the analysis presented in the report on protein supply.

4.110. *The Council Compromise of 26 June 2003, based on the Commission proposal ⁽¹⁾, a long-term policy perspective for sustainable agriculture, adopted decoupling for the dried fodder sector and a flat processing aid at the same rate for both dehydrated and sun-dried fodder, while merging the MGQ's.*

The Commission will reassess all these checks in the light of the new reform.

⁽¹⁾ COM(2003) 23 final, 21.1.2003.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

4.112. The overall objective of the scheme is to support the production of cotton and to allow the producers concerned to earn a fair standard of living. The main producer Member States are Greece and Spain. A small amount of production takes place in Portugal.

4.113. The aid is granted to the ginnerers who have to pay a minimum price to the producers. It varies in amount with market prices and on quantities produced. The mechanism used to determine the aid aims to provide the ginnerers with a constant level of income sufficient to cover their operating costs and to allow EU produced cotton to compete on price with the imported product. When selling the cotton to the ginnerers the producers receive an amount approximately two to three times greater than the commercial value of the cotton sold.

4.114. Since the establishment of the scheme in 1981, annual production of cotton in the EU has increased from 0,3 million tonnes to 1,7 million tonnes. This increase reflects the fact that the aid for cotton production is three to four times that paid for crops grown as an alternative. A comparison of the gross margins for cotton and grain maize indicates a ratio of about 1,5 in favour of cotton. About a quarter of the increase in production is due to the accession of Spain to the EEC in 1986.

4.115. In 1987 a stabiliser mechanism was introduced with the objective of reducing the support payable when production exceeds the guaranteed maximum quantity.

4.116. In 2001, a reform of the production aid scheme took place and included a strengthening of the stabiliser mechanism, the effect of which causes a sharp drop in the support payable when production exceeds stated thresholds.

4.117. Higher than expected Greek production in 2001/02 led to an application to have certain production eliminated from the scheme. The examination of this application identified a number of issues regarding quantities eligible for aid and the quantities which should be used to determine the penalty for production in excess of the guaranteed quantities. Amending legislation followed which sets down criteria for establishing such quantities because if ineligible cotton produced goes undetected, all producers are penalised through a higher penalty imposed by the stabiliser mechanism. One criterion for eligibility is that aid should only be paid on quantities coming from areas declared to cotton production under IACS. In practice the national

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authorities in Greece, when deciding on eligible production, are constrained by the weaknesses in IACS. Moreover, the results of checks by the authorities to determine quantities to be excluded from production for the purposes of applying the stabiliser mechanism are inconsistent with the results of checks on individual producers for the purposes of verifying area declarations. In view of the weaknesses in IACS in Greece, the ability of the Commission to monitor the correct application of the stabiliser mechanism is diminished. The Commission wished to introduce a reform of the present scheme to be effective from the marketing year commencing on 1 September 2003. This deadline has not been met and the Commission intends to submit a proposal for the reform of the aid scheme for cotton to the Council and to the European Parliament in the autumn of 2003.

4.118. In any year when the Community expenditure does not reach 770 million euro, the regulations provide for an increase in the amount payable to the producers provided certain conditions are met. In three of the seven years 1995/96 to 2001/02 an increase in support was paid to the producers under this provision. Furthermore, this measure mitigates the effect of the stabiliser mechanism and could be viewed as a bonus payable to the producers. Budget neutrality cannot be assured and expenditure in the other four years exceeded 770 million euro.

4.119. Within the Commission there is a lack of information on the negative impact cotton production can have on the environment and there is no continuous monitoring of the environmental situation in the regions within the Member States where cotton is produced.

4.120. The Commission is unaware of the effectiveness of the incentive given to the ginners to improve the quality of the cotton produced. The amount paid appears to represent unnecessary expenditure and to be a source of additional revenue as it duplicates the revenue obtained from the market place when better quality and increased yields are produced. In addition, the

THE COMMISSION'S REPLIES

4.118. *In the context of a deficiency payments scheme, the expenditure depends by definition, at least partially, on the world prices and consequently budget neutrality as mentioned by the Court cannot be assured.*

As an integral part of the stabiliser this provision is a reduction of the penalty in the level of support when the expenditure does not reach EUR 770 million.

4.119. *Since 2001, on the basis of Council Regulation (EC) No 1051/2002, Member States have taken environmental national provisions, which have been examined by the Commission services.*

The follow-up of these national measures and a subsequent report to be submitted by Member States before the end of 2004 should give the Commission additional information on the environmental situation in the cotton sector.

4.120. *The Commission considers that the fact that the yields in ginned cotton are usually higher than the standard 32 % is an indicator of the effectiveness of the provisions related to the improvement of the quality.*

The quality premiums on the world market prices for ginned cotton are relatively modest and, considering the level of

THE COURT'S OBSERVATIONS

Commission has not reviewed the operating costs incurred by the ginners and is thus unaware of whether the potential exists to reduce Community expenditure by altering the amount of aid paid to the ginners.

4.121. While the audit in Spain did not give rise to material observations, serious weaknesses were observed in the checks undertaken by the Greek national authorities in relation to the area declarations submitted by the producers. The effects of these weaknesses are compounded by the lack of progress in implementing IACS in Greece. For the marketing year 2001/02 the Greek authorities have estimated that about 10 % of the land planted with cotton was either not declared under IACS or was declared as cultivated with another crop. In such circumstances and if not detected, producers receive aid twice for the same parcels of land, once on the basis of the arable crop declaration and again on the basis of the actual production of cotton.

4.122. The Court recommended that the Commission should take the opportunity of the proposed reform to address weaknesses in the present regime (absence of budget neutrality, the attractiveness of the aid rate on quantities produced and the impact of cotton production on the environment). In addition, and with regard to the present scheme, the Court recommended that the Commission review the financial arrangements of the ginners and examine the effectiveness of the incentive given to improve quality.

THE COMMISSION'S REPLIES

the world prices for ginned cotton, might not be a source of significant additional revenue for the ginners.

The Commission has in the past tried to review the operating costs incurred by the ginners but the discussions with the Member States were inconclusive due to the high variability of the results. Consequently, in the context of the 1995 reform, the Council decided to determine the calculation of the world price of unginned cotton on the basis of the historical ratio between the world price for ginned cotton and that calculated for unginned cotton, which took the ginning costs into account.

4.121. *The Commission is well aware of the problems arising from the shortcomings of the IACS in Greece, particularly the system for identifying parcels and inspections there and pays particular attention to both area and other forms of aid during the clearance of accounts procedure.*

The same is true of the under-declaration of areas sown to cotton in Greece. In addition to the problems of the IACS in Greece, this phenomenon relates to the recent introduction of national environmental rules, the desire of certain producers to avoid them and their under-estimation of the importance of the link between quantities produced (the objects of the aid) and the areas where they are grown.

4.122. *The Commission will take the weaknesses mentioned by the Court into consideration when formulating the reform proposals. In addition, it will also take account of the fact that the present regime is highly complicated and not in line with the recent evolution of the CAP.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

*Support for less favoured areas***Introduction**

4.123. Under the aid scheme to support less favoured areas, compensatory aid is granted to 55,8 % of the Community's farms. The annual cost of this aid is around 2 000 million euro, almost half of which is financed by Community funds.

4.124. The Court's audit aimed to establish whether this aid scheme is being implemented in a legal and regular manner, it is being suitably monitored, relevant information is available on its impact, and measures are being taken in due course to remedy any shortcomings ⁽³⁸⁾.

Main findings

4.125. The Commission does not have sufficient evidence at its disposal to corroborate the validity of the classification of less favoured areas. Following the observations made by the Court in 1990, the Commission undertook a review of the existing classification, but it never came to anything, partly because of the opposition of some Member States. Subsequently, even though some statistical indicators tend to show that some regions underwent considerable economic and social development and there was a possibility that some classifications were no longer valid, the Commission did not propose any amendments to the existing regulations.

4.126. The Member States apply a wide variety of indicators to determine whether or not an area is less favoured, and this may lead to disparities in the way aid recipients are treated.

4.127. The Commission does not have sufficient valid information on the impact of the aid scheme and, in particular, on the validity of the level of compensation, thus making overcompensation possible.

4.125. *The bulk of the work on designating 'less favoured areas' (LFA) was completed during the previous programming period (1994 to 1999) on the basis of the information provided by the Member States. Under the new rules for the current programming period 2000 to 2006, the classification has remained stable.*

4.126. *The use by Member States of different indicators within the general criteria established by the Regulation to determine LFA designation reflects the less favoured character in relation to the productive agricultural areas within the Member State or region concerned (and not in comparison with other Member States).*

4.127. *During the process of approving the rural development programs, the Commission examines the system and level of aid proposed.*

Several elements of Council Regulation (EC) No 1257/1999 minimise the risk of overcompensation. The total envelope a Member State has for its rural development program is fixed for the programming period. This envelope has to be allocated to all the rural development measures the Member State wishes to apply. The Regulation also puts a ceiling of EUR 200/ha on the compensatory amount. When exceeding this limit, the Commission requires supplementary information.

⁽³⁸⁾ Special Report No 4/2003 on rural development: support for less favoured areas (OJ C 151, 27.6.2003).

THE COURT'S OBSERVATIONS

4.128. The notion of 'good farming practices' is from now on an important eligibility criterion. However, in the absence of definitions that are clear, verifiable and consistently applied, observance of this basic criterion is difficult to ascertain and the checks made in this respect were found to be insufficiently effective.

4.129. After 30 years of implementation, there has still not been an overall assessment of this aid scheme making it possible to judge its effectiveness.

THE COMMISSION'S REPLIES

Because of the decentralised way in which the measure operates, the Member States are best placed to prevent risks of over-compensation.

4.128. *The definition of good farming practice (GFP) exists in every rural development program. Under Agenda 2000, it was a deliberate policy to define GFP at the level of each Member State/Region in order to deal with real local conditions. In view of the very different environmental situations from region to region, a common code of GFP defined at Community level is not appropriate.*

When approving the RDPs the Commission insisted on clear indications on how the respect of GFP is controlled and verified by the national and/or regional authorities.

The Commission is aware of the complexity of the concept of good farming practices (GFP), which depends on complex rules governing a variety of sectors. That is why in 2000 a practical approach was proposed to the Member States through guidelines. The effective implementation of the management, control and sanction mechanisms by the Member States is assessed during the audits carried out by the Commission.

4.129. *A Community synthesis of the ex-post evaluations is to be completed by the end of 2003. Furthermore, the evaluation methodology for rural development, including LFA, has been reinforced for the current programming period in cooperation with the Member States.*

In accordance with the Regulation (EC) No 1257/1999, Member States quantify, where possible, for the various measures (including LFA measures) objectives which allow progress in implementing the monitoring process to be measured, and which provide a benchmark for the evaluations.

THE COURT'S OBSERVATIONS

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Recommendations

4.130. On the basis of these observations, the Court recommended that:

- (a) a comprehensive, thorough overhaul should be made of the current classification of all the less favoured areas;
- (b) the Commission, working closely together with the Member States, should define a more suitable set of indicators for identifying the less favoured areas;
- (c) relevant information on the impact of the aid scheme in question should be available; any cases of systematic overcompensation should be identified and the necessary corrective measures taken;
- (d) 'good farming practices' should be exactly and verifiably defined or, failing this, support for less-favoured areas should be based on a clearer concept;
- (e) an overall assessment of the aid scheme should be made and relevant indicators should be defined for monitoring the latter.

4.130.

- (a) *The evaluation of the results of the previous programs will provide information on the need for a review of the classification for the next programming period (post 2006). The monitoring and evaluation system put in place for the current programming period has improved the availability of relevant information.*

- (b) *The use of various indicators by the Member State is in conformity with the Regulation.*

The new evaluation system introduced by Regulation (EC) No 1257/1999 will provide the information required for a possible review of the classification criteria.

- (c) *An overall synthesis of the previous programming period will be available before the end of 2003.*

Practical guidelines on how to execute the controls of rural development measures (including LFA measures) have been worked out with the Member State. These guidelines were updated in 2002. The Member States' control systems will continue to be audited.

- (d) *When approving the rural development plans containing the definition of GFP, the Commission also insisted on clear indications on how compliance is monitored and verified by the national and regional authorities via the verifiable standards to be included in the program.*

- (e) *For the period 1994 to 1999, a synthesis will be available by the end of 2003. The monitoring and evaluation system put in place for the current programming period has been improved so that more detailed information will be available. Some of the monitoring indicators may need to be adjusted as more experience is gained in their application.*

ANNEX 1
Evolution of key observations — Agriculture

	2001		2002	
	Observations	The Commission's replies	Observations	Measures still to be taken
Arable crops	Reporting of IACS inspection results needs to be improved and in particular to distinguish between the results of risk-based and random checks (see paragraph 2.44).	Member States are required to report separately the results of cases selected on a risk and random basis with effect from 2000.	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 (see paragraph 4.23).	IACS statistics should provide more detailed information about the categories of transactions tested (see paragraph 4.50). 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 (see paragraph 4.51).
Animal premiums	The Court found discrepancies between, on the one hand, records kept by the farmer and, on the other hand, the declaration on which premiums have been paid (see paragraph 2.23). Reporting of IACS inspection results needs to be improved and in particular to distinguish between the results of risk-based and random checks (see paragraph 2.44).	The quality of record-keeping by farmers is less than satisfactory. IACS Regulations lay down the means to control and proportionately sanction such occurrences.	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 (see paragraph 4.31). Both the results of IACS testing and the direct work of the Court indicate that there is significant risk in this area (see paragraph 4.33).	IACS statistics should provide more detailed information about the categories of transactions tested (see paragraph 4.50).
Subsidies paid on the basis of quantities produced	Aid paid on quantities produced which cannot be verified ex post demand a strong control system. However, the largest schemes of this kind (olive oil and cotton) show particular weaknesses in terms of the implementation of checks by the Member States (see paragraphs 2.28, 2.29, 2.36 to 2.40 and 2.46).	The weaknesses noted by the Court are being, or will be, followed up in the context of the clearance of accounts procedure. As from 1 November 1998, the olive register has been replaced by the geographical information system for olives, for which the deadline for completion is 1 November 2003. Member States are required to conduct an increasing number of on-the-spot inspections. The Commission services are closely monitoring progress in this domain.	Two risks are apparent here: (a) 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; (b) 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) (see paragraph 4.34).	For the olive oil agencies, the Commission should ensure that inspections and results are classified on a consistent basis (see paragraph 4.50).
Cotton	The Court found serious weaknesses in the application of control arrangements in Greece (see paragraphs 2.37 and 2.38).	The incompatibility of parcel identification for cotton in Greece, and the consequent difficulty in confirming the areas of cotton parcels, is the subject of an ongoing enquiry by the Commission services. However, regulatory provisions have already been put into place.		
Rural development	Standards for 'good farming practice' are poorly defined or are unverifiable (see paragraphs 2.30 and 2.31).	The Commission department have striven to ensure a degree of harmonisation between the Member States by issuing recommendations in a guidelines paper.	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 (see paragraph 4.39).	The criterion of good agricultural practice should be clarified or replaced by a more robust criterion.
Other expenditure			The Commission has identified weaknesses in the checks carried out under Regulations (EEC) No 4045/89 and (EEC) No 386/90 (see paragraphs 4.44 and 4.45).	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 (see paragraph 4.50).

ANNEX 2

IACS Indicators

MS	PAYING AGENCY	Area aid				Animal premiums			
		Administrative procedures & controls to ensure correct payment	Risk analysis & selection procedures for inspections	Inspection methodology and reporting of individual results	Preparation and reliability of statistics on inspections and results	Administrative procedures & controls to ensure correct payment	Risk analysis & selection procedures for inspections	Inspection methodology and reporting of individual results	Preparation and reliability of statistics on inspections and results
B	MIN. LANDB	1	2						
	BW		2				2		
	BYL		2			1	2	5	
D	MV						2		
DK	DFFE								
	CAMA LAMA		2		6		2		
	DARP CATA								
E	FAGA ANDA								
	OFIVAL (1)								6
F	ONIC (1)		2		7		2		
IRL	DAF				6				
I	AGEA								
NL	LASER		3	4			2	5	
P	INGA								
S	SJV								
	Commission review over MS paying agency								

A Works well, few or minor improvements required

B Works, but improvements necessary

C Does not work as intended

1 Just adequate administrative procedures & controls to ensure correct payment — due to manner in which penalties and sanctions are applied, calculation of areas on which aid is paid and acceptance of animal identification changes after the inspection notifications.

2 Just adequate risk analysis & selection procedures for inspections — due to lack of evaluation of risk criteria effectiveness. Often, significant irregularities are also not identified. Inspections may be incorrectly classified as risk or random. Selections may be made such that certain categories of claimants are less likely to be picked for inspections, or are picked for inspection every year. Risk criteria does not select enough risk/random inspection, take account of all regulatory criteria, or is not objective.

3 Not adequate risk analysis & selection procedures for inspections — as for category B, plus insufficient risk selection. Some claims may have been excluded from the population for sampling.

4 Just adequate inspection methodology and reporting of individual results — inspections do not cover minimum requirements and quality control of original inspections show different results.

5 Not adequate inspection methodology and reporting of individual results — inspections may not cover all scheme animals, or requirement to carry out inspections within retention period is not complied with. There may be no cross checks with animal database, or discrepancies between animals found, number of passports, herd register and animal database are not resolved. Inspection quality may not be checked.

6 Just adequate preparation and reliability of statistics on inspections and results — due to discrepancies between statistics sent to the Commission and underlying data. No satisfactory explanations of queries arising from analytical review of statistics.

7 Not adequate preparation and reliability of statistics on inspections and results — as for category B, and problems with regional data.

Source: Court of Auditors review of paying agency IACS systems

(1) Note: While OFIVAL is the paying agency for animal premiums, the schemes are administered and inspected by local services of the Minister of Agriculture. While 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.

CHAPTER 5

Structural measures

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INTRODUCTION

5.1. Structural measures concern the implementation of the Cohesion Fund and of the four Structural Funds (SFs): 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 finance socioeconomic development programmes in the 15 Member States and the Cohesion Fund 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⁾.

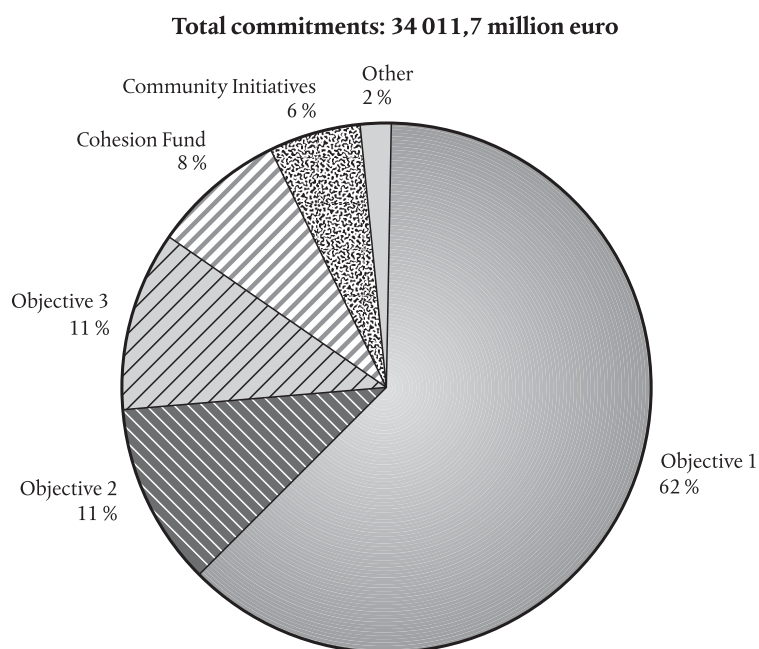
5.2. The structural measures are listed under heading 2 of the financial perspective. For the period 2000 to 2006, this heading accounts for appropriations totalling 230 032 million euro ⁽²⁾. **Graphs 5.1 and 5.2** give a breakdown of the commitments and payments for 2002. Most of the expenditure is directed towards three priority 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 2 % of structural measures expenditure in 2002. These are operations of Community interest carried out at the initiative of the Commission to supplement those implemented under the main programmes. Other expenditure includes specific actions such as the cost of checks on the application of agricultural legislation and participation in fisheries surveillance measures operated by the Member States.

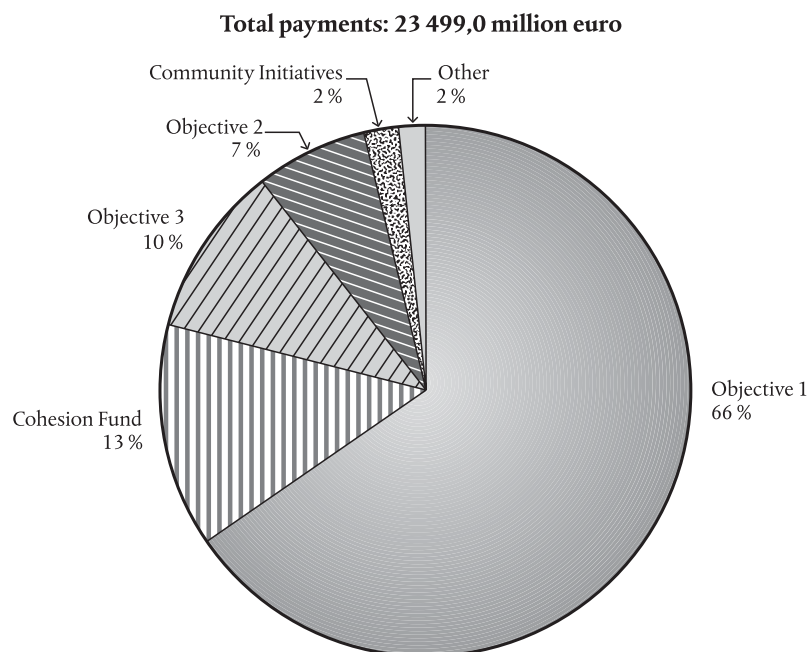
⁽¹⁾ Greece, Spain, Ireland and Portugal.

⁽²⁾ 211 039 million euro for the Structural Funds and 18 993 million euro for the Cohesion Fund (2002 prices).

Graph 5.1 — Breakdown of commitments by budgetary area in 2002

Source: 2002 revenue and expenditure accounts.

NB: For more detailed information see Diagrams III and IV of Annex I.

Graph 5.2 — Breakdown of payments by budgetary area in 2002

Source: 2002 revenue and expenditure accounts.

NB: For more detailed information see Diagrams III and IV of Annex I.

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5.3. Structural measures are managed by four Directorates-General of the Commission on the basis of multi-annual programmes. The Directorate-General for Regional policy manages the ERDF and Cohesion Fund, the Directorate-General for Employment and Social Affairs manages the ESF, the Directorate-General for Agriculture manages EAGGF-Guidance and the Directorate-General for Fisheries manages the FIFG. Each intervention ⁽³⁾ is accompanied by an indicative financing plan which specifies the amount of Community aid and the Member State's contribution. For the 1994 to 1999 and previous programming periods, contributions for structural measures were committed in instalments and were paid in the form of advances and final payments, the latter constituting the 'closure' of the period. Community financing in the programming period 2000 to 2006 takes the form of commitments according to the financial plan, followed by an initial payment, the periodic reimbursement of expenditure declared by the Member States and final payments. These reimbursements are called 'interim payments'. In 2002, 34 012 million euro was committed and 23 499 million euro was paid ⁽⁴⁾.

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Scope and nature of the audit

5.4. The Court's 2002 audit of structural measures concentrated on the evaluation of supervisory and control systems at the Commission and in the Member States including substantive testing at both these levels ⁽⁵⁾ and the follow-up to previous observations on ineligible expenditure.

⁽³⁾ Project in the case of the Cohesion Fund and operational programme or single programming document (SPD) in the case of the Structural Funds.

⁽⁴⁾ See table 2.1 of this report.

⁽⁵⁾ Since only a very small number of forms of assistance were closed during 2002, the audits in the Member States concerned two closures (Cohesion Fund) and 15 interim payments of the period 2000 to 2006. 'Forms of assistance' is a general term to describe operational programmes, single programming documents and Community initiatives.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Evaluation of supervisory and control systems

5.5. The previous audits of the Court concerning the supervisory and control systems for structural measures have revealed weaknesses both in the Commission and in the Member States. These weaknesses have again contributed to the declaration of ineligible expenditure and the making of undue payments. **Annex 1** summarises developments in the main issues arising from the Court's recent audits affecting the legality and regularity of operations.

Systems at the Commission*Risk analyses carried out by the Commission*

5.6. The main risks to the legality and regularity of the expenditure on structural measures arise because management is shared between the Commission and the Member States, because the supervisory and control systems span a large number of different bodies and authorities and because each programming period is spread over a number of years. The Court's examination of the risk analyses carried out by the Directorates-General responsible for managing the structural measures did not give rise to any observations. As in previous years, the Commission recognises the risk that it is unable to provide adequate assurance that operations carried out in Member States for the programming period 2000 to 2006 are legal and regular. In 2002, the Commission concentrated on improving its internal control systems and continued carrying out analyses of the systems descriptions sent by Member States'. However, the checks on Member States' internal controls have not been completed.

The implementation of the internal control standards

5.7. An examination of the activity reports of the Directorates-General managing the structural measures indicates that adequate implementation of the internal control standards (ICSs) ⁽⁶⁾ was still ongoing at 31 December 2002. The Directorate-General for Regional Policy had implemented at least the minimum requirements ⁽⁷⁾ for all of the 24 ICSs. The Directorate-General for Employment and Social Affairs and the Directorate-General for Fisheries had implemented the minimum requirements for 15 ICSs. In the Directorate-General for Agriculture this was the case for 18 ICSs. The ICSs not yet implemented to the minimum requirements were, mostly, in the 'performance and risk management' and 'control activities' categories.

5.5. The Commission refers to its replies given in Annex 1 opposite the Court's observations. The Commission would point out that substantial progress has been made in implementing the internal control standards within the Commission and in its opinion the management and control systems in the Member States have improved.

5.6. The declarations made for 2002 by the Directors-General responsible for the Structural Funds contain a reasonable assurance, even though this is accompanied by reserves and depends on the progress made by the Directorate-General concerned in examining the management and control systems of the Member States (see replies to points 5.10 to 5.13).

In 2002, the Commission continued to devote a major part of its auditing resources to checking the systems put in place by the Member States for the 2000-2006 programming period. It is pursuing this work in 2003 alongside that for the closure of the programmes implemented over the 1994 to 1999 period.

5.7. The Commission undertook to implement the Internal Control standard (ICSs) as soon as possible and, as shown in the table annexed to Chapter 1, the implementation of those still outstanding is under way. The Commission will ensure that they are implemented.

⁽⁶⁾ See paragraphs 1.89 to 1.96.

⁽⁷⁾ See paragraph 1.89.

THE COURT'S OBSERVATIONS

5.8. ICS 17 required all Directorates-General to put systems in place which would allow them to exercise adequate supervision and control over the activities for which they are responsible. The structural measures Directorates-General implemented the systems as required by this ICS, but the Court observed weaknesses in the operation of the systems which put in doubt the ability of the Commission to give adequate assurance on legality and regularity. These weaknesses concern the closure of programmes from before 1994 and the programming period 1994 to 1999 (see paragraphs 5.15 to 5.21), the systems for making interim payments on the programming period 2000 to 2006 (see paragraphs 5.22 to 5.25) and repayment of unused advances (see paragraph 5.35).

Follow-up to the 2001 action plan

5.9. The structural measures Directorates-General began to meet the requirements of the action plan introduced by the Commission to remedy weaknesses identified in 2001 ⁽⁸⁾. However, further progress is needed to complete implementation of actions 4 and 12 of the plan relating to shared management. Action 4 of this plan led the Commission to propose measures on the simplification of the management of the structural measures to the Member States. The proposals were made to take account of the request by Member States that procedures should be simplified, at the same time allowing the Commission to manage the Community budget properly. In its Annual Report for 2001 (paragraphs 3.12, 3.31 and 3.32) the Court pointed out that delays in the implementation of structural measures were in part due to the complexity of the management procedures. The Court also stressed, in its Special Report No 7/2003 ⁽⁹⁾, that the proposed simplification process should be compatible with good management of the structural measures in terms of legality, regularity and sound financial management.

⁽⁸⁾ This action plan contains 18 actions. For example: action 4: With the Council, define the responsibility of the Commission for achieving the objectives in the shared management of the structural measures and the presentation of proposals defining the role of the Commission in the supervision and control of operations; Action 12: Analysis of the problems arising from shared management, presentation of a proposal to the Commission concerning the extent of the authorising officer in each domain of shared management and the preparation of a base allowing the directors-general to take appropriate action in cases of uncertainty or where difficulties are revealed.

⁽⁹⁾ Special Report No 7/2003 on the implementation of assistance programming for the period 2000 to 2006 within the framework of the Structural Funds.

THE COMMISSION'S REPLIES

5.8. *The Commission considers that any remaining deficiencies identified do not seriously put in doubt the quality of its internal control systems. It refers to its responses given to the relevant points.*

5.9. *Under action 4 the Commission has been checking that the management and control systems in Member States meet the required standards, is intensifying the coordination of audit work, and is pursuing an initiative whereby Member States will enter into a 'contract of confidence' which will enable the Commission to rely more directly on national audit work.*

The package of measures to simplify implementation of Council Regulation (EC) No 1260/1999, without amending it, was adopted in April 2003 ('Communication on the simplification, clarification, coordination and flexible management of the structural policies' — C(2003) 1255). The measures concern audit and controls, the mid-term review and programme amendments, indicators, the performance reserve, annual meetings and monitoring committees, reporting and financial management. The communication indicates that the Member States should also streamline their internal procedures, which can be a source of complication. The Commission took account of the requirements of sound financial management in adopting the measures.

In application of action 12 of the action plan, a communication was drafted with the departments concerned in order to clarify the role of directors-general in shared management, within the relevant legal context and within the limits of their responsibilities [C(2003) 1830].

Under the action plan based on the summary report on the annual declarations for 2002, the Commission will further analyse the scope of responsibilities within shared management with a view to issuing a communication, including possible recommendations, by March 2004.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Annual activity reports and declarations of the Directors-General

5.10. The Court notes an improvement in the 2002 annual activity reports prepared by the Structural Measures Directorates-General compared to those of 2001 ⁽¹⁰⁾. However, while all of the Directors-General declare that they have reasonable assurance that the systems guarantee the legality and regularity of the underlying transactions, the declarations contain reservations which highlight serious difficulties, although without any attempt at quantification. Moreover, the assurance given by the structural measures Directors-General is mainly limited to the internal systems, which means that little assurance is given concerning most of the systems operated by the Member States. This reduces the value of the assurance given in the declaration.

5.10. *The scope of the assurance given and of the reservations entered in the declarations of the Structural Fund Directorates-General for 2002 depended to a large extent on the progress they had made in checking the compliance of the Member States' management and control systems for 2000-06 programmes and on the results of these controls. On the basis of the verifications carried out under Article 6 of Regulation (EC) No 438/2001 the Regional Policy and Fisheries Directorates-General were able to give an assurance, with certain reservations, based on both their internal systems and the results of the assessment of the systems put in place by the Member States.*

The Employment and Social Affairs Directorate-General's assurance was limited to its internal systems.

Given the nature of the reservations for 2002 and in particular the continuing dialogue with Member States, quantification was not always appropriate. The Commission also refers to its reply at point 1.101.

5.11. The Director-General for Regional Policy excludes all management and control systems relating to the Cohesion Fund for the post-2000 period, and also gives a reservation on important aspects of the pre-2000 period. For the ERDF post-2000, the Director-General for Regional Policy gives reservations on two Member States (which it had audited in 2001 and 2002) and one region, due to persistent structural weaknesses in the management systems ⁽¹¹⁾. Reservations are also given on three regions for which systems descriptions had not yet been received ⁽¹²⁾. For the other regions and Member States which receive finance in the 2000 to 2006 programming period, the Director-General for Regional Policy concluded that he has reasonable assurance based on desk reviews of systems descriptions and systems audits in the Member States but in the absence of checks on projects. Finally, the Director-General for Regional Policy does not include the Community Initiatives in his declaration of reasonable assurance because desk reviews of the documentation received from the Member States have not been completed.

⁽¹⁰⁾ See paragraphs 9.80 and 9.81 of the Court's 2001 Annual Report.

⁽¹¹⁾ Greece, Spain and Calabria (Italy).

⁽¹²⁾ Piemonte, Emilia-Romagna and Friuli-Venezia Giulia.

THE COURT'S OBSERVATIONS

5.12. The reservation given by the Director-General for Employment and Social Affairs is based on its audits of management and control systems set up by the Member States relating to the 2000 to 2006 programming period and states that the Directorate-General for Employment and Social Affairs does not have reasonable assurance that these systems guarantee the legality and regularity of the underlying transactions at the national or local level. Expenditure related to those systems covers 98 % of all the ESF payments in 2002. Despite this, the Director-General declares that she has reasonable assurance that the control procedures established offer the necessary guarantees regarding the legality and regularity of the underlying transactions.

5.13. The reservations of the Director-General's declaration concerning EAGGF-Guidance cover all of the expenditure on the programming period 2000 to 2006 under the EAGGF-Guidance section, although the amount involved represents only 3,5 % of the total expenditure implemented during the year by the Directorate-General. The reservations stated in the declaration of the Director-General of the Directorate-General for Fisheries are not quantified, but taking into account the systems related to forms of assistance still not verified in the Member States, they can be estimated to cover about 40 % of the FIFG expenditure for 2000 to 2006.

5.14. The Court also notes for all the Directorates-General that for the period 1994 to 1999, the Directors-General do not make reservations for the four Structural Funds. This is not consistent with the observations of the Court (see paragraphs 5.16 to 5.21) and confirmed by the Commission ⁽¹³⁾, which indicate numerous systems weaknesses relating to the period 1994 to 1999.

THE COMMISSION'S REPLIES

5.12. *The Commission confirms that the Directorate-General for Employment and Social Affairs was able to provide reasonable assurance only regarding its own internal control systems and that it had reserves concerning the national, regional and/or local systems responsible for guaranteeing the legality and regularity of all the underlying transactions.*

On the basis of the audit work carried out, the Directorate-General concluded that it could not have assurance that all payments in 2002 were made within a system that guaranteed at national/local level the legality and the regularity of the operations, which does not mean that the whole ESF budget was implemented outside such a framework.

5.13. *By the end of 2002 the Fisheries Directorate-General had verified in the Member States the systems for 8 of the 16 programmes for which it is lead department representing some 60 % of the Financial Instrument for Fisheries Guidance (FIFG) budget for 2000 to 2006. In addition the systems description of one programme representing 5 % had been examined. In its annual activity report the reservations only concern the Member States or programmes where the analysis of system descriptions had not yet been completed.*

5.14. *The reasons why the Structural Funds Directorates-General did not enter reservations in their 2002 annual activity reports for 1994 to 1999 programmes were, firstly, the small amount of payments made for pre-2000 programmes in 2002 and, secondly, the process of pre-payment checks and post-payment audits in place designed to ensure that final payments are regular. Moreover, the Structural Fund Directorates General continued in 2002 their audits of Member States' control systems for 1994 to 1999 programmes, which provided evidence that the Member States visited were taking steps to remedy weaknesses in the systems.*

⁽¹³⁾ Commission reply to paragraph 3.57 of the Court's Annual Report concerning the 2001 financial year (OJ C 295, 28.11.2002).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Closures from periods prior to 1994 to 1999

5.15. At 31 December 2002, 29 million euro (exclusively ESF) remained committed for projects from before 1989 which were not closed. This figure is virtually unchanged from the amount remaining at the end of 2001. Also at the end of 2002, 31 programmes from the programming period 1989 to 1993 remained open, representing almost 100 million euro. More than half of this amount relates to ESF cases, which are now at about 50 % of the value of ESF cases which remained at the end of 2001.

5.15. At the end of 2002, 222 ESF projects involving a total of EUR 28,8 million were still open from before 1989. In 2003, the situation improved: when this reply was drafted (June 2003), 35 projects involving a total of EUR 4,7 million had been closed and 24 projects involving a total of EUR 1,4 million were in the process of being closed. For the ERDF the outstanding commitments on pre-1994 programmes were reduced by the end of 2002 to EUR 20,2 million from the EUR 398,0 million outstanding at the end of 2001.

A considerable proportion of the pre-1994 files concerned are the subject of legal procedures or are suspected to contain irregularities, which justifies the fact that they have not yet been closed (see Commission' reply to points 3.27 and 3.28 of the Court's report for 2001).

The Commission is continuing to give close attention to these cases in the framework of its action plan on the RAL adopted in 2002.

Closures relating to the period 1994 to 1999

5.16. Regulation (EC) No 2064/97 ⁽¹⁴⁾, introduced following the observations made by the Court and the budgetary authority, sets out the supervisory and control systems applicable to 1994 to 1999 programmes and aims to improve the quality of the financial management of the structural measures. It requires that Member States verify the effectiveness of the management and control systems in place and check the expenditure declarations made at the various levels. The checks are to cover at least 5 % of the total eligible expenditure in respect of each form of assistance and be representative and at the same time risk based. Article 8 requires that, no later than at the time of the request for final payment and the final declaration of expenditure in respect of each form of assistance, an independent body presents to the Commission a closure statement summarising the conclusions of these checks and provid

⁽¹⁴⁾ Commission Regulation (EC) No 2064/97 of 15 October 1997 establishing detailed arrangements for the implementation of Council Regulation (EEC) No 4253/88 as regards the financial control by Member States of operations co-financed by the Structural Funds (OJ L 290, 23.10.1997, p. 1).

THE COURT'S OBSERVATIONS

ing an overall conclusion as to the validity of the request for final payment and the legality and regularity of the operations underlying the final declaration of expenditure. The Commission has to ensure compliance of the systems in the Member States with the Regulation. To this end, the Commission coordinates its programme and methods for its checks in the Member States⁽¹⁵⁾ and cooperates with the Member States in order to guarantee that the objectives of Regulation (EC) No 2064/97 are met⁽¹⁶⁾.

5.17. In its Special Report No 10/2001, the Court pointed out that Regulation (EC) No 2064/97 was not sufficiently clear and that adequate guidance was not made available early enough to Member States⁽¹⁷⁾. In the same report the results of the Court's audit indicated that substantial progress was still necessary for the successful implementation of the Regulation. The Court also reported that the Commission's evaluation of Member States' implementation of the Regulation was limited⁽¹⁸⁾.

5.18. During 2002, the Commission continued to carry out checks on systems under Regulation (EC) No 2064/97. Although improvements were noted, cases of serious systems weaknesses were found at the stage where the final declarations of expenditure were already due. Given this fact, the Commission should satisfy itself as to the legality and regularity of the underlying expenditure. In cases of significant doubt, checks have to be carried out on the spot.

THE COMMISSION'S REPLIES

5.17. In its reply to the Special Report the Commission indicated the considerable efforts it had made to provide guidance to the Member States from the date of adoption of Regulation (EC) No 2064/97 onward and referred in particular to the detailed explanations provided in the appendices to the Structural Funds Audit Manual. The Commission has also replied to questions of interpretation of the Regulation raised by Member States.

5.18. The Commission carried out a significant number of audits on the application of Regulation (EC) No 2064/97 in 2001 well before the due date for final declarations of expenditure (see Commission reply to point 3.57 of Annual Report 2001). It carried out further checks in 2002 in preparation for the closure process. The follow-up by the Commission of its audits from 2001 indicated that improvements had been made in the Member States visited to take account of recommendations made. The Commission uses the results of its audit work in examining closure documents and in particular takes account of the weaknesses which had been identified (see reply to point 5.38).

The Commission in any event carried out audits of expenditure in Member States during the programming period before the closure process began and brought the results to the Member States' attention.

⁽¹⁵⁾ Article 6 of Regulation (EC) No 2064/97.

⁽¹⁶⁾ Article 10 of Regulation (EC) No 2064/97.

⁽¹⁷⁾ Paragraphs 20, 26, 75 to 78, 81 and 83 of Special Report No 10/2001 (OJ C 314, 8.11.2001).

⁽¹⁸⁾ Court of Auditors, Annual Report concerning the financial year 2001, paragraph 3.56 and paragraphs 29 to 34 of Special Report No 10/2001.

THE COURT'S OBSERVATIONS

5.19. The Commission only made available guidelines on the closure of programmes under Article 8 of Regulation (EC) No 2064/97 in May 2002 ⁽¹⁹⁾, which was too late given that the regulatory deadline for the Member States to send final payment claims to the Commission was 30 June 2002. Moreover, the guidelines were not always clear. For example, the need to provide data separately by fund when submitting closure statements for multi-fund programmes was not clarified.

5.20. Thus, for a multi-fund programme examined by the Court, the need for annexes to the closure statement to be detailed by fund was dealt with in a coordinated manner by the three Directorates-General concerned, but it took five months to address a request to this effect to the Member State ⁽²⁰⁾. In another case ⁽²¹⁾, the Court observed that a technical problem affecting the conversion of national currencies to euro was not solved until the end of 2002, although the Commission had been aware of the problem since 2001. Instructions on financial corrections for the ESF were only provided to the Member States at the end of 2002 concerning final payment requests introduced during 2001 ⁽²²⁾. The Commission's internal procedures provide for the extension in certain cases of the deadline for paying Member States following receipt of the payment claim (a maximum of two months). However, one Member State audited, to whom this procedure was applied, considered that it had not been adequately informed of the deadlines arising from this procedure, given that the guidelines issued by the Commission in September 1999 ⁽²³⁾ do not cover this aspect. In the absence of such guidance, it was not clear how the extension would be applied or for how long ⁽²⁴⁾.

THE COMMISSION'S REPLIES

5.19. An information note on the application of Article 8 of Regulation (EC) No 2064/97 was discussed at a technical meeting with Member States in September 2001. A more detailed guidance document on the closure statement was discussed with Member States at a technical meeting in February 2002 and the document was finalised in May that year. Closure was also discussed at all the annual bilateral meetings with the Member States' financial control authorities in 2001 and 2002. The guidance was not too late because for virtually all programmes, the bodies concerned had not yet started the preparation of the declarations and the effective deadline was 31 March 2003, as fixed by Article 52(5) of Regulation (EC) No 1260/1999. The contacts with control bodies have not indicated that the guidance is unclear.

5.20. In cases where coordination of positions between Directorates-General is necessary it is inevitable that the closure process will take longer.

The instructions ensured that the Spanish files were dealt with in the same way as those of the other Member States.

The Commission may interrupt the payment period where elements necessary for the closure process must be completed by the Member State. The Member State is formally notified in such cases. The Member States were informed of this at the meetings on closure referred to in the reply at point 5.19 and by a note presented to the Structural Fund committees in September 2002.

⁽¹⁹⁾ Commission document CDRR-02-0026-00.

⁽²⁰⁾ 1994 to 1999 Valle d'Aosta Objective 5b (ESF).

⁽²¹⁾ Ten programmes 1994 to 1999 Germany Objective 3 (ESF).

⁽²²⁾ Eleven programmes 1994 to 1999 Spain Objective 3 (ESF).

⁽²³⁾ SEC(1999) 1316 final.

⁽²⁴⁾ Three programmes in Portugal: PPDR, Pediza, Norte (ERDF).

THE COURT'S OBSERVATIONS

5.21. The Commission has frequently replied to the Court's observations with the statement that adequate checks would be carried out at the closure of the forms of assistance, when the payments relating to the six-year period become definitive. However, the Court's audit revealed that the Commission plans to carry out checks on underlying expenditure only after the final payments have been made. Recoveries will be made after closure if ineligible expenditure is found. Only in exceptional cases will the Commission make checks of the expenditure declared in the Member States before final payment.

Implementation by the Commission of the programming period 2000 to 2006

5.22. Commission Regulation (EC) No 438/2001 ⁽²⁵⁾ lays down detailed rules for the management and control systems to be set up for the programming period 2000 to 2006. The Court's audit examined to what extent the requirements of the Regulation had been met by the end of 2002 at the Commission.

5.23. The Commission did not adopt Regulation (EC) No 438/2001 on setting up the management and control systems until March 2001, by which time most of the forms of assistance had already been approved. As a result, systems were set up late and many of the communications to inform the Commission of the organisation of the managing authorities ⁽²⁶⁾, the paying authorities ⁽²⁷⁾ and the intermediate bodies ⁽²⁸⁾, of the management and control systems established and of the improvements planned, required by the Regulation were not sent by the deadline set.

⁽²⁵⁾ Commission Regulation (EC) No 438/2001 of 2 March 2001 laying down detailed rules for the implementation of Council Regulation (EC) No 1260/1999 as regards the management and control systems for assistance granted under the Structural Funds (OJ L 63, 3.3.2001, p. 21).

⁽²⁶⁾ Managing authority: authority or body designated by the Member State to manage assistance; responsible for the efficiency and regularity of the management.

⁽²⁷⁾ Paying authority: authority or body designated by the Member State for the purposes of drawing up and submitting payment applications and receiving payments from the Commission.

⁽²⁸⁾ Intermediate body: any body which acts on behalf of a managing authority or a paying authority or which carries out tasks on their behalf.

THE COMMISSION'S REPLIES

5.21. The Commission is following a three-phase audit approach to gain assurance with regard to the correctness of the final expenditure that is part-financed. The first phase was the systems audits that have been carried out on the application of Regulation (EC) No 2064/97. The second phase is the desk checking of the closure statements under Article 8 of Regulation (EC) No 2064/97 in the framework of the closure process, which includes any open audit findings and reported irregularities. The third phase is on-the-spot audits of a sample of programmes, on the basis of the Article 8 statements and other closure documentation, to verify the reliability of the closure procedures in the Member States. The Commission considers that this is a sound strategy that avoids the serious delays that would result from undertaking wide-ranging audits of expenditure declared before final payment. During closure the Commission also examines the final implementation reports.

5.23. Part of the requirements to be met by management and control systems, those concerning independent audit, were already known to Member States from Regulation (EC) No 2064/97 and systems had already largely been put in place. The other provisions of Regulations (EC) No 438/2001 and (EC) No 448/2001 were discussed with Member States in the Structural Fund committees between February and November 2000 and were finalised in December of that year, although the Regulations were only formally adopted on 2 March 2001. These, too, were thus known to Member States reasonably early in the programming period. Most Member States sent the system descriptions before the end of 2001, although in most cases further information had to be requested. The Commission would refer to its reply to Special Report No 7/2003, point 55.

In some cases, the establishment of the new management and control systems took time because of the degree of reorganisation this involved (see reply to Special Report No 7/2003, point 56) and because the Member States were preoccupied with closure of the 1994 to 1999 programmes.

THE COURT'S OBSERVATIONS

5.24. The Commission's response to the requirement of the Regulation that it should carry out regular reviews of the operation of the management and control systems in the Member States has been variable between Directorates-General. In some cases, the Commission carried out desk reviews of this information, but did not always make comments, or they were not timely, and has not carried out checks on the system in the Member States. In one case the Commission sent its comments and a request for additional information to the Member State almost two years after receipt of the description sent by the Member State⁽²⁹⁾. Given the systems' weaknesses detected by the Court (see paragraphs 5.26 to 5.32), the Commission should accord the highest priority to completing these systems checks as soon as possible, applying, as the case may be, the regulatory provisions requesting the interruption of payments in cases of serious irregularities⁽³⁰⁾, or when serious failings in the management or control systems are found which could lead to systemic irregularities⁽³¹⁾.

5.25. For the ERDF the Commission was completely satisfied with the descriptions of the management and control systems in only three Member States. When not satisfied, the Commission's reaction was not always consistent. For one multi-fund programme, it stopped payments on one form of assistance because the systems were considered too weak⁽³²⁾. However, it did not take the same action in a similar case for the ESF⁽³³⁾ where the Directorate-General's audit and control unit recommended the interruption of payment in application of the relevant regulatory provisions⁽³⁴⁾.

⁽²⁹⁾ 2000 to 2006 South of Scotland Objective 2 (ERDF).

⁽³⁰⁾ Article 38(5) of Regulation (EC) No 1260/1999 (OJ L 161, 26.6.1999, p. 1).

⁽³¹⁾ Article 39(2) of Regulation (EC) No 1260/1999.

⁽³²⁾ 2000 to 2006 Calabria Objective 1 (ERDF and EAGGF-Guidance).

⁽³³⁾ 2000 to 2006 West Wales and the Valleys Objective 1 (ESF).

⁽³⁴⁾ Article 38(5) and Article 39(2) of Council Regulation 1260/1999.

THE COMMISSION'S REPLIES

5.24. Articles 5 and 6 of the Regulation required a first assessment of the Member States' systems for the sound financial management of Structural Funds on the basis of the descriptions of the systems submitted after the enactment of the Regulation.

This has been largely completed for ERDF and FIFG except Community Initiative programmes. For ESF, the Directorate-General for Employment and Social Affairs carried out 30 system audits in all Member States in 2002. These audits were based on the system descriptions received and analysed and they included conformity testing. For ERDF, the Directorate-General for Regional Policy has produced a report which details the work done in its enquiry into the management and control systems for 2000 to 2006. As the report shows, on-the-spot systems audits were carried out in all the Member States, though without substantive testing. As Article 6 requires, this first assessment will be regularly reviewed.

The desk checks of systems descriptions were delayed in some cases owing to the sheer volume of material submitted especially from Member States with a federal or regionalised structure such as Germany. The Commission intends to continue its system audits in future years, with substantive testing of the effectiveness of the systems in practice. The Commission interrupts or suspends payments in appropriate cases.

5.25. For the systems for ERDF in most Member States the Commission was able to conclude that it had a basis for reasonable assurance subject to the confirmation of certain improvements that had been found necessary on the basis of the desk checks of the information provided and of on-the-spot audits.

In the ESF case referred to, for which an on-the-spot systems audit was carried out, the conclusions of the audit report had not been finalised when payment was made. Given the general obligation of paying within two months and the still preliminary nature of the findings, the Directorate-General for Employment and Social Affairs went ahead with the second interim payment. In the meantime, in response to a letter from this Directorate-General flagging the issues raised by the audit mission, the Welsh authorities indicated that they would introduce improvements to their management and control systems. These will be the subject of a follow-up audit before the end of 2003.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Systems in the Member States: implementation of Regulation (EC) No 438/2001

5.26. The Court examined the management and control systems ⁽³⁵⁾ operated by the Member States by auditing 15 interim payments (in Belgium, Germany, Greece, Spain, France, Austria, Portugal and the United Kingdom) on forms of assistance for the programming period 2000 to 2006 ⁽³⁶⁾. In addition, 149 of the projects funded by these 15 interim payments selected were also audited in order to corroborate the results found in the audit of the systems. **Annex 2** provides an overview of the results of the Court's examination.

5.27. Member States did not always distribute adequate guidance to managing authorities, paying authorities and intermediate bodies on the provision of the necessary management and control systems until the end of 2002. At the end of the third year of implementation of the programming period, some of the procedures had still not been either formalised or applied (see paragraphs 5.28 to 5.29) by the managing and paying authorities and intermediate bodies.

5.28. The Regulation states that management and control systems should include procedures to verify, at least on a sample basis, the delivery of the products and services co-financed and the reality of expenditure claimed. In two forms of assistance audited ⁽³⁷⁾ the procedures provide for at least one visit by the managing authorities (or intermediate bodies) during the life of each project. However, in other cases the procedures are not fully in line with the requirement of the Regulation ⁽³⁸⁾.

5.27. The dissemination by Member States of guidance on the requirements for management and control systems has been a key aspect of the Commission's review of the national systems. It has made appropriate recommendations whenever deficiencies have been found.

5.28. On-site monitoring of projects during implementation and checking of declared expenditure have been a major issue in the Commission's reviews of systems. It, too, has found this to be one of the main weaknesses in the systems as initially described and audited.

⁽³⁵⁾ For its 2001 Statement of Assurance the Court audited 13 interim payments, see paragraph 3.59 of Court of Auditors Annual Report concerning the financial year 2001.

⁽³⁶⁾ Six ERDF, six ESF, two EAGGF-Guidance and one FIFG.

⁽³⁷⁾ 2000 to 2006 Upper Austria Objective 2 (ERDF), 2000 to 2006 Roads, Ports, Urban Development Objective 1 in Greece (ERDF).

⁽³⁸⁾ The failure to respect Article 4 of Commission Regulation (EC) No 438/2001: 2000 to 2006 Castille-La Mancha Objective 1 (ERDF), 2000 to 2006 Roads, Ports, Urban Development Objective 1 in Greece (ERDF), 2000 to 2006 Baden-Württemberg Objective 2 (ERDF) and 2000 to 2006 South of Scotland Objective 2 (ERDF).

THE COURT'S OBSERVATIONS

5.29. The Court identified a number of weaknesses, for example, an incomplete audit trail ⁽³⁹⁾, the lack of a procedures manual ⁽⁴⁰⁾ and the absence of an account for amounts recoverable at the managing or paying authority ⁽⁴¹⁾. In several cases the internal separation of duties between certifying expenditure declared and authorising payment of claims (Article 9(1) of Regulation (EC) No 438/2001) was obscured by the fact that the certificates were signed by the authorising officer ⁽⁴²⁾. In other cases the paying authority had not carried out sufficient checks (as specified in the Regulation) before certifying statements of expenditure ⁽⁴³⁾.

5.30. The Regulation requires Member States to organise checks on operations, which should cover at least 5 % of the total eligible expenditure and be based on a representative sample of the operations approved. By the end of 2002 for the programmes concerned in

⁽³⁹⁾ The failure to respect Article 7 of Commission Regulation (EC) No 438/2001: 2000 to 2006 France outside Objective 1 (FIFG), 2000 to 2006 West Wales and the Valleys Objective 1 (ESF) and 2000 to 2006 Murcia Objective 1 (ESF).

⁽⁴⁰⁾ 2000 to 2006 Nord-Pas-de-Calais Objective 1 (ESF); 2000 to 2006 Flanders Objective 3 (ESF).

⁽⁴¹⁾ The failure to respect Article 8 of Commission Regulation (EC) No 438/2001: 2000 to 2006 Saxony-Anhalt Objective 1 (ESF).

⁽⁴²⁾ 2000 to 2006 Nord-Pas-de-Calais Objective 1 (ESF); 2000 to 2006 West Wales and the Valleys Objective 1 (ESF), 2000 to 2006 Flanders Objective 3 (ESF) and 2000 to 2006 France outside Objective 1 (FIFG).

⁽⁴³⁾ The failure to respect Article 9(2)(b)(ii) of Commission Regulation (EC) No 438/2001. For 2002 this observation relates to the 2000 to 2006 South of Scotland Objective 2 (ERDF), the 2000 to 2006 Roads, Ports, Urban Development Objective 1 (ERDF) in Greece, 2000 to 2006 France outside Objective 1 (FIFG) and 2000 to 2006 Valencia Objective 1 (EAGGF-Guidance).

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5.29. The Commission's audits have also discovered a number of shortcomings in the audit trail, in the recovery procedures and in the separation of functions inside the management and payment authorities. The Commission has required changes in such cases. The existence of a debtors' ledger has been verified and corrective action is being required where appropriate in the Commission's recent enquiry into irregularity reporting and follow-up, on which it will report in late 2003.

In the two ESF cases referred to, Belgium and France (footnote 40), even though the procedures had not yet been formalised, they were nevertheless in place.

As regards the French ESF cases (footnote 42), the organisation put in place complies with the rules. In addition, the Commission obtained from the French authorities the creation in the regions of a certification unit separate from the managing units.

As regards the other cases, the Commission is in the process of examining the Court's observations and the replies from the national authorities. It will take the necessary measures, including, where appropriate, on-the-spot audits.

5.30. The Commission, too, has identified the late start of independent sample checks as one of the main faults in the management and control systems for 2000 to 2006 and has impressed on Member States the urgent need to catch up on this work. However, the Commission considers that the delays will not be as serious as those encountered for 1994 to 1999 programmes, as the requirements are now well known and the audit resources in place in most instances. The Commission refers to the guidance note on sample checks that will be included in the updated Audit Manuals for the Structural Funds and the Cohesion Fund (doc. CDRR/03/0034/00).

For the cases concerning the separation of checks, the Commission will take steps to verify the information provided by the Member States that adequate separation now exists.

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the Court's audit, the Member States had either not yet started carrying out these checks, or were carrying them out at a level well below 5 %. This means that similar problems of late implementation of the checks reported for the previous programming period (see paragraphs 5.16 to 5.21) are likely to recur for the programming period 2000 to 2006. The Regulation stipulates that Member States should ensure that these checks are separate from implementation or payment procedures concerning operations. Two cases were found where this requirement was not met ⁽⁴⁴⁾. For four of the 15 operational programmes audited, Member States had not checked the systems set up to implement the Regulation ⁽⁴⁵⁾.

5.31. A majority of Member States had not informed the Commission by 30 June 2002 of the application in 2001 of the checks described in the preceding paragraph and of any changes to the management and control systems ⁽⁴⁶⁾, and four of these ⁽⁴⁷⁾ had still not sent a complete report by March 2003. The Commission had not issued a standard structure for the reports and had not reminded the Member States concerned of the missed deadline.

5.32. In conclusion, numerous weaknesses were detected by the Court's audit of a sample of Member States' supervisory and control systems established to meet the requirements of Regulation (EC) No 438/2001. Only in one Member State were all the requirements of the Regulation found to have been applied for the form of assistance examined ⁽⁴⁸⁾. The management and control systems examined do not all yet satisfy the regulatory requirements, although the programming period 2000 to 2006 is already into its fourth year of operation. The Commission has already made many interim payments (about 15 % of total expenditure for the period 2000 to 2006) without having sufficient assurance that the national supervisory and control systems are

5.31. Seven Member States submitted their annual financial control reports to the Commission by or around the deadline. A further seven Member States sent reports by the end of 2002, but in three cases the transmissions were incomplete. In one case the whole report only arrived in the first part of 2003. The Commission reminded Member States that had not sent their reports of this requirement informally during the preparation of the annual financial control coordination meetings in the autumn of 2003. A standard structure of report was presented at the annual financial control coordination meetings with Member States.

5.32. The provisions for reviewing Member States' management and control systems under Articles 5 and 6 of Regulation (EC) No 438/2001 do not require the process to be completed before any interim payments are made.

The Commission has also identified weaknesses in its desk checks and on-the-spot audits. There are certainly further improvements to be made, and the Commission has not yet been able to complete its checks of all systems or to verify the effective functioning of the systems. The Commission refers to its replies to the observations of the Court at points 3.66 to 3.72 of its Annual Report for 2001.

⁽⁴⁴⁾ 2000 to 2006 South of Scotland Objective 2 (ERDF); 2000 to 2006 Baden-Württemberg Objective 2 (ERDF).

⁽⁴⁵⁾ 2000 to 2006 Upper Austria Objective 2 (ERDF); 2000 to 2006 Roads, Ports, Urban Development Objective 1 in Greece (ERDF), 2000 to 2006 Castile-La Mancha Objective 1 (ERDF) and 2000 to 2006 South of Scotland Objective 2 (ERDF).

⁽⁴⁶⁾ Article 13 of Commission Regulation (EC) No 438/2001.

⁽⁴⁷⁾ Spain, Ireland, Italy and the United Kingdom.

⁽⁴⁸⁾ 2000 to 2006 Upper Austria Objective 2 (ERDF).

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functioning as required. The findings reported in paragraphs 5.40 and 5.41 confirm that this affects the legality and regularity of operations.

Results of substantive testing at the Commission

Commitments and payments

5.33. The Court audited a random sample of 57 commitments and 57 payments. There were few observations and none of these were material (see also paragraphs 5.26 and 5.40).

Outstanding commitments

5.34. The Court audited a random sample of 88 commitments that were still open at the end of 2002, and a single error ⁽⁴⁹⁾ was identified (see also paragraphs 5.15, 5.19, 5.20, 5.36 and 5.37).

Repayment of unused advances

5.35. Regulation (EC) No 1260/1999 requires ⁽⁵⁰⁾ that all or part of a payment on account, depending on progress towards implementation of the assistance, shall be repaid to the Commission if no payment application is sent to the Commission within 18 months of its decision to grant a contribution from the Funds. The rule was not applied during 2002 although for 62 programmes (totalling 946 million euro ⁽⁵¹⁾) no expenditure declaration was received by the eighteen-month deadline. For 38 of these programmes (866 million euro), a declaration was nevertheless received in 2002. For the other 24 programmes (80 million euro), there remained no declaration at the end of 2002. The Commission considers that in the case of multi-fund programmes, if a payment claim has been received for any one of the funds, that is sufficient for the rule not to be applied to the other funds. This is a loose interpretation of the Regulation, and does not encourage balanced implementation of different parts of programmes.

5.35. *The Commission's interpretation of Article 32(2) referred to by the Court keeps to the letter of the Regulation, which requires only the submission of a 'payment application' for an 'intervention' (and not for each Fund). The Commission confirmed this in its communication to the Member States on simplification of the management of the Structural Funds (C(2003) 1255 of 25 April 2003).*

⁽⁴⁹⁾ ESF, Portugal Objective 1, OP 904001P1.

⁽⁵⁰⁾ Article 32, paragraph 2.

⁽⁵¹⁾ 572 million euro ERDF, 349 million euro ESF, 21 million euro EAGGF-Guidance and 4 million euro FIFG.

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Closures from the period 1994 to 1999

5.36. During 2002, 10 operational programmes (OPs) out of 605 and 26 Community Initiatives out of 499 from the programming period 1994 to 1999 were closed and decommitted. A further four final payments on Objective 1 OPs were made although the decommitments had not yet been made, as there was the possibility that they would be contested by the Member State.

5.37. Around 200 of the 650 closure statements received by the Commission were not accepted, for example where it could not be determined whether all the issues raised in previous checks had been addressed or where the information provided did not contain sufficient details on the checks carried out. In other cases, the closure statements were rejected because of doubts about the independence of the auditors carrying out checks, or of the provider of the closure statement⁽⁵²⁾. Other reasons for not making the final payments arose from the failure of Member States to provide adequate and clear closure statements⁽⁵³⁾ or to gain the approval of the Monitoring Committee before submitting final reports to the Commission⁽⁵⁴⁾.

5.38. Thirty-five 1994 to 1996 Objective 2 OPs were also closed in 2002. The Court audited the 14 1994 to 1999 OPs and eight of the 1994 to 1996 Objective 2 OPs closed during 2002. The Court's audit revealed cases where payments were made although the Commission's own checks gave rise to doubts⁽⁵⁵⁾. In other cases, the information in the final report was not adequate, yet the final balance was paid and in those cases where indicators were established, they were in many cases not quantified⁽⁵⁶⁾. A final payment was also found to have been made where the checks carried out to meet the requirements of Article 3(2) of Regulation (EC) No 2064/97 had not always been made by bodies independent of the management of the programmes concerned⁽⁵⁷⁾. Other cases were noted where the content of these checks was not sufficiently explicit

5.38. *The Commission is carrying out its examination of the closure statements on the basis of detailed checklists. The analysis is based on the requirements of the Regulation and takes account of the guidance given notably in the document of 7 May 2002. It covers both the formal aspects and the substantive elements and results in a conclusion as to whether the closure statement provides an adequate basis for payment of the final balance. Where other sources of information are available, such as audits of the Commission, these are taken into account also. It is possible therefore, and in the Commission's view justifiable, that a deficiency with regard to one element does not automatically give rise to the rejection of the statement, where there is sufficient assurance from other information available that this did not have a material effect on the conclusions drawn.*

With regard to the particular cases cited:

For the Irish OP 'Transport' the closure statement refers to the additional work undertaken on behalf of the independent body by the Financial Control Unit in Ireland which established that measures had been taken to correct earlier weaknesses. The independent body qualified its opinion by referring to the lack of functional independence of certain bodies carrying out

⁽⁵²⁾ EAGGF Guidance programmes in Germany.

⁽⁵³⁾ FIFG programmes in Denmark and Ireland, ERDF.

⁽⁵⁴⁾ Several Spanish programmes (ESF) and 1994 to 1999 Madeira Objective 1.

⁽⁵⁵⁾ 1997 to 1999 Schleswig-Holstein Objective 2 (ESF) and 1994 to 1999 Ireland Transport Objective 1 (ERDF).

⁽⁵⁶⁾ Several Objective 1 and Objective 2 programmes (ERDF).

⁽⁵⁷⁾ 1994 to 1999 Ireland Transport Objective 1 (ERDF).

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or the sample was not selected on the basis of a risk analysis or where the sample was considered adequate despite the absence of checks by the body providing the closure statement ⁽⁵⁸⁾, or the final expenditure statement did not contain enough detail ⁽⁵⁹⁾.

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control and the lack of application of risk analysis. However, the body goes on to say that these issues were not so significant as to impugn the quality of the verification work undertaken. This opinion, for which adequate evidence was provided, was accepted by the Commission. It should also be noted that there is no express requirement in the Regulation for functional independence of the control bodies.

As regards the Irish Tallaght Hospital programme the review of the control work done by the Financial Control Unit revealed that a random selection had taken place ensuring representativity in the sample. The Commission accepted that since more than 5 % of expenditure was checked and a random selection had been carried out, the control work done provided a sufficient basis for the conclusions of the independent body.

With the Reform of the financial circuits, the Directorate-General for Employment and Social Affairs decided that Article 8 declarations have to be treated by the geographical units which have the responsibility to decide on their acceptability. In the case of Germany (footnote 55, Schleswig-Holstein, Objective 2 ESF), following the audit carried out by the Commission, the geographical unit obtained additional information from the Member State concerning the Article 8 declaration, which allowed it to deal with the file.

Results of substantive testing in the Member States

5.39. Most payments made by the structural measures Directorates-General in 2002 related to the programming period 2000 to 2006. As noted by the Court in its 2001 Annual Report ⁽⁶⁰⁾, the implementation of the management and control arrangements for the period 2000 to 2006 has been marked by delay. Regulation (EC) No 438/2001 was not adopted in time to ensure that all structures were operational and that independent auditing of the operations was carried out during 2002. The same types of errors observed by the Court during its 2001 audit were again observed in 2002.

5.39. The Commission refers to its replies to points 5.23 and 5.30.

Regulation (EC) No 438/2001 was adopted at the beginning of 2001 and took over many of the existing provisions of Regulation (EC) No 2064/97. Delays in sample checks by Member States were mainly due to the need to complete checks for 1994 to 1999.

⁽⁵⁸⁾ 1994 to 1999 Tallaght hospital Ireland Objective 1 (ERDF); 1994 to 1999 Ireland Transport Objective 1 (ERDF); 1994 to 1999 Global subsidy in Sepri, Italy, Objective 1 (ERDF).

⁽⁵⁹⁾ 1994 to 1999 Tallaght hospital Ireland Objective 1 (ERDF).

⁽⁶⁰⁾ Paragraph 3.82.

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Interim payments 2000 to 2006

5.40. The Court carried out substantive tests in order to corroborate the results of the systems audits reported in paragraphs 5.26 to 5.32. In its audit of 15 interim payments in eight Member States both at the Commission and at Member State level (for which 149 projects were audited), the Court noted a large number of errors at the final beneficiaries' level. The weaknesses in the management and control systems described in paragraphs 5.26 to 5.32 allowed the persistence of a level of errors similar to those found in previous years and programming periods. The most frequent errors affecting the eligibility of expenditure were the inclusion of actions or persons unrelated to the programmes concerned ⁽⁶¹⁾, failure to take account of revenue generated or other income when calculating the net cost of projects ⁽⁶²⁾, the same expenditure being declared more than once ⁽⁶³⁾, expenditure without supporting documents ⁽⁶⁴⁾, the use of arbitrary cost allocation rates ⁽⁶⁵⁾, calculation errors ⁽⁶⁶⁾ and several other failures to respect Community rules ⁽⁶⁷⁾.

5.40. *Given that the Commission has not been able to complete its examination of all the replies of the Member States, it will carry out the necessary analysis and make corrections where appropriate.*

⁽⁶¹⁾ 2000 to 2006 Roads, Ports and Urban Development in Greece Objective 1 (ERDF); 2000 to 2006 Castile-La Mancha Objective 1 (ERDF); 2000 to 2006 Nord-Pas-de-Calais Objective 1 (ESF); 2000 to 2006 South of Scotland Objective 2 (ERDF).

⁽⁶²⁾ 2000 to 2006 Castile-La Mancha Objective 1 (ERDF); 2000 to 2006 Nord-Pas-de-Calais Objective 1 (ESF); 2000 to 2006 South of Scotland Objective 2 (ERDF) and 2000 to 2006 Flanders Objective 3 (ESF).

⁽⁶³⁾ 2000 to 2006 Castile-La Mancha Objective 1 (ERDF); 2000 to 2006 Nord-Pas-de-Calais Objective 1 (ESF).

⁽⁶⁴⁾ 2000 to 2006 Roads, Ports and Urban Development in Greece Objective 1 (ERDF); 2000 to 2006 Castile-La Mancha Objective 1 (ERDF); 2000 to 2006 Lisbon and Tagus Valley Objective 1 (ESF); 2000 to 2006 Nord-Pas-de-Calais Objective 1 (ESF); 2000 to 2006 Flanders Objective 3 (ESF); 2000 to 2006 South of Scotland Objective 2 (ERDF); 2000 to 2006 West Wales and the Valleys Objective 1 (ESF) and 2000 to 2006 Saxony-Anhalt Objective 1 (ESF).

⁽⁶⁵⁾ 2000 to 2006 Flanders Objective 3 (ESF).

⁽⁶⁶⁾ 2000 to 2006 France outside Objective 1 (FIFG) and 2000 to 2006 Flanders Objective 3 (ESF).

⁽⁶⁷⁾ 2000 to 2006 Roads, Ports and Urban Development in Greece Objective 1 (ERDF); 2000 to 2006 Castile-La Mancha Objective 1 (ERDF); 2000 to 2006 France outside Objective 1 (FIFG); 2000 to 2006 South of Scotland Objective 2 (ERDF); 2000 to 2006 Baden-Württemberg Objective 2 (ERDF) and 2000 to 2006 Valencia Objective 1 (EAGGF-Guidance); 2000 to 2006 Flanders Objective 3 (ESF) and 2000 to 2006 Nord-Pas-de-Calais Objective 1 (ESF).

THE COURT'S OBSERVATIONS

5.41. The errors of a formal nature are also similar to those of previous years, namely failure to conserve underlying evidence ⁽⁶⁸⁾, co-financing of expenditure not yet defrayed ⁽⁶⁹⁾ or minor failures to respect Community rules ⁽⁷⁰⁾.

Cohesion Fund closures 1994 to 1999

5.42. The Court audited two Cohesion Fund projects closed in 2002. In one project it was found that expenditure had been co-financed without adequate evidence of the reality of this expenditure ⁽⁷¹⁾.

5.43. For another Cohesion Fund project ⁽⁷²⁾ weaknesses were noted in the tendering procedures for the selection of the bidder to construct and participate in the operation and ownership of the project. The procedure of awarding the contract lasted more than four years and certain decisions made by the Evaluation Committee were disputed by one of the tender parties ⁽⁷³⁾. In addition, the part of the project which qualified for Community support was not sufficiently described or quantified in the project application, the Commission decision approving the project or the payment claim.

Follow-up to previous observations on ineligible expenditure

5.44. As in previous years, the Court audited the action taken by the Commission concerning the substantive errors reported by the Court. Although improvements were noted in the follow-up procedure, there remain a number of cases from the 1998, 1999 and 2000 Statements of Assurance for which follow-up has not been timely, appropriate or complete.

THE COMMISSION'S REPLIES

5.41. *The replies of the Member States to formal errors will be analysed and necessary follow up undertaken.*

5.42. *The issue raised by the Court relates to fees for technical assistance provided by a public organisation. The Commission considers that, having regard to the nature of the services provided, a flat-rate fee was justified.*

5.43. *The Commission considered, following examination of the complaint, that the Greek authorities had complied with Community rules in the award of the main contract.*

The project description in the decision and the subsequent quantification were considered adequate to meet the standards prevailing at the time (1996). Since then, however, there have been substantial improvements made to funding decisions, including in particular specific cost estimates for each item of works as well as the physical quantities for each item.

⁽⁶⁸⁾ 2000 to 2006 Murcia Objective 1 (ESF); 2000 to 2006 South of Scotland Objective 2 (ERDF); 2000 to 2006 Baden-Württemberg Objective 2 (ERDF) and 2000 to 2006 Flanders Objective 3 (ESF).

⁽⁶⁹⁾ 2000 to 2006 South of Scotland Objective 2 (ERDF); 2000 to 2006 Baden-Württemberg Objective 2 (ERDF) and 2000 to 2006 Saxony-Anhalt Objective 1 (ESF).

⁽⁷⁰⁾ 2000 to 2006 Roads, Ports, Urban Development Objective 1 (ERDF) in Greece; 2000 to 2006 South of Scotland Objective 2 (ERDF) and 2000 to 2006 West Wales and the Valleys Objective 1 (ESF).

⁽⁷¹⁾ Portugal Cohesion Fund Project No 96/10/61/001-012.

⁽⁷²⁾ The new Athens International airport at Spata, Cohesion Fund project 95/09/65/040.

⁽⁷³⁾ This was due mainly to the changes in the selection criteria and contract terms, and the way the negotiation process with the two last bidders was handled.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

1998 and 1999 Statements of Assurance

5.45. For a number of cases examined by the Court, the Commission had already followed up the errors reported in 2000 or 2001. In some cases, no evidence was available to demonstrate that the expenditure concerned had been reimbursed or excluded from the final declaration of expenditure ⁽⁷⁴⁾. In other cases, the Commission initiated follow-up action, but once it had received information from the Member States concerned, it did not continue to take action ⁽⁷⁵⁾. In other cases, the Commission could not continue its follow-up action because the Member States concerned did not send the necessary information ⁽⁷⁶⁾. In the case of one closed programme ⁽⁷⁷⁾, the Commission communicated its final position on the case to the Member State in 2002, but no recovery order has yet been established.

5.45. *For the three cases from 1998 cited in footnote 79, the Commission has in the meantime recovered the funds from the Member State in question.*

Concerning the Irish Tourism OP 1989 to 1993 the Commission adopted a correction decision on 3 April 2003 following the same approach as suggested by the Court of Auditors, whereby it extrapolated the result of errors in projects selected at random. The total correction applied was EUR 4 926 067,72.

The cases for which the Commission could not yet complete the follow-up due to lack of information from the Member States relate to programmes from the 1994 to 1999 period which are now being closed. The Commission will take appropriate follow up action at the closure of these two programmes.

As regards the closed programme referred to by the Court, following further exchanges with the Member State a correction decision is currently being established.

⁽⁷⁴⁾ 1994 to 1999 Bavaria Objective 5b (ERDF); 1989 to 1993 Martinique Objective 1 (ERDF), 1992 to 1993 Pays de la Loire Objective 1 (ERDF), 1989 to 1992 PIM PACA Objective 1 (ERDF).

⁽⁷⁵⁾ 1989 to 1993 Tourism Ireland Objective 1 (ERDF; 1992 to 1993 North Rhine-Westphalia Objective 2 (ERDF).

⁽⁷⁶⁾ 1994 to 1999 Greece Industry (ERDF) (the Court audited this OP again in 2000 and noted that the error had not been corrected and continued to affect the eligibility of expenditure); 1994 to 1999 POP Campania Objective 1 (ERDF).

⁽⁷⁷⁾ 1989 to 1991 Fife Objective 2 (ERDF). This case was referred to in the Court's Annual Report 2001, paragraph 3.101.

THE COURT'S OBSERVATIONS

5.46. In two other cases ⁽⁷⁸⁾, the Commission did not accept the errors reported by the Court, but the Court is not convinced by the Commission's arguments and considers that the Commission should make a recovery on the project ⁽⁷⁹⁾.

5.47. It is a matter of concern that so many cases have not been properly followed up so long after they were first reported to the Commission and the Member States concerned and despite the fact that the Court has already followed up these cases in its 2000 and 2001 Annual Reports.

2000 Statement of Assurance

5.48. For some cases, no follow-up action has been taken, as agreement was not reached between the Court and the Commission or between the Commission and the Member States concerned. For one OP, the Member State did not agree with the Court's observations that the Community financing rate did not take account of the expected income to be generated by the project ⁽⁸⁰⁾. Although the Commission requested the Member State to substantiate its position, no evidence has yet been provided.

⁽⁷⁸⁾ 1994 to 1999 Central Macedonia Objective 1 (ERDF) and 1997 to 1999 United Kingdom Objective 3 (ESF).

⁽⁷⁹⁾ The error in Greece concerned the failure to carry out an environmental impact study before approving the project. The Commission based its rejection on an opinion delivered by the Directorate-General for the Environment. The Court does not agree with the Commission's argument that it was not necessary to carry out a study as it concerned the modernisation and extension of an existing road rather than the construction of a new road. The error in the United Kingdom concerns a project in the context of the 'equality of opportunity between men and women' measure. The Court maintains that the expenditure on this project, totalling 1,16 million euro, is not eligible because, contrary to the objectives of the measure, the promoter did not organise specific courses but financed participants attending various general courses without documenting the relevant selection criteria.

⁽⁸⁰⁾ 1994 to 1999 Eastern Macedonia and Thrace Objective 1 (ERDF).

THE COMMISSION'S REPLIES

5.46. For the ERDF case mentioned (OP Macedonia Greece), the Commission considers that its decision not to carry out a recovery for the project was adequately justified.

The Court and the Commission disagree over the ESF case referred to. The Commission refers to its reply to point 3.103 of the Annual Report for 2001.

5.47. The Commission considers that there are now only six cases from the 1998 and 1999 reports whose follow-up has not been completed.

The fact that the cases take longer than desired to be resolved does not necessarily mean they are not being properly followed-up by the Commission services. Account has to be taken of the fact that the follow-up of the cases often involves further exchanges of information with the national authorities and the recipients of the funds concerned in the Member States.

5.48. The Commission takes, as a general rule, action as regards the cases reported by the Court, even in case of disagreement of the Member State. When significant discrepancies arise between the facts reported by the Court and by the Member State, the Commission requests the Member States to substantiate their position before deciding on the course of action.

For the case referred to by the Court, the Member State was requested to substantiate its position before deciding on the follow-up action to take. The Commission has received, further to the Court's work, information from the Member State. These elements will be examined and the Commission will take appropriate action at the closure of the programme, which will take place shortly.

THE COURT'S OBSERVATIONS

5.49. In another case ⁽⁸¹⁾, the Court observed that the equipping of vehicles was eligible, but not their purchase. The Commission disagreed with this point of view and has not followed up the case. The Court, however, maintains that the rules do not allow for the purchase of vehicles which may have multiple uses, and that if the Commission had been willing to make an exception to this, the rules should have been modified accordingly.

5.50. The Court's observation related to the co-financing of the construction of a radio cable between an area eligible for co-financing and an area not eligible. The Court concluded that only 50 % of the project should have been co-financed. The Commission disagreed with this conclusion, but the Court continues to consider that the justification provided was not adequate.

5.51. In two other cases, although the Commission agreed with most of the Court's observations, follow-up remains insufficient. In the first case ⁽⁸²⁾ recovery of expenditure that was not in accordance with the tender and the initial contract had not been initiated and there was no follow-up to the Commission decision that sufficient account had not been taken of the revenue generated. In the second case ⁽⁸³⁾, the Commission waited until the end of 2002 before contacting the Member State concerned.

5.52. As in the past, it was found that the Commission rarely extends its investigations beyond the samples examined by the Court (see **Annex I**).

Conclusions

Evaluation of supervisory and control systems

5.53. The structural measures Directorates-General made considerable efforts to improve the systems of supervision and control during 2002. Progress is notable in the systems internal to the Commission. However, the systems of fundamental importance in ensuring the supervision and control over the implementation of the Community budget are those governing the areas of shared management with the Member States. The Court's audit again revealed numerous weaknesses in these systems which must be addressed urgently. The declarations of the directors-general do not yet enable the Court to take assurance from them.

THE COMMISSION'S REPLIES

5.49. *The Commission considers that the current rules applicable to the European Regional Development Fund do not prohibit the part-financing of the purchase of vehicles, provided that this is justified in the context of a particular eligible action to be part-financed. The Commission concluded that the vehicles in question were not of a multiple-use nature, as they were police patrol vehicles to be equipped with advanced communication instruments.*

5.50. *The main reason for accepting the part-financing of the totality of the project was that, in spite of the fact that part of the project was physically located outside the eligible area, the benefit of the action was wholly for the eligible area.*

5.51. *The Commission is following up these cases but on the first case considers that the revenues generated have been sufficiently taken into account.*

5.52. *In clear cases of systemic problems, the Commission does extend the follow-up action, for example in relation to public procurement in Spain. Furthermore, the Commission takes account of findings of the Court as far as possible in its own audit planning.*

5.53. *From the substantial work that has been carried out for the 2000 to 2006 period, the Commission has been able to conclude that Member States have in general made significant steps in improving their systems. However, there are certainly further improvements required, and the effective functioning of the systems needs to be regularly verified. The Commission will pursue its audit strategy to achieve this aim in order to provide a basis for assurance as to payments made by the Funds.*

The Commission refers to the Action Plan to strengthen monitoring and control of the implementation of the Community budget within the framework of shared management (actions 4 and 12) and to its reply to point 5.9.

⁽⁸¹⁾ 1997 to 1999 'Sicurezza per lo sviluppo del Mezzogiorno Objective 1' (ERDF).

⁽⁸²⁾ Cohesion Fund 'Chalkida' project in Greece (ERDF).

⁽⁸³⁾ 1994 to 1996 Piedmont Objective 2 (ERDF).

THE COURT'S OBSERVATIONS

Commission's assurance on the legality and regularity of operations

5.54. Little progress has been made in closing interventions either from the periods before 1994 or from the programming period 1994 to 1999. The implementation of Regulation (EC) No 2064/97 for the programming period 1994 to 1999 has encountered problems such as guidelines being issued too late resulting in misunderstandings by Member States or failure to set up systems early enough for them to be effective before the date for the closure of the programmes. The Commission increased the number of checks made in the Member States, but the results of these checks do not add to the Commission's assurance on the legality and regularity of operations from the programming period 1994 to 1999. The introduction of Regulation (EC) No 438/2001 provided a framework for improved systems for the programming period 2000 to 2006. However, the results of the Court's audit have revealed the continued existence of the same type and level of errors as in previous years. Therefore, the Commission should carry out checks of the systems put into place and of the legality and regularity of the underlying operations as soon as possible.

THE COMMISSION'S REPLIES

5.54. *Progress has been achieved in closing pre-1994 assistance (see reply to point 5.15) and assistance from the period 1994 to 1999 (see replies to points 5.17 and 5.18).*

Since Regulation (EC) No 2064/97 was adopted, the Commission has provided detailed guidelines on its key provisions. For the closure of assistance from the 1994 to 1999 period, general instructions were issued in September 1999 and these were clarified by a whole series of documents sent to the Member States in 2001 and 2002. The Commission refers to its reply to point 5.19.

Member States have in general made serious steps to ensure effective implementation of Regulation (EC) No 2064/97 and have taken action in response to recommendations from the Commission as a result of its audit work. The Commission continued its audits of the implementation of Regulation (EC) No 2064/97 in 2002.

The Commission is obtaining assurance on the regularity of expenditure declared at closure of interventions from its audit work already completed and from the desk checks being undertaken on the closure statements. It will verify the reliability of the closure process in Member States by audits of a sample of programmes and will draw the necessary financial consequences where appropriate with recoveries from Member States.

With regard to the 2000 to 2006 programming period, the Commission refers to its replies at point 5.23 with particular reference to its audit work at point 5.24. The Commission's audit strategy for the 2000 to 2006 period is moving towards a form of integrated audit and is based on increased and effective cooperation with the national inspection authorities in order to obtain a reasonable assurance regarding the very large number of management and control systems in the 15 Member States.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

FOLLOW-UP TO PREVIOUS OBSERVATIONS

Special Report No 15/2000 on the Cohesion Fund ⁽⁸⁴⁾

Introduction

5.55. The report covered both the Commission's management of the Cohesion Fund (CF) and its implementation in the Member States. The main conclusions were aimed at improving the following issues:

- (a) project applications either did not contain essential information or the information presented was unreliable. In particular, the cost-benefit analyses were not always prepared with sufficient rigour and the revenue-generating potential of the projects was not always taken into account adequately;
- (b) lack of coordination between the Cohesion Fund and the ERDF;
- (c) the Commission intervened mainly in the initial and final stages of the project cycle. The intermediate stages would merit a greater level of involvement. Projects were often amended without thorough examination by the Commission;
- (d) there were a number of anomalies in respect of eligibility and accounting for expenditure and also in the closure of projects;
- (e) the limited evaluation of the macroeconomic impact of projects;
- (f) the Commission devoted insufficient resources to on-the-spot checks in order to detect weaknesses in the management systems.

5.56. The Court examined changes and improvements made to the Commission's management based on the recommendations in the Special Report, which the Council supported. The Court's work also included an examination of the application of recent changes in the regulatory framework.

⁽⁸⁴⁾ OJ C 279, 2.10.2000.

THE COURT'S OBSERVATIONS

Project applications

5.57. A general improvement has been noted in the quantity and quality of the information provided in the project applications. However, some weaknesses still need to be addressed:

- the Commission is required to assess whether the projects comply with the criteria laid down in the Regulation. There was not always sufficient evidence to show that the necessary detailed assessments had been carried out,
- one of the main factors contributing to the frequent requests for amending decisions is the incomplete or non-existent technical studies at the project approval stage. These studies are the basis for estimating a project's cost, but little evidence was found that they had been thoroughly examined by the Commission. In addition, in some cases the project applications did not provide a detailed analysis of the works to be carried out or the related cost,
- the treatment and calculation of the socioeconomic variables used in the analysis differ from project to project. The Commission has still not drawn up sufficiently precise guidelines to encourage a harmonisation of the methods applied and make the analyses more comparable,
- in the case of revenue-generating projects, the Commission has not been able to agree on a common methodology for calculating future net revenues and their effect on co-financing rates. The projects examined showed that there continues to be a general lack of justification of the grounds on which the co-financing rates are awarded. The lack of a clear and transparent set of rules on the basis of which co-financing rates may be determined results in different treatment of Member States ⁽⁸⁵⁾ and as such the Commission cannot assure that the best use is made of the available financial resources.

THE COMMISSION'S REPLIES

5.57. *The staff of the Directorate-General for Regional Policy use a detailed manual of procedures, which is regularly updated. The manual draws attention to all the requirements of the regulations and to the need to document work done. The Commission is constantly striving for improvements in these areas.*

The Commission attaches the utmost importance to the existence and the quality of the technical studies. It now asks the final recipients to certify that such studies have been completed before the invitation to tender for work. It cannot, however, scrutinise the studies for each part-financed project itself. This is part of the management and control system at national level, which the Commission is examining under Regulation (EC) No 1386/2002. The descriptions of the physical works in Cohesion Fund applications have steadily improved. This is particularly true for Greece where, since 2000, applications and decisions have been very detailed with a full description of the work by category and costs estimates.

The Commission is endeavouring to standardise cost-benefit analyses and in December 2002 updated the Guide to cost-benefit analysis in ERDF, Cohesion Fund and ISPA projects. It has held several meetings with national authorities to improve the methodology of cost/benefit analyses.

The Commission has now issued further guidance in order to standardise the methods for taking account of revenue in the part-financing rates of Cohesion Fund projects. The new Guide to cost-benefit analysis referred to in the answer to the previous indent sets out the principles to be applied in the financial analyses that serve as a basis for determining the part-financing rate, including revenue, residual value and discount rates. In April 2003 the Commission wrote to the Member States to remind them of these principles and setting certain parameters for the calculation of the part-financing rates. The aim of the Cohesion Fund is to provide a strong stimulus to economic development. Net revenue is one of a number of factors that are taken into account in determining the part-financing rate of projects, but the Regulation only requires this when the net revenue is substantial. In practice, the differences in the part-financing rates of similar projects in different Member States are rarely significant and the Commission generally attempts to set part-financing rates as low as possible in the circumstances in order to make maximum use of the resources available.

⁽⁸⁵⁾ In Spain, the methodology applied results in generally higher Community co-financing rates.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Coordination with the ERDF

5.58. Reference frameworks have been drawn up for the transport and environment sectors in the Member States which provide an overall guideline for project selection and increase the synergy with ERDF interventions. In addition, the coordination of the two funds has been further enhanced following the transfer of responsibility for the Cohesion Fund to the respective geographical units in the Directorate-General for Regional policy.

Amending decisions

5.59. Many of the amending decisions continue to breach the deadline set in the Regulation. Furthermore, the reasons for an amending decision are often the inclusion of new elements which were not directly linked to the project. In such cases a new application should be submitted.

5.60. In July 2002, the Commission issued guidelines for the modification of Cohesion Fund project decisions so as to limit the number of amending decisions that may be issued for a project. The overall objective is to ensure that the Member States improve their preparation of the project applications, as amending decisions are frequently the result of applications based on weak preliminary studies.

Closure of Cohesion Fund projects

5.61. In the new Regulation on the Cohesion Fund, a number of elements should be included in a project final report ⁽⁸⁶⁾. These include a clear description of the works carried out and an initial assessment as to whether the expected results are likely to be achieved. In the majority of the final reports examined, these elements were either omitted or were not adequately addressed. In some cases, the works carried out as described in the final report differed from the works set out in the approving decision.

5.59. The reasons why the three-month deadline is not always observed for amending decisions are the same as for initial decisions. The main reasons are technical complexity and poor presentation. The Commission agrees that a new application should be made for the inclusion of new elements not directly linked to the initial project.

5.61. The standard of information provided at closure has steadily improved. The Commission considers that the description of the works in the final reports for the projects referred to by the Court was adequate. Modification of the works originally approved is accepted only where justified.

⁽⁸⁶⁾ Annex II, Article F, to Council Regulation (EC) No 1164/94 establishing a Cohesion Fund, as amended by Article (1)6 of Council Regulation (EC) No 1265/1999 of 21 June 1999 (OJ L 161, 26.6.1999, p. 62).

THE COURT'S OBSERVATIONS

5.62. A declaration, drawn up by a person or department independent of the authority managing the project, has to be submitted when a project is closed ⁽⁸⁷⁾. The declaration should summarise the results of checks carried out and conclude on the validity of the application for payment of the final balance. In the cases of the closed projects audited, no such declaration was submitted. The Commission has decided to apply this requirement to projects approved during the period 2000 to 2006 only, although no such transitional measures were included in the Regulation.

Follow-up to the anomalies identified

5.63. The Court examined whether the Commission had adequately followed up the specific cases mentioned in the report. Of the five cases where follow-up action should have been taken, the Commission provided a satisfactory explanation of its action in only one case. In the remaining four cases, either no action was taken or the action taken was not prompt. In two of these cases the Commission decided to wait for the closure of the projects to resolve the problems identified. In one of these two cases, a new project application from an implementing body was approved even though the Court's audit had revealed serious concerns regarding ineligible expenditure and the quality of that implementing body's work on a previous project, which remain unresolved.

Impact evaluation

5.64. Regarding the methods for evaluating the macroeconomic impact of Cohesion Fund projects, the Commission stated in its reply to the Special Report that it would 'endeavour to improve the evaluation tools in the light of experience', following the recommendation of the Court. However, the further use and development of evaluation tools has been abandoned by the Commission.

THE COMMISSION'S REPLIES

5.62. *The closure procedures for projects granted assistance before 1 January 2000 were set out in Annex III to the grant decision based on Regulation (EC) No 1164/94 as it existed when the grants were awarded. In Commission Regulation (EC) No 1386/2002 (Article 13 in conjunction with Article 1) the Commission has taken the view that it could not require Member States to provide declarations under Article 12(f) of Regulation (EC) No 1164/94, as amended, and had to apply the legal requirements prevailing when the grant decision was made.*

5.63. *The cases raise complex issues of which the follow-up necessarily takes a certain time to bring to a conclusion. The Commission's follow-up has progressed in all four cases referred to by the Court. In the case last mentioned, the national authorities are still investigating the Court's findings. The Commission is following the matter closely and will draw appropriate conclusions from the results.*

5.64. *The Court refers to a specific model for evaluating macroeconomic impact that was developed by consultants under a contract with the Commission. The Commission decided not to use this model because the regulation now requires cost-benefit analysis to be used. The Commission has issued new guidance on cost-benefit analysis (see answer at point 5.57). The impact of projects is investigated as part of this analysis.*

⁽⁸⁷⁾ Council Regulation (EC) No 1164/94 establishing a Cohesion Fund, as amended by Article 1(10)(f) of Council Regulation (EC) No 1264/1999 of 21 June 1999 (OJ L 161, 26.6.1999, p. 57).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

A substantial increase in the number of Commission audits

5.65. A unit dedicated to auditing Cohesion Fund projects, was set up in the Directorate-General for Regional policy in 2001. This has resulted in a significant increase in the number of audits carried out in 2002, which is welcomed by the Court. The results of these audits have confirmed the Court's findings.

PRINCIPAL OBSERVATIONS IN SPECIAL REPORTS*Special Report No 7/2003 on the implementation of assistance programming for the period 2000 to 2006 within the framework of the Structural Funds*

5.66. The aim of the Community's structural policy is to reinforce the structural factors that promote the harmonious development of the Community as a whole. In this respect, the Structural Funds programming periods 1989 to 1993 and 1994 to 1999 have already made a substantial contribution towards reinforcing the EU's policy of social and economic cohesion. The Berlin European Council (24 and 25 March 1999) confirmed that efforts in favour of this priority area of Community policy were to continue and decided to earmark 195 000 million euro for operations under the Structural Funds for the period 2000 to 2006.

5.67. In the interests of simplification and improved effectiveness, structural assistance programming for the new period has laid the emphasis on more decentralisation, a clearer division of responsibilities and further expansion of the management, payment, monitoring and control functions. The effectiveness of the Commission's efforts to encourage regional policy can be seen in the quality and consistency of the programming.

THE COURT'S OBSERVATIONS

5.68. Although some improvements have been made by comparison with the preceding programming period, the implementation of structural assistance is still affected by a number of persistent weaknesses and inadequacies. These are as follows:

- (a) as regards the selection of eligible areas within the framework of Structural Fund programming for 2000 to 2006, it appears that:
 - the Objective 1 eligible areas were determined in accordance with the Regulation. However, the statistics used were unable to take account of all the most recent socioeconomic effects. This was necessary if the principle of focusing on the least favoured regions was to be scrupulously respected,
 - the criteria taken as the basis for determining Structural Fund eligible areas for Objective 2 were insufficiently objective and left too much room for manoeuvre in the bilateral negotiations between Member States and the Commission; furthermore, national criteria have gained in importance as compared to the objective Community criteria referred to in the Structural Fund rules,
 - the areas eligible for State aid do not always coincide with those eligible for Structural Fund assistance. Regional policy is not sufficiently consistent with competition policy;
- (b) in comparison to the previous programming period there has been significant progress in the quantification of objectives and in programming quality. However, the process of approving structural programmes was found to contain significant delays and inefficiencies. In particular, Community and national responsibilities in relation to the new programme complement procedure have not been sufficiently clarified and the procedure itself has ultimately proved to be an additional process which heightens delays and generates difficulties of interpretation that contradict the aim of simplification referred to in the Structural Funds Regulation. Furthermore, the programme complements do not always provide the relevant information required;

THE COMMISSION'S REPLIES

5.68.

- (a) For Objective 1, the Regulation provides for no mechanism for adjustments on the basis of more recent data, since the regions whose development is lagging behind require long-term assistance.

In view of the differing situations of the regions undergoing socioeconomic change, the Regulation allowed half the population covered to be in areas meeting objective and justified qualitative criteria based on national statistics. For these areas, Member States submitted their proposals along with comparative tables also giving data for other regions or for the whole Member State. The other 50 % had to be industrial or rural areas fully meeting Community criteria.

The Member States made use of the freedom that the Regulation allowed them, given the narrow economic gap between those regions 'assisted' under Article 87(3)(c) and other 'non-assisted' regions also experiencing problems of restructuring. In addition, for regions meeting the Objective 2 criteria, the status of assisted region allowing aid to be granted not only to SMEs but also to large undertakings is not of great importance. Nevertheless, the two maps are now more similar than before.

- (b) The Commission shares the Court's opinion on the progress achieved in these fields, the inefficiency of the procedures laid down by the Regulation and the consequent difficulty in meeting the deadlines. It clarified the division of responsibilities as regards the programming complement in 2001. The gaps in the information contained in the complements were sometimes due to the information being divided between two documents. It would however be useful to assess the advantages of the system of programming complements in the light of experience over the whole period.

THE COURT'S OBSERVATIONS

- (c) the Commission's working documents are still too imprecise to serve as a methodological framework for programmes. This has repercussions on the techniques of policy analysis that are applied to ensure that, on the one hand, the Community support frameworks (CSFs) are consistent with the measures adopted and that, on the other hand, the choices governing the use of resources are the optimum ones in terms of the specific needs of regions. On the evidence of the programmes examined, the Court considers that *ex ante* evaluation has not played a decisive role and that it has added little to the selection of strategies on the basis of anticipated results and impacts. Various weaknesses have been found in the application of methods and techniques of analysis, evaluation and programming. In particular, the indicators are still insufficiently quantified and relevant, despite the progress identified by the Court;
- (d) as regards the internal and external consistency of the structural measures approved, analysis of the various programmes has enabled several weaknesses in this area to be revealed (lack of agreement between objectives on the one hand, and between objectives and resources on the other, lack of any clear synergy between Funds or operations, insufficient supporting information, etc.). The negotiations between the Commission and the Member States have not always resulted in measures being as consistent as possible before their approval, largely because information on national and regional policies has not been available;
- (e) the budgetary allocations for Community support frameworks and assistance programmes are based more on earlier rates of consumption of appropriations in respect of certain measures, experiments in implementation and the need to guarantee optimum take-up of funds within each Member State, rather than on a well-established development strategy;
- (f) the fixing of criteria or indicators, and their establishment as concrete objectives to be achieved at mid-term with a view to the distribution of the performance reserve, is to all intents and purposes left to the discretion of the Member States. This can lead to inconsistencies and ineffectiveness;

THE COMMISSION'S REPLIES

- (c) *The Commission's working papers contain guidance to the Member States on evaluation, but do not aim to cover every specific situation, as the selection of an appropriate methodology for the ex ante evaluation is the responsibility of the Member State. Working Paper No 2 recommended that the ex ante evaluation should demonstrate the sound foundation of the strategy and the proposed financial allocations. The Commission believes that the majority of ex ante evaluations were constructively critical and informed the choice of strategies. In a few cases where it was not satisfied with the quality or it desired additional inputs, the Commission contracted its own experts to give an alternative view. It is true that in some cases the quantification of objectives has been inadequate. Nevertheless, here too, the Commission believes that significant improvements have taken place since the last programming period.*
- (d) *The conclusion of the Commission's communication of 5 July 2001 on the results of the programming of Structural Funds for 2000 to 2006 was that the quality of the strategies adopted in the programming documents for the current programming period has improved. The ex ante evaluation made an important contribution in this respect — particularly in developing the SWOT (strengths, weaknesses, opportunities, threats) analysis approach and in the quantification of objectives.*
- (e) *The Commission is of the opinion that progress has been made on Structural Fund programming that will ensure implementation in accordance with a well-established development strategy and that the take-up of funds has not taken priority over effectiveness. The calculation of the resources required to achieve given goals is not always easy without reference to the take-up of appropriations for previous measures of the same type.*
- (f) *The selection of indicators for the performance reserve was not left solely to the Member States. There are three types of indicators, relating to management, finance and effectiveness. Although Member States could choose, management and finance indicators are in most cases those proposed by the Commission. Effectiveness indicators must vary by programme and Member State since they are output and result indicators from the programmes. The Commission is monitoring the situation closely.*

THE COURT'S OBSERVATIONS

- (g) management, payment, supervisory systems and controls in the Member States still show weaknesses as regards compliance with deadlines (particularly in relation to the introduction of control structures and the organisation of controls), the separation of functions, certification of expenditure, electronic data exchange or the preparation of annual implementation reports;
- (h) the eligibility rules for the period 2000 to 2006 are still incomplete and imprecise and this may result in unjustifiable differences of treatment between beneficiary Member States. Certain eligibility principles which were applicable to the period 1994 to 1999 but have been cancelled in respect of the new period fall into this category. Similarly, certain eligibility concepts taken up again in the new rules have had their content modified or reduced by those rules and this allows the final beneficiaries a great deal of latitude as regards limitations or differing interpretations. Finally, the procedures for implementing the additional concepts are not always sufficiently detailed;
- (i) the project selection criteria submitted in the programme complements are often too broad and do not do enough to enhance the benefit of structural measures in terms of optimising objectives and priorities.

5.69. The aim of simplification has not always been achieved and its effects have sometimes been the opposite of what was originally intended. This applies particularly to the procedures for adopting programmes, consistency in programming, the setting-up of decentralised management procedures and eligibility rules. The process of simplification has also suffered as a result of the very slow start of programmes, the overlapping of two programming periods and an underimplementation of the budget in 2000/2001 and 2002.

THE COMMISSION'S REPLIES

- (g) *The Commission considers that the Member States have made and are continuing to make substantial progress in all these areas. The Commission is continuing to carry out audits covering the various aspects of the new systems and in May 2003 circulated to the institutions and the Member States a report on its findings as far as the ERDF is concerned.*
- (h) *The Commission takes the view that the rules are sufficiently precise and complete given the aim of regulating no more than the necessary minimum at Community level, leaving any provisions beyond these basic common provisions to the Member States. It endeavours to provide clarification whenever there is any doubt. The Commission's approach in adopting Regulation (EC) No 1685/2000 was to leave out those rules previously contained in the eligibility datasheets that were redundant or unnecessary, to learn from the experience of applying the datasheets by being less restrictive where this was justified and to present the rules adopted more clearly and concisely in the form of a regulation. For its replies to specific observations of the Court, the Commission refers to the Special Report.*
- (i) *The Commission has encouraged the establishment of relevant selection criteria and insists on their systematic application. It is well aware of the crucial importance of project selection for the impact of assistance and acknowledges that in certain cases improvements are still possible.*

5.69. *The Commission acknowledges that the objective of simplification has not always been achieved, principally because of the time needed by Member States and the Commission to familiarise themselves with the new provisions and sort out difficulties. Programming was complicated by the additional requirements intended to ensure that assistance complies with the rules and to improve the quality of assistance. The establishment of new decentralised management structures and familiarisation with the amended eligibility rules also took time. It is equally true that the closure of 1994 to 1999 programmes, for which the requirements on Member States were more stringent than before, delayed the launch of the new programmes and contributed to the underutilisation of the budget in 2000 to 2001 and 2002.*

The Commission has already taken steps to simplify or clarify the application of certain rules for the current period and will bear the experiences of the previous programming round in mind in its reflections for the new period.

THE COURT'S OBSERVATIONS

5.70. The Court recommends that:

- (a) the Commission take account of all reliable and up-to-date information available in order to concentrate the Structural Funds in the most seriously affected areas and at the most suitable geographical level. As regards Objective 2, the Commission should be careful to ensure that the criteria for selecting eligible areas are objective, so that their application to Member States is consistent and homogeneous;
- (b) there is a clearer definition of responsibilities, particularly as regards the programme complement and the duties of the bodies involved in the management of interventions at Member State level;
- (c) the Commission and the Member States introduce the procedures and provisions needed for the correct implementation of the later phases of the programming for 2000 to 2006 (mid-term review, performance reserve and *ex post* evaluation based, in particular, on more satisfactory indicators) and for a consistent and well-founded allocation of performance reserves;
- (d) regarding management, the Commission gathers sufficient necessary information for it to be able to carry out the relevant analysis in order to guarantee the consistency of the structural programmes adopted;
- (e) the Commission defines the eligibility rules more precisely and ensures that adequate selection criteria are developed;
- (f) the Commission pursues its efforts to make the current simplification more effective, whilst guaranteeing the high quality of the structural measures in terms of legality, regularity and sound financial management. The primary aim of programming, programme revision and management should be the effectiveness of the programmes and not simply the optimum take-up of funds.

THE COMMISSION'S REPLIES

5.70.

- (a) *The Commission will take account of the Court's comments in the programming of the Structural Funds after 2006.*
- (b) *This question is being studied in the current review of the rules for the period after 2006.*
- (c) *The Commission has already taken steps to organise the mid-term review and the allocation of the performance reserve in a correct and efficient manner and will do likewise when the time comes for the ex post evaluations.*
- (d) *The central database for the Structural Funds is already the main source of financial information and it should gradually take over more and more of the monitoring information that is currently collected on other databases.*
- (e) *The regulations lay down certain rules that need to be applied in the same way throughout the EU and leave the remainder to national legislation. The experience of the Commission is that to attempt to cover eligibility questions would lead to increased complexity or rules that were not appropriate for many specific situations.*
- (f) *The Commission has already made efforts to simplify the application of provisions wherever possible and will continue its efforts in this direction. It is not sacrificing the impact of programmes to the concern for rapid absorption of funds.*

ANNEX 1 Follow-up of key observations

Observations	Action taken	Additional information	Commission's reply
<p><i>Time differences between commitments and legal obligations</i></p> <p>Management of commitments is modelled on the annual breakdown of the appropriations provided for in the financial perspective. This means that the legal obligations entered into by the Community are entered gradually, in annual instalments, instead of being entered in the accounts in full when the intervention is decided on (SR 16/98, paragraph 4.5; AR 1999, paragraphs 3.24, 3.27; AR 2000, paragraph 3.132; AR 2001, paragraphs 3.9 to 3.10).</p> <p><i>The Court's audits not taken into account in time</i></p> <p>The Commission did not take the necessary measures at the right time to follow up the results of its own audits and those of the Court. As a result, when interventions were closed it found itself faced, sometimes years after the checks, with many problems, the resolution of which may involve protracted discussions with the Member States. Examples included the need to provide fuller supporting documentation, to establish any errors or irregularities or to identify precisely transactions suspended for legal reasons (AR 1999, paragraphs 3.83 to 3.92; AR 2001, paragraphs 3.28, 3.48 to 3.52, 3.94 to 3.104).</p> <p><i>Weaknesses in supervisory systems and controls, persistent errors in payments</i></p> <p>The weaknesses afflicting the supervisory systems and controls pose a risk to the legality and regularity of the transactions, at both Commission and Member State level. The effectiveness of controls on the application of Community rules is also insufficient. On occasion, because the Commission has not provided adequate guidelines, the procedures followed by national managers have all too often been out of line with the Community regulations. From one programming period to the next the eligibility rules have remained imprecise, in spite of the Commission's efforts, resulting in inequalities in their application and making control more difficult. As a consequence ineligible expenditure has been declared and undue payments made, especially when interventions were closed. Similarly, certifying agencies' lack of independence, an absence of follow-up where shortcomings were detected, insufficient checking of supporting documentation and the incompleteness of the national reports all pose a risk to the legality and regularity of transactions.</p>	<p>No action has been taken. The Commission's argument is that the situation is a direct consequence of the existing regulatory framework.</p> <p>There have been improvements. However, the Commission still tends to confine remedial action to the cases pointed out by the Court and still does not extend its own investigations to the intervention as a whole.</p>	<p>In the Court's opinion this aspect should be considered in the context of the new programming period.</p> <p>The observations in paragraphs 5.47 and 5.52 indicate that the Commission should take the necessary steps to effect appropriate follow-up in good time.</p>	<p>The Commission refers to its reply to point 3.9 of the Court's report for 2001.</p> <p>Concerning the follow-up of audits by the Court, the Commission systematically follows up all cases, but in some cases this takes time because of their complexity and other priorities. In clear cases of systemic problems, the Commission does extend the follow-up action, for example in relation to public procurement in Spain. Furthermore, the Commission takes account of findings of the Court as far as possible in its own audit planning.</p> <p>The application of Internal Control Standards in the Commission, which aim to improve the verification procedures for payments, is well advanced.</p> <p>The Commission obtains assurance on the regularity of expenditure at the closure of 1994 to 1999 interventions from its audit work already completed and from the desk checks being undertaken on closure statements. It will verify the reliability of the closure process in Member States by audits of a sample of programmes and will draw the necessary financial consequences where appropriate by making recoveries from Member States.</p> <p>From the work the Commission has carried out for the 2000 to 2006 period, it has been able to conclude that Member States have in general made significant steps in improving their systems. However, further improvements are necessary, and the effective functioning of the systems should be regularly verified. The Commission will pursue its audit strategy to achieve this aim in order to provide a basis for assurance as to payments made from the Structural Funds.</p> <p>For both programming periods the Commission is continuing to follow up the Court's findings made in previous SOA exercises in the light of the Member States' replies and further audits in some cases, and will take corrective action where appropriate. Similar follow-up will be given to the Court's findings in the 2002 SOA.</p>
<p>The audit manual update (SF and CF) was to be finalised for May 2003. It was, however, confined to taking into account the changes introduced by Regulation (EC) No 438/2001. However some Directorates-General have introduced more systematic audit programmes.</p> <p>The Commission has proposed to the Member States a 'contract of confidence' which would further commit them to compliance with the rules laid down. In consideration of this, the Commission could reduce its own controls.</p>	<p>The Commission undertook to produce a comparative analysis of national financial management and control systems (ERDF end of 2002, ESF and EAGGF Guidance in 2003), with the aim of highlighting best practice and recommending new solutions to problems of a cross-boundary nature. At the end of April 2003 the Commission drew up a report on the management and control systems for the ERDF. That report, which also contains an appraisal of the systems by Member State, is substantially based on descriptions which Member States themselves supplied. The results of a number of on-the-spot visits have also been taken into account, although the Commission did not undertake any substantive testing.</p>	<p>As the Commission itself has admitted, it cannot at this stage give any guarantee as to the practical effectiveness of the systems. The Court again draws attention to the necessity of carrying out appropriate on-the-spot tests (see paragraphs 5.18 and 5.24). The conclusions of the report confirm some of the Court's findings, e.g. delays in carrying out sample checks on 5 % of expenditure (see paragraph 5.30). On the other hand, the Court is unable to confirm the assertion concerning the solution to the problems associated with the lack of adequate guidelines for the management and paying authorities in connection with the organisation of systems. This also applies to the absence of segregation of functions between manager and payer authorities. The Court therefore recommends that the necessary action be taken (see paragraphs 5.29 to 5.32).</p>	<p>The Commission has carried out for the 2000 to 2006 period, it has been able to conclude that Member States have in general made significant steps in improving their systems. However, further improvements are necessary, and the effective functioning of the systems should be regularly verified. The Commission will pursue its audit strategy to achieve this aim in order to provide a basis for assurance as to payments made from the Structural Funds.</p>
<p>The audits carried out by the Court indicated persistent errors for both the 1994-1999 period and the 2000 to 2006 period:</p> <ul style="list-style-type: none"> — substantive errors of legality and regularity having a direct impact on the amount of the underlying transactions were mostly at final beneficiary level, — formal errors were divided between the Commission and beneficiaries (AR 1999, paragraphs 3.43 to 3.52; AR 2000, paragraphs 3.36 to 3.38, 3.44 to 3.56; AR 2001, paragraphs 3.56 to 3.64) 			

ANNEX 2

Structural measures

Management and control systems

Assessment by the Court of implementation of Commission Regulation (EC) No 438/2001 in the Member States visited									
Commission Regulation (EC) No 438/2001 — Implementation of Management and Control systems									
Key audit areas	1	2	3	4	5	6	7	8	9
	Clear definition, allocation and separation of functions (Article 3)	Satisfactory day-to-day procedures to verify legality and regularity of co-financed operations (Article 4)	Sufficient audit trail (Article 7)	Adequate recovery procedures (Article 8)	Assurance of reliability of certificates of expenditure (Article 9)	Progress of checks to cover at least 5 % of total eligible expenditure (Article 10)	Adequate organisation of 5 % checks (Articles 10 to 12)	Independence and auditing standards of body issuing declaration at closure of programme (Article 15)	Examination of management and control systems in preparation for providing declaration at closure of programme (Article 16)
Member State/Region/Fund									
Flanders (Belgium) ESF				(¹)					
Saxony-Anhalt (Germany) ESF				(¹)					
Nord-Pas-de-Calais (France) ESF				(¹)					
Lisboa e Vale do Tejo (Portugal) ESF				(¹)					
Murcia (Spain) ESF				(¹)					
West Wales and Valleys (United Kingdom) ESF				(¹)					
Baden-Württemberg (Germany) ERDF				(¹)					
Greece Roads, etc ERDF (²)				(¹)					
Castile-La Mancha (Spain) ERDF				(¹)					
Upper Austria (Austria) ERDF				(¹)					
Portugal ERDF									
Scotland (United Kingdom) ERDF				(¹)					
Crete (Greece) EAGGF Guidance (²)				(¹)					
Valencia (Spain) EAGGF Guidance				(¹)					
France outside Objective 1 FIFG				(¹)					

(a) Works well, few or minor improvements required.

(b) Works, but improvements necessary.

(c) Does not work.

For details see paragraphs 5.26 to 5.33.

⁽¹⁾ Procedures not tested as they have not had to operate.⁽²⁾ The same authorities are responsible for the implementation of the procedures in columns 5 to 9 for these programmes.

CHAPTER 6

Internal policies, including research

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INTRODUCTION

6.1. The European Union's internal policies focus in particular on the implementation and development of the single market and cover four complete subsections of the budget plus several headings in another subsection:

- (a) education, vocational training and youth (subsection B3);
- (b) energy, Euratom nuclear safeguards and the environment (subsection B4);
- (c) consumer protection, the internal market, industry and trans-European networks (subsection B5);
- (d) research and technological development (subsection B6);
- (e) 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 Article B1-3 8 2 (enhancing public awareness of the common agricultural policy).

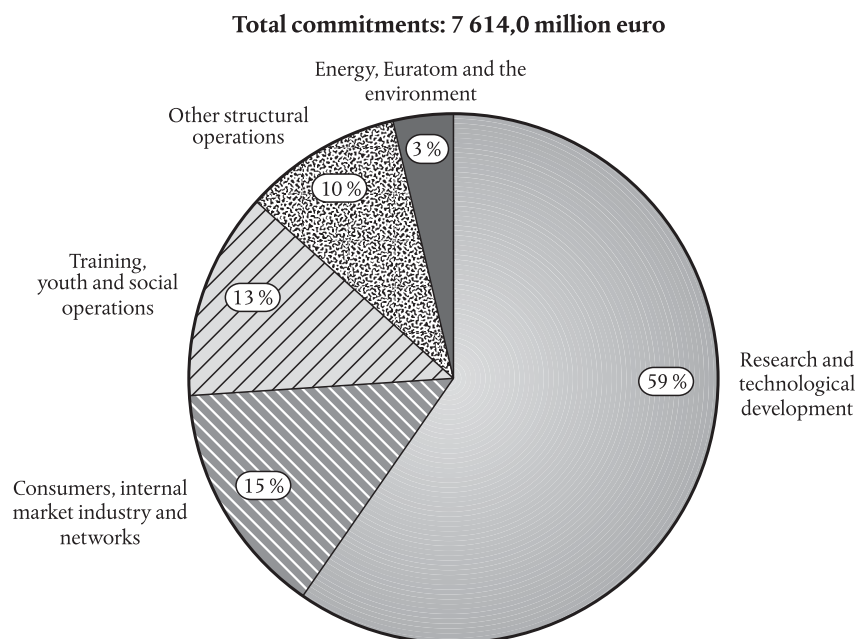
Graphs 6.1 and **6.2** show how the funds were spent in 2002.

6.2. The responsibility for implementing the Internal policies and managing the corresponding budget is spread across 13 directorates-general, the principal ones — in terms of the appropriations managed — being the Directorate-General for Research (RTD), the Directorate-General for Energy and Transport (TREN) and the Directorate-General for the Information Society (INFOS).

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

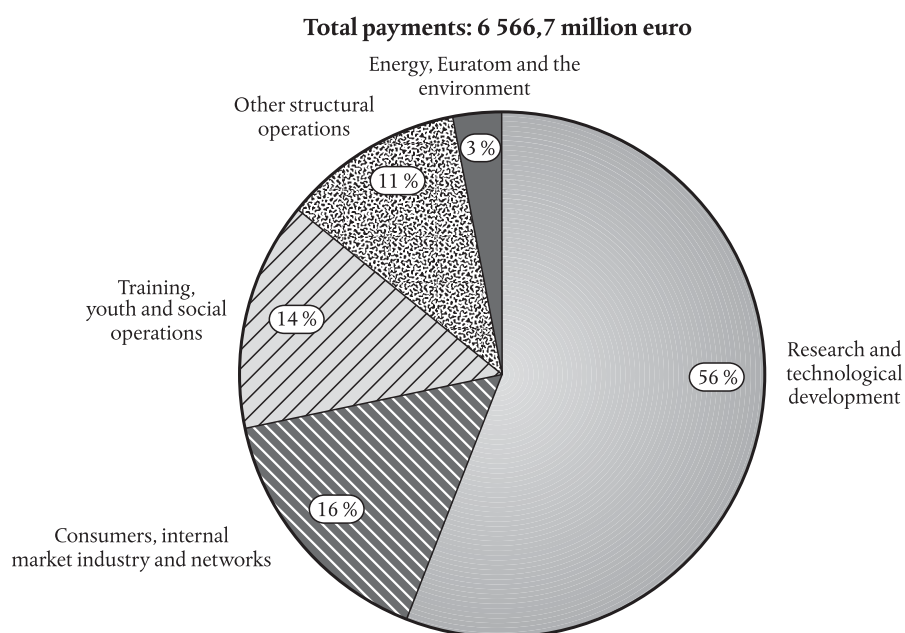
Audit objectives and scope of the audit

6.3. The objectives of the audit were to contribute to the Court's Statement of Assurance on the general budget through a specific assessment based on the collection of audit evidence, for the internal policies area as a whole. The reliability of the accounts and the legality and regularity of the underlying transactions were examined.

Graph 6.1 — Breakdown of commitments by budgetary area in 2002

Source: 2002 revenue and expenditure accounts.

NB: For more detailed information see Diagrams III and IV of Annex I.

Graph 6.2 — Breakdown of payments by budgetary area in 2002

Source: 2002 revenue and expenditure accounts.

NB: For more detailed information see Diagrams III and IV of Annex I.

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6.4. The Court

- examined whether the Commission's internal control system operated effectively to ensure the legality and regularity of the underlying transactions; and in particular it reviewed the Annual Activity Reports and Declarations by the relevant Directors-General,
- tested a sample of commitments and payments made in 2002, as an independent check on their legality and regularity,
- followed up its investigation last year of the control system for the trans-European Network — Transport (TEN-T) programme (part of the second largest category of internal policies spending) with tests of the legality and regularity of individual transactions, including at final beneficiary level,
- investigated, primarily for research and technological development (RTD) expenditure (more than half of internal policies), whether the Commission's *ex post* audits allowed it to assess the legality and regularity of transactions.

*Assessment of the Commission's supervisory systems and controls***Follow-up of the reservations made in the Annual Activity Reports for 2001**

6.5. The objective of the audit was to review whether the Directorates-General for Energy and Transport, Research and Justice and Home Affairs have taken corrective action to remedy the weaknesses detected and reported on in their Annual Activity Reports (AARs) for 2001.

6.6. The AARs for 2001 of the Directorates-General for Research and for Energy and Transport together contained nine reservations. Unlike the other Directorates-General (for Energy and Transport, the Information Society and Enterprise) operating the RTD framework programmes, the Directorate-General for Research did not make a reservation in 2001 concerning the capacity of internal controls to reduce the risk of overpayments in the research area, even though the Directorate-General for Research manages by far the largest

6.6. In 2002 the Commission increased the degree of harmonisation of the process of drafting the directors-general's annual reports and declarations provided the situations were comparable.

In its 2001 report, the Directorate-General for Justice and Home Affairs described the difficulties encountered in establishing certain internal control standards but did not include a corresponding reservation.

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proportion of funds in this area. In 2001 the Director-General of the Directorate-General for Justice and Home Affairs did not raise any formal reservations in his report, although it was mentioned in the body of the text of the report that the non-implementation of internal controls may cause potential weaknesses in the Directorate-General's management.

6.7. The Annual Activity Reports for 2001 also included preliminary plans to solve identified weaknesses. More detailed action plans were presented by the directorates-general that were examined by the Court after they had issued their Annual Activity Reports. By the end of 2002 the implementation of these plans had in most cases started. Most of the reservations were repeated in the Annual Activity Reports for 2002, which shows the difficulty of overcoming the identified weaknesses.

6.8. To overcome certain common problems of the RTD framework programme noted by the directorates-generals concerned, the synthesis of the Annual Activity Reports for 2001 ⁽¹⁾ issued by the Commission contained a specific action. This action envisages improvements in the financial and contract management systems for indirect research actions, an increase in the effectiveness of controls and the intensification of measures for the protection of the financial interests of the Community ⁽²⁾. The resulting action plan drawn up by the directorates-general was adopted by the Commission in January 2003.

Annual Activity Reports and Declarations by selected directorates-general for 2002

General observations on the annual activity reports for 2002

6.9. The objective of the audit task was to assess the annual activity reports (AARs) for 2002 drawn up by

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Given more detailed instructions resulting from the Commission-wide harmonisation process, the Directorate-General for Justice and Home Affairs did include in 2002 reservations in the declaration of its Director-General for the non-implementation of two ICS and the management of the European Refugee Fund (ERF) (see paragraphs 6.15 and 6.19).

6.7. *A substantial amount of work has been carried out throughout 2002 in accordance with these action plans. Some plans will take more than a year to implement.*

⁽¹⁾ 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, 24 July 2002).

⁽²⁾ See Action 1, page 8 of the Synthesis of the Annual Activity Reports and Declarations of the Directors-General and Heads of Service (COM(2002) 426 final, 24 July 2002).

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four Directorates-General (for Research, the Information Society, Energy and Transport and Justice and Home Affairs ⁽³⁾) and to examine whether internal control has improved in the Commission services concerned since 2001. In addition, an appraisal of the implementation of the Internal Control Standards (ICS, see **Annex 2A**) had been performed at the Directorates-General for Research, Energy and Transport and Justice and Home Affairs covering seven ICS ⁽⁴⁾.

6.10. All the directorates-general had described the procedures for the preparation of the AARs and Declarations for 2002. They generally followed the Commission's guidelines on the structure and content. The coordination responsibilities between the directorates-general in the preparation process have been clarified since 2001. The AARs for 2002 are more standardised than in 2001.

Overview of the observations and reservations for 2002

6.11. All the Directors-General concerned claimed to have reasonable assurance that the funds for which they were responsible had been legally and regularly spent. On the other hand, they expressed significant reservations. The number of reservations for 2002 was similar to the 2001 figure. The directorates-general raised 12 reservations, of which seven were repeated from 2001. The Directorates-General for Research, Energy and Transport and the Information Society included reservations concerning the frequency of errors in the area of contracts for indirect RTD actions ⁽⁵⁾. All the reservations were covered by action plans. However, the

6.11. *The Annual Activity Reports 2002 of the Commission's Research Directorates-General contain information on the level and frequency of errors detected through ex post financial audits. This explains the declarations of assurance of the directors-general concerned.*

⁽³⁾ Annual Activity Report for the year 2002 of the Directorate-General for the Information Society and Declaration of the Director-General (signed 15 April 2003). Directorate-General for Justice and Home Affairs: Annual Activity Report for 2002 and Declaration of Assurance (signed 14 April 2003).

Directorate-General for Research: Annual Activity Report for 2002 and Declaration of the authorising officer by delegation (signed 14 April 2003).

Directorate-General for Energy and Transport: Annual Activity Report for 2002 and Declaration of the authorising officer by delegation (signed 11 April 2003).

⁽⁴⁾ Internal control standards 7, 11, 15, 17, 20, 21 and 22.

⁽⁵⁾ Management of multiannual programmes (Directorate-General for the Information Society), control of the regularity of payments (Directorate-General for Energy and Transport), errors in the area of research contracts (Directorate-General for Research).

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directorates-general did not quantify in all cases the monetary or financial impact of their reservations. The Directorate-General for Research also reported weaknesses in the form of observations in addition to reservations.

6.12. As noted in the previous paragraph, for 2002 all the directorates-general operating the RTD framework programmes introduced similar reservations as regards the regularity of payments for indirect RTD actions, mainly due to final beneficiaries not complying with the contractual provisions ⁽⁶⁾. These reservations corroborate the corresponding findings by the Court.

The information on the implementation of the Internal Control Standards in the AARs for 2002

6.13. Each Annual Activity Report that was examined contained information and the mandatory Annex about the implementation of the Internal Control Standards (ICS). The assessment and the Annex were prepared in accordance with the Commission's guidelines.

6.14. The directorates-general proceeded with the evaluation of the Internal Control Standards ⁽⁷⁾, applying the following four categories: standard not implemented (one case), implementation of minimum standard in progress (27 cases), minimum standard implemented (32 cases) and more than minimum standard implemented (36 cases). The actual meaning of the category 'implementation of minimum standard in progress' remains unclear and, in particular, does not indicate whether certain standards have been implemented within the specified deadlines.

6.15. The Directorate-General for Research made one observation regarding the implementation of two standards (ICS 3 and 15). The Directorate-General for the Information Society reported that one standard (ICS 5) had not been implemented and that the implementation of the minimum standard was in progress for 11 standards. The Directorate-General for Justice and Home Affairs has issued a reservation regarding the non-implementation of two standards (ICS 16 and 17). The ways in which difficulties in the implementation of the ICS were reported by the directorates-general in their AARs and Declarations differed between directorates-general.

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6.14. The Commission points out that the category 'implementation of minimum standard in progress' means that for the internal control standard in question one of the baseline requirements had either not been implemented (where another baseline requirement had been implemented for the same standard) or had been only partly implemented.

The internal audit capabilities of the directorates-general in the frame of their audit activities ensure regular review of implementation of internal control.

6.15. Throughout the period of evaluation of the implementation of internal control standards, the Commission has done its best to provide advice and guidance on best practice to the directorates-general in an attempt to bring a degree of consistency and uniformity to the annual activity reports.

The task of implementing internal control standards lies with each individual directorate-general.

⁽⁶⁾ Court of Auditors Annual Report concerning the financial year 2001 (OJ C 295, 28.11.2002), paragraphs 4.41 to 4.46.

⁽⁷⁾ Communication on the clarification of the responsibilities of key players in the field of internal audit and internal control at the Commission (SEC(2003) 59 final).

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6.16. The Directorate-General for Research did not report the delay in implementing the supervisory arrangements (ICS 17) in the AAR. Even though the Directorate-General for Energy and Transport reported that the minimum standard concerning ICS 17 had been implemented, the Court found deficiencies in the way in which the supervisory arrangements were being carried out. The Directorate-General for the Information Society did not make a reservation concerning the Internal Control Standards, even though implementation of more than half of the standards was still in progress at the end of 2002. The Directorate-General for Justice and Home Affairs, the Directorate-General for Research and the Directorate-General for the Information Society reported that the full implementation of the documentation of procedures (ICS 15) was delayed, especially concerning procedures for the management of indirect research programmes.

6.17. The comments and figures provided by the Directorates-General for Research and the Information Society on their *ex post* financial audits in the research field are incomplete. For example, neither directorate-general indicates the amounts of adjustments paid to or recovered from the beneficiaries as a result of the follow-up action taken on the external *ex post* financial audits carried out on behalf of the Commission, which were concluded in 2002.

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6.16. As regards the Directorate-General for Research and control standard 17 on supervision, while it is true that the supervision plans were adopted late, since the plans relate to *ex post* checks they cannot be applied until the financial year in question has elapsed. The results of the controls for the first half of 2002 and some for the second half of 2002 have in fact been taken into account in the annual activity report. Consequently, and contrary to what is said in Annex 2B, the Directorate-General for Research considers that standard 17 has actually been implemented beyond the minimum standard.

*The Court's observation about deficiencies found as to how the supervisory arrangements are being carried out at the Directorate-General for Energy and Transport is based mainly on findings linked to the audit of interim payments made by the Commission for TEN-T projects. This fails to take into consideration the important controls that take place only at the end stage of the project (in-depth internal verification of the final cost statements, on-the-spot financial and technical controls and on-the-spot *ex post* financial audits).*

Delays with the completion or the renewal of a number of actions at the Directorate-General for the Information Society was not considered to have caused any significant control risk which might have required the entry of a reservation.

The delay affecting control standard 15 (documentation of procedures) in the Directorates-General for Research, the Information Society and Justice and Home Affairs is the result primarily of the introduction of a new framework programme and the recasting of the Financial Regulation.

6.17. The AARs of the Directorates-General for the Information Society and Research contain a lot of relevant, but not necessarily exhaustive information on financial *ex post* audits. The implementation of audit results is followed up closely.

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6.18. The adjustments in favour of the Commission (grants received unduly by the beneficiaries) are higher than those in favour of the beneficiaries. No net adjustment of errors in costs declared should be made when indicating a general trend in the underlying error rate of a management and control system. Off-setting both types of adjustments is, however, a useful indicator for the budgetary impact of the Commission's financial *ex post* audits.

Conclusion

6.19. The directorates-general examined by the Court all included in their Annual Activity Reports reservations covering a large part of the internal policies area, such as on the regularity of payments for the multiannual research programmes (the Directorates-General for Research, the Information Society, Energy and Transport) and the non-implementation of the Internal Control Standards (the Directorate-General for Justice and Home Affairs). The reservations raised in the research area, which represents more than half of the internal policies expenditure, mean that the control procedures put in place cannot guarantee the legality and regularity of the underlying transactions. As a result, the weaknesses reported in the reservations are not consistent with the reasonable assurance given in the Declarations of the Directors-General.

Results of the audit tests

6.20. The objective of the audit tests was to verify the legality and regularity of the underlying transactions and to contribute to an assessment of the Commission's control activities covering the whole budgetary area of internal policies. A sample of 54 payments, 16 commitments and six old open commitments were selected.

6.21. The audit was limited to the Commission directorates-general. No material errors were found at that level. This reflects the fact that the checks carried out by the Commission cannot assess whether the underlying transactions are legal and regular. At the Commission level it is only possible to check such matters as whether the expenditure declared was incurred within the eligible period, and whether the costs declared by the final beneficiary as incurred are plausible within the terms of the contract or Commission decision and the

6.19. *The reservations regarding shared-cost research contracts relate to the errors in the declarations of expenditure submitted by the beneficiaries. Their importance and financial impact of the errors are studied in the annual activity reports of the directors-general concerned, which explains their statements of assurance. These statements, accompanied by the reservations, are thus highly significant.*

As regards the Directorate-General for Justice and Home Affairs, the Commission does not feel that the reservation regarding the non-implementation of two standards (16 and 17) and the administration of the European Refugee Fund, and their importance and financial impact, conflict with the Director-General's statement of assurance.

6.21. *The Commission agrees with the Court's analysis that the funding mechanism as set up by the legal bases for the Community research programmes has limitations as far as desk controls are concerned. The exactitude of cost as declared by beneficiaries and their conformity with the provisions of the research contracts, cannot completely and accurately be verified by the Commission as part of its normal checks carried out prior to authorisation of payments. Only full financial audits can determine with certainty and exactitude the correctness of the costs claimed. It is for that reason that the*

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agreed budget contained therein. One of the main inherent risks in the internal policies area is, however, that the final beneficiaries may over-declare their costs to the Commission. This was also confirmed by the results of the audits carried out by or on behalf of the Commission at the final beneficiary level.

Extension and continuation of the systems analysis of the TEN-T programme

Scope of the audit and audit approach

6.22. In the context of the 2002 Statement of Assurance, the Court continued and extended its analysis of the management and control system of the TEN-T programme operated by the Directorate-General for Energy and Transport. The main objective of this year's audit was to assess the legality and regularity of the underlying transactions at final beneficiary level, taking into consideration the qualitative assessment of the strengths and weaknesses of internal controls at the Commission identified in last year's Annual Report ⁽⁸⁾.

6.23. In total, a sample of 38 TEN-T actions with commitments and/or payments authorised in 2002 were audited. Tests were carried out at the Commission for all actions sampled, while 14 actions with cost-claim-based payments (six interim and eight final payments) were also audited at the final beneficiary level. The transactions audited, involving payments amounting to 286,1 million euro and commitments of 274 million euro, represent 49 % of the 2002 TEN-T commitment and payment appropriations respectively.

6.24. The sample covered all transport modes (rail, road, air and maritime transport) and the three main intervention mechanisms (studies, direct grants for investments and interest rebates). It included actions based only on Commission decisions (adopted in 2002 or before) and actions based on Commission decisions complemented by a contract.

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Commission has substantially reinforced, since the launch of the fifth framework programme its audits on the level of beneficiaries. For the sixth framework programme cost claims by beneficiaries will need to be certified by independent auditors.

⁽⁸⁾ Court of Auditors Annual Report concerning the financial year 2001.

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Drafting of Commission decisions granting aid

6.25. The audit of TEN-T actions in 2002 found that most of the Commission decisions continued to be incomplete and/or incorrect, corroborating last year's audit findings ⁽⁹⁾:

- the identification of the recipient of aid, the beneficiary of aid and the authority responsible for implementation in the Commission decisions to grant aid continues to be often incorrect or incomplete. Also, changes to company structures, legal status or legal names are not reflected in the Commission decisions,
- the date of receipt of the application, set out in the text of the Commission decision, which indicates the starting date of the eligibility period, does not always match the date on which the Commission in fact received the application. In these cases the date in the Commission decision is prior to the actual date of receipt so that the period in which costs are eligible is unduly extended,
- beneficiaries continued to be notified inadequately. The definitions of work and eligibility of costs and fixed end dates are still not included in the decisions.

These weaknesses confirm the Court's previous position that the legal framework of the TEN-T programme should be strengthened by drawing up contracts between the Commission and the beneficiary after the Commission decisions granting aid.

6.25. Further to the recommendations made by the Court last year, the Commission took immediate steps to improve the standard text of the 2002 decisions. Improvements are acknowledged by the Court in point 6.26 and 6.37 of this report. As most of the payment transactions audited by the Court in 2002 concern decisions from 2001 and earlier, it is clear that these improvements are not reflected in the decision texts prepared at the time.

Improvement of the standard text includes, in particular, the technical annex developed to give more details concerning the activities covered by the funding, the estimated breakdown of costs of the activities and fixed rather than indicative time-tables.

Further improvements continue to be developed within the new version of the Commission decision 2003 for the multiannual indicative programme (MIP). In particular distribution of responsibilities will be better identified ⁽¹⁾ as well as the obligations of these partners at the operational level (description of activities, report, follow-up, request of payment, control etc.).

The Commission has strengthened the rules for the deadline for receipt of proposals and will emphasise the specific control of the correct transfer of the eligible date into the decisions in all future cases. The update of the Manual of procedures of the Directorate-General for Energy and Transport includes a more detailed selection process from 2003.

The question of a proposal received after the deadline for non MIP is duly taken into account in the 2003 process. Such cases have been rejected.

Further to the recommendations made by the Court last year, the Commission took immediate steps to improve the standard text of the 2002 decisions, in particular, the technical annex, as mentioned above. From 2003 onwards the final beneficiaries also will be informed by the Commission of the financial decisions awarded. Further improvements

⁽⁹⁾ Court of Auditors Annual Report concerning the financial year 2001, paragraphs 4.18 to 4.20 and 4.31.

⁽¹⁾ The body with final responsibility for the financial contribution (mainly the Member State concerned), the entity responsible for receiving the funds, the entity responsible for the implementation of the project and for management of the funds.

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6.26. The audit identified improvements regarding these provisions in the model TEN-T Commission decision used from 2002 onwards. Although suggested in last year's Annual Report ⁽¹⁰⁾, the new model text still does not include a clear definition of the different forms of aid, in particular for studies and direct grants. Moreover, a standardised cost claim form is not included and the requirement that publicity should be given to Community aid is no longer specifically mentioned in the text.

6.27. The new model Commission decision text includes guidelines neither for the description of activities covered by the Commission decision nor for the structure of statements of expenditure to be used by applicants to support their cost claims. The provisions relating to the eligibility of costs, as defined in the TEN Financial Assistance Committee Glossary, are very general and need to be reviewed. In the Court's opinion these provisions for beneficiaries of TEN-T actions should be defined in a manual and sent to them. Such a manual could be based on the example of the Cohesion Fund Manual.

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continue to be developed within the new version of the Commission decision 2003 for the multiannual indicative programme (MIP); and mainly the clarification of each partner involved in the implementation of the project and in the using of funds.

In particular, it will include notification to each beneficiary and organisation executing the project.

The comments regarding definition and eligibility of activities and fixed end dates and the steps taken by the Commission in this regard are covered above.

The Commission maintains its position that contracts are not always necessary on top of decisions for TEN-T projects.

6.26. *Improvements for a standardised cost claim have been considered and, within the new version of the Commission decision 2003, an appendix will be used as a first model for a standardised structure of statements of expenditure.*

In the framework of the review in 2003 of the TEN procedures, a TEN-T handbook for Member States and beneficiaries, a first version of which will be prepared by the end of 2003, will further develop the idea and clarity of model cost statements. The handbook will also cover the clear definition of studies and works and include detailed requirements with regard to the publicity obligation for the Member States and beneficiaries in line with structural funds practice.

6.27. *In addition to comments on 6.26, the guidelines for description of activities, the structure of technical reports and cost statements as well as definitions of eligible costs will be developed and contained in the TEN-T handbook already mentioned.*

⁽¹⁰⁾ Court of Auditors Annual Report concerning the financial year 2001, paragraphs 4.18 and 4.19 and the Commission's replies.

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Operation of controls*Basic condition for Community aid*

6.28. According to Article 5 of Council Regulation (EC) No 2236/95 specifying the conditions for Community financing, aid shall only be granted if the achievement of a project is encountering financial obstacles. This basic condition for TEN-T financial aid was not satisfied in 10 out of 36 applicable cases audited representing a total amount of 113,8 million euro of TEN-T financial assistance. In most of these cases, beneficiaries indicated in their detailed application form that the action would 'go ahead as planned' even if TEN-T financial assistance was not awarded.

Specific preconditions for interim and final payment

6.29. The audit found that interim and final payments were authorised by the Commission without the specific preconditions stipulated in the financial implementing provisions being satisfied:

- the statements of expenditure submitted by beneficiaries on the basis of which the Commission authorised payments were in most cases unclear, inconsistent and incomplete and did not enable the eligibility of the costs declared to be assessed. The activities for which costs were claimed were not always specified and therefore it was not possible to verify from the documents submitted by the beneficiary whether these activities were covered by the relevant Commission decision. In addition, beneficiaries did not sufficiently differentiate between costs relating to studies and those related to works. This is a significant weakness because the rates for financial support for studies and works differ. Similarly, the audit found that costs declared did not relate to the correct Commission decision,
- insufficient guidance on the structure and content of financial and technical progress reports resulted in the content of the latter reports often being not specific enough to verify whether the project activities were carried out as described in the Commission decision,

6.28. The question raised refers to article 5.1 of TENs Financial Regulation which states that aid shall be granted 'in principle, only if achievement [...].'

For TEN-T the promoter is normally a public organisation or a public company therefore the question of financial obstacles for public investment is a matter of choices between options for public expenses. The Community funds are a catalyst, particularly in the study and start-up phases when Member States do not otherwise attach the necessary priority to TEN's projects.

6.29. Where initial information received by the Commission was incomplete or unclear, adequate steps were taken to obtain clarification of such issues prior to proceeding with final payment. In addition the Commission takes into account the principle of ensuring continuity of the action under public support where more than one decision covers the same project. Where absence of distinction between studies and works for some costs declared was noticed, adequate measures will be taken as appropriate.

Studies may include works as technical support measures when this is necessary for these studies. Works may include technical studies carried out during implementation phase provided that the subject of the study is directly linked to the works, in agreement with normal practice acknowledged by the Committee of Member States.

Improvements are considered especially through the TEN-T handbook to be developed (see paragraph 6.27).

It is true that in two cases considered as irregular payments by the Court, the executive summaries were not submitted before the final payment. In one of these, the project consists of consecutive decisions concerning the same study. The study activities were carried out according to the decision concerned although a formal executive summary would only be presented upon completion of the last decision linked to the study phase.

The Commission will no longer make final payments in the absence of executive summaries.

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- in addition, executive summaries of studies, which should be provided together with the application for final payment, were missing in two out of the three studies audited. These summaries are essential for the Commission staff to be able to assess project execution, as the full study reports are often very long and complex documents.

Controls of cost statements

6.30. On-the-spot audits by the Court found that the checks carried out at Commission level had failed to detect and correct claims for ineligible costs. As noted in paragraph 6.19, on-the-spot checks at the final beneficiary level need to be carried out to detect most errors of legality and regularity in the transactions. Even when the Commission had carried out on-the-spot checks, the Court found that some expenditure that had been cleared for reimbursement was not regular. Failure to detect irregular expenditure at both Commission level and on the spot led in some cases to undue interim payments or overpayments:

- one beneficiary reallocated Community funds to other project subactivities which had not been the subject of an application, evaluation, selection and Commission decision. The final cost statement for this project was accepted and paid by the Commission even though this misallocation was evident from the documents supporting the payment claim. Moreover, the project subactivities thus co-financed by the Commission had already been fully financed from regional or national funds, making the activity ineligible for TEN-T financial assistance,
- costs directly relating to works were charged and authorised in study projects benefiting from a higher funding rate of 50 %. In one case about 90 % of the amount paid for a study consisted of costs related to the supervision of works,
- costs outside the eligibility period, costs for activities not covered by the Commission decisions or costs which are explicitly excluded (such as value

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6.30. *On-the-spot controls, where made, were appropriate in the specific cases to determine the eligibility or otherwise of costs in the context of the Council regulation and project descriptions contained in the decisions. In the one particular case where a misallocation of funds was mentioned by the Court, no on-the-spot control had been made. In this case, a financial and technical audit will be carried out and adequate measures will be implemented.*

The more detailed description of activities requested with the 2002 decisions and further developed in the 2003 decisions should reduce the risk of funding of non-eligible activities. In addition, in the context of the TEN Regulation, the new 2003 text underlines and strengthens the responsibility of Member States in the implementation and follow up of financial aid, in particular, their competences in the fields of financial control, appraisal, monitoring and evaluation of projects.

As mentioned above, a financial and technical audit will be performed and adequate measures implemented as necessary.

As explained in point 6.26, definitions of works and studies will be further developed in the TEN-T handbook.

The 'costs outside the eligibility period' refer to a case where the same project is covered by two decisions (lack of available funds to allocate all in one year) and the same eligibility criteria applies to both decisions in order to respect the principle of continuity of the action and the support:

- activities such as environmental measures are inextricably linked to the project measures,
- VAT is not accepted. In case of erroneous declarations, corrective action will be taken,

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- added tax and contributions in kind) were claimed and accepted by the Commission,
- in many cases where the eligibility of costs should have been questioned by the Commission, the costs concerned were accepted without further inquiry as to their nature,
 - the requirement to ensure suitable publicity for the Community financing granted, as defined in the Council regulation and the relevant Commission decisions, was not respected in four out of 16 cases where it was applicable.

6.31. Although in most cases the authorisation of a final payment is preceded by an on-the-spot control carried out by the Commission, no ex post financial audits for TEN-T actions were carried out in 2002, despite the Commission having indicated that they would be in its reply to a previous observation made by the Court ⁽¹¹⁾.

THE COMMISSION'S REPLIES

- *any correction to contribution in kind would be made at the stage of the final payment at the latest.*

In general the Commission carries out on-the-spot missions (technical and financial) before proceeding with the final payments and requests more details in case of doubt.

The Commission checks when it goes on an on-the-spot mission that this element is covered. Of course the check cannot be continuous and on every part of the project.

6.31. *The fact that no ex post financial audits on TEN projects have taken place in 2002 is due to the fact that since the merger of the Directorate-General for Energy and Transport, the emphasis has been put on the reduction of the RAL, and thus the closure of old contracts has used a lot of the Directorate-General for Energy and Transport's human resources available in the financial sector. To compensate the lack of sufficient resources to undertake ex post audits by outsourcing a number of financial audits, the Directorate-General for Energy and Transport is preparing a framework contract with an external audit company; this contract is expected to be operational by the end of the year 2003 and will allow the Directorate-General for Energy and Transport to increase the number of ex post audits undertaken on TEN projects considerably.*

The financial audit cell of the Directorate-General for Energy and Transport has already accompanied the Court of Auditors in a limited number of financial audits in 2003 as observer, and will itself undertake a number of ex post audits of TEN projects in the months to come. For 2004, and apart from the audits that will be undertaken by the external audit company, the Directorate-General for Energy and Transport's financial audit cell will, as well, undertake an increased number of ex post audits. To this end, the team will be reinforced.

Finally it should be mentioned that the in-depth internal financial controls carried out on all final payments and the on-the-spot financial controls undertaken for almost all works-projects, allow the verification of eligibility of costs declared, and reduce the risk of overcharging considerably.

⁽¹¹⁾ Court of Auditors Annual Report concerning the financial year 2001, paragraph 4.33.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Documentation of controls carried out

6.32. In several cases audited, project files were incomplete, mainly due to the Directorate-General for Energy and Transport's internal reorganisation, but also due to the frequent staff turnover. In general, the audit found that project files did not contain checklists or detailed reports from the desk or financial officer with information on the nature and results of controls carried out, except in those cases where an on-the-spot control has been carried out. In some cases, cost categories which are eligible (such as indirect costs) were rejected, while cost categories whose eligibility is questionable were accepted without any justification being provided. In most cases only additional information provided by the beneficiary on the spot made it possible for the Court to verify the eligibility of all the costs declared and paid by the Commission.

Legality and regularity of payments

6.33. Although the commitments were legal and regular, proposals were not always submitted within the deadlines set by the Commission and the evaluation process was not sufficiently documented.

6.34. Owing to inadequate controls, payments were made for a project which had not been the subject of a Commission decision, for costs considered as ineligible (such as value added tax and contributions in kind), for activities which are ineligible as studies or which had already been financed under another Commission decision.

6.35. Cases of undue interim payment or overpayment were found in two out of three studies and in three out of 11 works audited. As for works, the risk of overpayments is limited because of the overall restriction of the EU contribution to 10 % of the total investment costs and the fact that actual investment costs are higher than budgeted costs.

6.32. *The Commission will develop and implement checklists to cover particular funding programmes.*

6.33. *The Commission has strengthened the rules for the deadline for receipt of proposals, and will emphasise the specific control of the correct transfer of the eligible date into the decisions in all future cases. The update of the Manual of procedures of the Directorate-General for Energy and Transport includes a more detailed selection process than that of 2003.*

The question of a proposal received after the deadline for non MIP is duly taken into account in the 2003 process. Such cases have been rejected.

6.35. *On the basis of information available and internal controls performed the preconditions for interim payments were met. At the level of final payment more detailed controls are made. Difference of interpretation for eligibility of costs remains.*

THE COURT'S OBSERVATIONS

6.36. In addition, as noted in paragraph 6.29, some final payments were irregular as the specific preconditions required by the financial implementing provisions had not been satisfied at the time of payment.

Legal and control framework of the TEN-T programme

6.37. The TEN-T legal framework should be further strengthened. The new model Commission decision text is an improvement but still lacks certain key elements:

- although the Commission committed itself to improving the clarity of the definition of works, there is still no separate technical Annex in the new model Commission decision ⁽¹²⁾,
- the recommendation by the Court to include a standardised cost statement form in the new model Commission decision text has not been followed although this would allow controls to be carried out more efficiently,
- on-the-spot audits have shown the need to reinstate the publicity provision in the model Commission text, and to define in more detail the requirement to ensure suitable publicity for actions to which Community assistance has been granted.

6.38. In order to ensure coherent and consistent interpretation and application of the different rules applicable to TEN-T and to increase awareness and comprehension of these rules among beneficiaries, it is recommended that a specific TEN-T manual for beneficiaries be drawn up in cooperation with the Member States. This manual should, amongst other things, address the need for guidance on the interpretation of cost eligibility rules, define the scope of the different forms of aid and specify minimum rules and, preferably, formats for technical and financial reporting. It should also include guidelines regarding the verification of the legal and financial viability of beneficiaries which are not public entities.

THE COMMISSION'S REPLIES

6.36. The Commission explained in point 6.30 why, in one of the two cases concerned, it considers the payment to have been regular.

For the future, the Commission undertakes not to make any final payments if the executive summaries are missing.

6.37. The Commission will go on improving the clarity of the definition of works as indicated above.

The Commission currently uses the Annex 'presentation of the project' as a technical Annex. The Commission will go on improving the clarity of the definition of works by introducing, as from 2003, a separate technical Annex for works and studies in the Commission Decisions.

The Commission will introduce the use of standardised cost statements within the new version of the 2003 Commission Decision, as well as within the 2003 review of the TEN-T procedures, which will result in a TEN-T handbook by the end of 2003.

The Commission will further develop relevant publicity obligations for the Member States and the beneficiaries.

6.38. Different measures will contribute to improvements and hence respond to the observations made by the Court:

- the new version of the 2003 Commission decision will identify the role and the responsibilities of each partner involved in using this financial contribution,
- the 2003 review of the TEN procedures,
- the forthcoming TEN-T handbook.

⁽¹²⁾ Court of Auditors Annual Report concerning the financial year 2001, paragraph 4.18.

THE COURT'S OBSERVATIONS

6.39. It is also recommended that the Commission should apply the provisions in the Council regulations and in the relevant Commission decisions more rigorously. This concerns, in particular, eligibility for TEN-T assistance, the preconditions for interim and final payments, the modification of Commission decisions, the conclusion of grant agreements and publicity.

6.40. In addition, checks should be more effective and better documented. The checklists and control reports which are used in the control process should be dated and signed by the responsible officials. The results of these controls should be communicated to the Member States and the beneficiaries.

6.41. As recommended previously, *ex post* financial and technical audits should complement on-the-spot checks performed by technical and financial officers prior to the final payment. Guidelines for these audits should be established and communicated to Member States and beneficiaries.

6.42. The Commission is reminded of its commitment to integrate TEN-T into the central IT project management system at the Directorate-General for Energy and Transport, the first integration phase of which should have been operational by the end of 2002.

Analysis of audits carried out by the Commission in internal policies

Number of audits carried out by the Commission

6.43. Compared with 2001, the 13 directorates-general involved in internal policies increased the number of completed audits from 393 to 516 (see **Table 1**), despite the decrease in the number of contracts audited from 892 to 840. Unlike all the other Commission directorates-general operating in internal policies, the Directorate-General for Justice and Home Affairs had not carried out any *ex post* audits at the end of 2002.

THE COMMISSION'S REPLIES

6.39. Control will be improved considerably by the introduction of the changes already mentioned in the previous paragraphs.

6.40. The Commission is introducing improvements in these areas; notably in the implementation of checklists and in informing Member States of the outcome of controls.

6.41. As mentioned under point 6.31, the Directorate-General for Energy and Transport is preparing a framework contract with an external audit company; this contract is expected to be operational by the end of 2003, and will allow the Directorate-General for Energy and Transport to increase the number of *ex post* audits undertaken on TEN projects considerably. It is clear that guidelines for these audits will be established and communicated to Member States and beneficiaries. The audits that the Directorate-General for Energy and Transport's financial audit cell has undertaken in 2003 together with the Court of Auditors, and the audits that this cell intends to undertake during the following months, will contribute to their preparation.

6.42. The Commission has continued its efforts to include the TEN-T in its IT system, which should be done before the end of 2003.

Table 6.1 — Audits by the Commission completed in 2002 ⁽¹⁾

Directorate-General	Number of audits completed		Number of contracts audited		Number of open contracts		Value of audited contracts (million euro)		Value of open contracts (million euro)		Amounts recoverable or reduced payments as a result of the audits (million euro)	
	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002
AGRI-Agriculture	4	15	(4)	21	387	280	12,94	30,45	69,40	68,69	(4)	2,94 ⁽⁸⁾
EAC — Education and Culture	11	32	12	47	20 165	28 063	1,87	30,84	670,56	689,05	0,44	0,64
EMPL — Employment and Social Affairs	14	21	36	39	1 697	1 464	8,15 ⁽²⁾	10,44	125,64 ⁽²⁾	116,80	0,65	0,46
TREN — Energy and Transport	21	65	55	153	2 996	2 133	1 025,86	3 261,35 ⁽⁹⁾	2 124,65 ⁽²⁾	2 084,25	1,67	2,92
ENTR — Enterprise	2	18	12	24	2 857	1 641	3,75	15,48	451,86	272,02	0,21	0,35
ENV — Environment	31	32	39	34	2 345	1 790	21,47	12,10	308,44	333,09	0,78	0,60
FISH — Fisheries	4	11	19	37	211	182	4,51	8,82	125,80	142,21	0,05	0,19
(6)	4	2	13	14	22	18	35,40	42,74	91,01	32,45	0,02	1,81
JHA — Justice and Home Affairs	5	0	269 ⁽⁵⁾	0	754	n.a.	1,78	n.a.	30,87	n.a.	0,06	0,06
SANCO — Health and Consumer Protection	12	17	25	17	712	n.a.	6	7	93	n.a.	0,21	0,23
(3)	14	7	14	7	n.a.	n.a.	109,21	958,42	(5)	n.a.	10,18	on going
INFSO — Information Society	38	54	99	107	4 502	3 984	66,60	58,60	1 657,80 ⁽²⁾	1 855,20	5,17	2,36
MARKT — Internal Market	1	1	0	31	268	113	0,00	4,19	8,54	9,83	0,00	0,00
RTD — Research	232	237	299	297	14 441	14 981	699,80	80,60 ⁽¹⁰⁾	4 302,00	4 594,00	6,90	3,90
TAXUD — Taxation and Customs Union	0	4	0	12	57	191	0,00	1,14	33,84	58,91	0,00	0,00
TOTAL	393	516	892	840	47 803	54 840	1 996,99	4 522,17	10 093,67	10 256,50	26,34	16,46

(1) Definitions used in generating 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' denotes both contracts (either a shared-cost action or a contract awarded through the public procurement procedures) and subsidies (where a financial agreement has been reached). 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 except TEN-T actions.

— Amount recoverable: amounts calculated in the on-the-spot audits as recoverable and evidenced in the audit reports.

(2) Commission's share only.

(3) Veterinary and plant health actions. 'Value of audited contracts' here means claims of the Member States.

(4) Not specified, or not available.

(5) Includes internal audit capability examination of internal control systems in place for budget heading B5-820 audited on a sample basis (265 contracts).

(6) Fishery control measures. 'Contract' here means programme of a Member State; 'value of audited contracts' here means value of audited items within a programme; 'value of open contracts' here means the total value of the multiannual measures for all Member States.

(7) The amounts recoverable are indicative only.

(8) This amount includes a suspended 2 million euro payment to the Netherlands under the project 'Idea' (Identification of Animals)

(9) The total value of TEN-T contract contains the Commission's co-financing of maximum of 10 %.

(10) This amount corresponds to the total audited cost statements.

Source: Commission departments.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Target for the audit of participants in RTD framework programmes

6.44. In the research area, the Commission has intensified its audit activities since 1999, defining an overall audit target of 10 % of contractors during an RTD framework programme ⁽¹³⁾. In total, 376 audits relating to 572 contracts for indirect RTD actions were closed during 2002 by the five Directorates-General (Research, the Information Society, Energy and Transport, Enterprise and Fisheries) involved in the management of the RTD framework programmes (see **Tables 6.2 and 6.3**). As in the previous year, the Directorate-General for Research performed most of the audits, finalising 237 audits covering 297 contracts.

6.45. 84 % of the audits concerning indirect RTD actions were carried out by external audit firms mandated by the Commission. The cost of an audit that is contracted out is, to a certain extent, independent of the number of contracts audited ⁽¹⁴⁾.

6.46. According to the information provided by the Commission, the number of audits completed in 2002 by the Directorate-General for Research represents 4,8 % of the auditable population of contractors as defined by the Commission. This compares with 9,2 % and 8,5 % for the years 2000 and 2001 respectively. Moreover, 41 % of the 378 audits closed during 2002 concerned indirect RTD actions related to the fifth framework programme (FP5) for research and technological development activities. This confirms the concerns expressed in the Court's Annual Report for 2001 that the target will be difficult to achieve for FP5 ⁽¹⁵⁾.

6.45. *The price to be paid for an audit of a single contractor is indifferent, whether one, two or three contracts are subject of the audit. In general, the Commission is seeking to make effective use of these price conditions. The method of calculating the price paid for the audits is laid down in the terms of the contract with the outside firm and was part of the information already set out in the call for tenders prior to the contract.*

6.46. *The Research Directorates-General have stepped up their audit activities since 1999, defining an overall audit target of 10 % of contractors to be audited during the lifetime of the FP5 contracts. The Commission still considers that overall this target will be reached for FP5.*

⁽¹³⁾ Written Commission reply to the questionnaire of the Budgetary Control Committee of the European Parliament, paragraph 4.3, dated 21 December 2001. See also the Court of Auditors Annual Report concerning the financial year 1999, and the reply by the Commission to paragraph 4.23.

⁽¹⁴⁾ For a lump sum of 15 000 euro and the obligation to deliver the final audit report within six months, up to three contracts per auditee can be requested from the external audit companies.

⁽¹⁵⁾ Court of Auditors Annual Report concerning the financial year 2001, the Commission's reply to paragraph 4.60.

Table 6.2 — Summary table of audits closed during 2002 — Research DGs

Directorate-General in charge		RTD-related audits closed in 2002				
		Total number of audits closed		Total number of contracts audited		Ratio contracts /audit
DG RTD	Internal	27	11,39 %	31	10,44 %	1,15
	External	210	88,61 %	266	89,56 %	1,27
	Total DG	237	100,00 %	297	100,00 %	1,25
DG INFSO ⁽¹⁾	Internal	7	13,21 %	7	6,54 %	1,00
	External	46	86,79 %	100	93,46 %	2,17
	Total DG	53	100,00 %	107	100,00 %	2,02
DG TREN	Internal	5	10,20 %	12	11,01 %	2,40
	External	44	89,80 %	97	88,99 %	2,20
	Total DG	49	100,00 %	109	100,00 %	2,22
DG ENTR ⁽²⁾	Internal	0	0,00 %	0	0,00 %	n.appl.
	External	16	100,00 %	22	100,00 %	1,38
	Total DG	16	100,00 %	22	100,00 %	1,38
DG FISH	Internal	21	100,00 %	37	100,00 %	1,76
	External	0	0,00 %	0	0,00 %	n.appl.
	Total DG	21	100,00 %	37	100,00 %	1,76
Total Internal		60	15,96 %	87	15,21 %	1,45
Total External		316	84,04 %	485	84,79 %	1,53
Total 2002		376	100,00 %	572	100,00 %	1,52

⁽¹⁾ The number of audits closed by DG INFSO includes four audits carried out by the Court of Auditors, where representatives from the Commission participated or where follow-up work has been carried out.

⁽²⁾ Two audits initially closed by DG TREN, but subsequently re-opened by the Commission's departments, have not been taken into account for the calculation.

Source: Commission DGs.

Table 6.3 — DG Research (RTD): Statistics on audit reports examined and time-to-audit analysis**2001**

Type	Number of audit reports examined	Period from audit start to date of report (in months)		Period from date of report to final assessment (in months)		Total period from audit start to final assessment (in months)	
		Information available for number of audits	Average (months)	Information available for number of audits	Average (months)	Information available for number of audits	Average (months)
Internal ⁽¹⁾	13	8	2,3	11	1,7	9	5,2
External ⁽²⁾	219	217	3,8	218	0,9	217	4,7
Total	232 ⁽³⁾	225	3,7	229	1,0	226	4,7

2002

Type	Number of audit reports examined	Period from audit start to date of report (in months)		Period from date of report to final assessment (in months)		Total period from audit start to final assessment (in months)	
		Information available for number of audits	Average (months)	Information available for number of audits	Average (months)	Information available for number of audits	Average (months)
Internal ⁽¹⁾	27	23	1,1	25	0,0	24	1,5
External ⁽²⁾	210	201	4,9	203	1,3	200	6,3
Total	237	224	4,5	228	1,2	224	5,8

⁽¹⁾ Executed by DG Research departments.

⁽²⁾ Executed by external audit firms.

⁽³⁾ Total number of audit reports.

Source: Analyses made by the Court based on the Commission's information.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Supervision and follow-up of *ex post* audits

6.47. Differences were found in the way in which the five directorates-general operating the RTD framework programmes manage and coordinate the *ex post* audits as well as in the procedures applied to the selection of contractors to be audited.

6.48. The results of the audits carried out by the Directorates-General for Research, the Information Society and Energy and Transport are systematically communicated to the other directorates-general in order to enable them to take action where appropriate. However, at the Directorates-General for Research and the Information Society, although there are specific procedures for the communication of the findings of their own audits to the operational units and for the assessment of the need to take corrective action, these procedures were not applied to the audits carried out by the other directorates-general. In no case did the Commission present evidence that corrective action had been taken following an audit report originally mandated by a different directorate-general.

6.49. The supervision by the Commission of the work performed by the external audit firm is of great importance for ensuring that their findings and conclusions are supported by reliable audit evidence, and can be relied upon. In most cases, the Commission's different *ex post* audit functions applied a coherent and consistent approach to the review of the results reported by the external audit firm. This review is mainly based on plausibility checks of the audit findings reported in the agreed audit report against the specific contractual provisions developed under the different RTD framework programmes. Despite the Commission's guidelines on the minimum scope of audit work, the re-performance

6.47. *The Research DGs use different sampling methods for selecting contracts and contractors for on-the-spot audits, which they consider to be just as valid.*

This is not the case for the management and coordination of external audit firms, however. On the contrary, the Commission wants to underline that the way in which the five Research Directorates-General manage and coordinate the external audit firms is harmonised. The same external audit firm is used by all directorates-general and instructions to the audit firm and handbooks are provided by the Commission's services in a coordinated manner. At monthly progress meetings the quality of the external audit firm is monitored and directly discussed between Commission representatives of all directorates-general concerned and the central management team of the external audit firm.

6.48. *Generally speaking, audit reports are used as an early warning for the operational units. However, the Commission recalls that the scope for generalisation of such audit results is limited. The Commission considers with a view to the applicable legal provisions each case must be considered on its merits and cannot be subject to general extrapolation without the necessary evidence.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

by the Court of one of the audits carried out by the external audit firm identified a number of problems.

6.50. As regards the follow-up given to the findings reported by the external audit firm to the Commission, the Court analysed the audit reports on audits of contractors participating in indirect RTD actions on behalf of the Directorate-General for Energy and Transport and completed in 2002 ⁽¹⁶⁾. These audits, 19 of which started in 2001, covered 44 different participants in indirect RTD actions involved in 97 research contracts. One of these 97 contracts was related to FP3 indirect RTD actions, 81 and 15 related to FP4 and FP5 respectively.

6.51. Out of 44 participants audited, eight revealed a high level of irregularities. Nearly all of the audit reports included in the Court's sample identified errors at final beneficiary level, mainly related to costs wrongly declared. In cases of over-declaration, funds that have been unduly paid should be recovered or, in the case of FP5 audits, the amount over-declared should be off-set against payments related to other contracts.

6.52. As at April 2003, for 45 of the contracts where over-declarations had been detected by the external audit firm, no action at all has yet been taken by the Commission. There is an opportunity cost associated with interest receivable on outstanding recoveries. The Commission should therefore ensure timely recovery of funds unduly paid.

6.53. Information on the potential amounts to be recovered by the Commission is available at the date on which the final report is submitted by the auditors and accepted by the Directorate-General for Energy and Transport. In line with the Financial Regulation, the definite amounts are entered in the accounts only when the Commission issues a formal recovery letter, but not at all if the overpaid funds are off-set against subsequent payments to the audited contractor. According to the

6.51. *Many of the Commission's audit observations relate to recommendations for system improvement, formal issues or interpretation of the participation rules without financial impact. In some cases the financial adjustments resulting from the audit were also in favour of the beneficiary.*

6.52 and 6.53. *Since the merger of the former Directorates-General for Transport and Energy, a lot of effort has been put on the reduction of the RAL by closing a high number of very old contracts. Together with the efforts required to implement the annual commitment and payment of appropriations in the most efficient way, this has mobilised all human resources available in the financial sector of the Directorate-General for Energy and Transport. Now that the reduction of old contracts has already been realised to a large extent, the Directorate-General for Energy and Transport's Director General has given clear instructions to give top priority to the implementation of the results of the financial audits. It is planned to make up the backlog in this area before the end 2003. This includes of course the provisional registration of estimated receivables and the launching of the necessary recovery orders.*

⁽¹⁶⁾ The Directorate-General for Energy and Transport considers an audit terminated on the date on which the audit service establishes an Audit Summary Sheet on the basis of the audit report to be submitted for follow-up to the operational units.

THE COURT'S OBSERVATIONS

Financial Regulation, provisional registration of estimated receivables should have been made earlier ⁽¹⁷⁾. Procedures for launching a recovery note sometimes took a considerable time.

Conclusions and recommendations in the context of the Statement of Assurance

6.54. The follow-up of the weaknesses stated in the Annual Activity Reports for 2001 in the audited directorates-general was adequate and led to action plans being drawn up. The implementation of those action plans is still in progress. At the end of 2002 it was not possible for the Court to give an opinion as to their impact on the legality and regularity of the underlying transactions of the directorates-general concerned (see paragraphs 6.6 to 6.7).

6.55. The audit revealed weaknesses in the Commission's reporting on the implementation status of the Internal Control Standards (ICS) (see paragraphs 6.14 to 6.16).

6.56. The procedures for drawing up the Annual Activity Reports for 2002, as well as the clarity of presentation, improved significantly compared to 2001. Several reservations from the 2001 declarations were repeated in the declarations relating to 2002, given that the corrective measures had not yet overcome the underlying constraints and weaknesses. Some reservations were still not quantified as regards their financial or monetary impact (see paragraph 6.11). The Declarations of the Directors-General do not yet enable the Court to derive assurance from them.

6.57. The extension and continuation of the systems analysis of TEN-T actions operated by the Directorate-General for Energy and Transport still gave rise to a large number of audit observations relating to payments for studies and for works (see paragraphs 6.31 to 6.34). Completed TEN-T actions have not yet been subject to external audits (see paragraph 6.39).

THE COMMISSION'S REPLIES

6.54. The annual activity reports are the responsibility of the directors-general. They draft their declarations, accompanied where appropriate by reservations, on the basis of the information set out in the annual reports, in particular the financial impact of these reservations where necessary. The action plans introduced as a result of the reservations expressed may cover several years.

6.55. The implementation of the 24 ICS is progressing in all three Commission directorates-general audited by the Court (see paragraphs 6.14 to 6.16).

6.56. The information contained in the annual activity reports form a basis for the assessment by the directors-general of the importance of any reservations and consequently for their declarations on the legality and regularity of the transactions.

6.57. Ex post audits will complement on-the-spot checks already performed by technical and financial officers prior to the final payment. For that purpose, a framework contract with an external audit company will allow the Directorate-General for Energy and Transport to increase the number of ex post audits undertaken on TEN projects considerably. In the meantime the financial audit cell of the Directorate-General for Energy and Transport has already accompanied the Court of Auditors on a limited number of financial audits in 2003 as observer, and will undertake itself a number of ex-post audits of TEN projects in the months to come. For 2004, and apart from the audits that will be undertaken by the external audit company, the Directorate-General for Energy and Transport's financial audit cell will as well undertake an increased number of ex post audits.

⁽¹⁷⁾ Article 28 of the Financial Regulation.

THE COURT'S OBSERVATIONS

6.58. An analysis of the audits in the field of internal policies, where research represents more than half of the budget, again shows a considerable incidence of errors. These audits, carried out by or on behalf of the Commission, revealed a large number of excessive declarations of costs by final beneficiaries for indirect RTD actions. The follow-up of the audit findings is not rigorous enough, and the recovery procedures for the Community's financial contribution already paid were found to be slow (see paragraph 6.50).

6.59. The level of errors detected by the Commission's own audits in the research field (see paragraph 6.48) corroborates the Court's audits during the last few years. These errors are to a great extent due to the existing rules governing the RTD framework programmes. Modifying these rules is a condition sine qua non for reducing the extent of irregularities in this area.

6.60. The Commission is recommended to:

- continue its efforts in implementing the reform concerning the Commission's internal control systems,
- harmonise the reporting in the Annual Activity Reports and the Declarations of the Directors-General for the same or similar underlying deficiencies,
- give follow-up to the Court's recommendations concerning the TEN-T programme ⁽¹⁸⁾,

⁽¹⁸⁾ Court of Auditors Annual Report concerning the financial year 2001, paragraphs 4.31 to 4.36.

THE COMMISSION'S REPLIES

6.58. *Internal policies are very varied and the situation can differ substantially from one DG to another. In the case of research, the audits carried out by the Commission revealed a high incidence of errors in the declarations of expenditure submitted by the beneficiaries.*

The Research Directorates General will improve and harmonise the follow-up of audit findings, including the recovery of undue paid contributions.

6.59. *Problems similar to those detected by the Court have been noted in the area of research, where these are problems with the way in which beneficiaries apply the terms of their contract when presenting their cost statements. An action plan following on from action 1 of the Report summarising the annual activity reports for 2001 came into force on 1 January 2003. This plan also covers actions administered under both the fifth and the sixth RTD framework programmes.*

Generally speaking, the rules for the management of framework research programmes are established by the legislature (Parliament and the Council).

The synthesis of the annual activity reports and declarations of the directors-general for 2002 provides for a 'co-financing' measure to examine the possibility of introducing flat-rate grants with a view, in particular, to concentrating control efforts on the situations of highest risk. This measure also provides for the development of common standards applicable to risk management and the assessment of the costs and benefits of control activities.

6.60. *The Commission is continuing its efforts to reform its internal control systems. In addition, a 'readiness assessment' will be carried out by all the directorates-general before the end of September 2003 to examine the extent to which they have implemented the baseline requirements of the internal control standards. The readiness assessment will make it possible to identify the measures to be taken and the additional support to be given to the directorates-general so that as many baseline requirements of the internal control standards as possible can be met by all DGs by the end of 2003.*

The Commission is also making a considerable effort to find ways of improving the consistency of the annual activity reports (see sections 4.2 and 4.3 of the 2002 synthesis report), including the 'peer review' of the 2002 reports — bearing in mind that the annual declaration remains the

THE COURT'S OBSERVATIONS

- strengthen and increase the external audit functions of the directorates-general operating the RTD framework programmes and achieve at least their own targets in this respect ⁽¹⁹⁾,
- reinforce its procedures for ensuring that the external audit firms perform the audits on the Commission's behalf to the highest professional standards,
- ensure adequate follow-up of the Commission's own audit findings.

THE COMMISSION'S REPLIES

responsibility of the directors-general, which inevitably implies a margin for discretion and a reflection of the special situation of each department.

As mentioned above, the Commission has taken into account remarks from the Court and will make further improvements in the decisions and through a TEN-T handbook that will be established by the end of 2003.

Controls are being stepped up. The Research DGs have moreover made specific mention of the fact in their action plan on action 1 of the synthesis annual activity report 2001.

The Commission is continuing to monitor the quality of audits carried out by outside firms.

It is making every effort to ensure that action is taken on these audits as quickly as possible.

FOLLOW-UP OF PREVIOUS OBSERVATIONS

Corrective action taken by the Commission in following up the audits carried out by the Court

6.61. The Court examined the follow-up by the directorates-general of previous audit findings on the financial audits of 28 contracts for FP5 indirect RTD actions audited at beneficiary level, all of which were reported by May 2002 at the latest, and assessed the appropriateness of the corrective action taken as at the end of March 2003.

⁽¹⁹⁾ Written Commission reply to the questionnaire of the Budgetary Control Committee of the European Parliament, paragraph 4.3, dated 21 December 2001.

THE COURT'S OBSERVATIONS

6.62. For all but one of the contracts for FP5 indirect RTD actions audited at beneficiary level, a recovery of funds unduly paid to the contractor (or compensation through the reduction of subsequent payments) was deemed necessary as a result of the Court's audit. The directorates-general have accepted the audit findings in almost half of the cases, and agreed in part to the other findings reported, agreeing to some of the audit findings or to the factual situation but disagreeing on the financial implications. In five cases, the Commission contested the findings reported. In four cases the Commission had not yet replied officially to the Court's audit findings.

6.63. As at the end of August 2003, only in 17 cases has corrective action been initiated by the Commission. The time needed by the directorates-general to take corrective action was excessively long, varying from one and a half to 20 months. The average period from the notification of the Court's audit findings to the Commission until the closure of the audit by the directorates-general (or the date of the corrective action) was seven months.

6.64. The follow-up of 11 of the audits carried out by the Court is still not complete, thus building up an average delay of more than one year from the notification of the audit findings. In nine of these audits, at least one further cost-claim-based payment has been authorised since the audit findings were transmitted to the Commission. These payments could already have included corrective action by means of adjustment to the accepted eligible costs for the subsequent period.

THE COMMISSION'S REPLIES

6.62. *This analysis of the Court's findings might take a long time (see paragraph 6.63) and it has not been possible up to now to conclude all these cases.*

When a decision is taken on financial adjustments, particularly recoveries, such operations are monitored regularly.

6.63 and 6.64. *The Commission is committed to respond to the audit findings of the Court as soon as possible. The Commission underpins the numerous steps necessary for the preparation of its follow-up, in particular the thorough analysis of the Court's findings, the execution of a contradictory procedure with the audited beneficiary and proper coordination between the different services concerned. Financial adjustments are applied as and where stated. The Commission accepts that improvement is necessary to shorten the delay.*

6.64. *The Commission is making every effort to close the outstanding audits. Before an audit report is drawn up, it is legitimate to follow up payments.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

SUMMARY OF SPECIAL REPORT No 11/2003
CONCERNING LIFE

6.65. The Court examined the management of the Financial Instrument for the Environment (LIFE), which is managed directly by the Commission and is being implemented in phases. The programme consists of three strands: LIFE Nature, LIFE Environment and LIFE Third Countries, plus accompanying measures. The audit focused in particular on the second phase (1996 to 1999, LIFE II).

6.66. The general objective of LIFE, which is to contribute to the development and, if need be, the implementation of Community policy and legislation in the environmental field, is very broad and has not been defined in sufficient detail. By contrast, with regard to the individual strands, LIFE Nature is more precisely defined, in as much as its actions depend on the implementation of two directives concerning the conservation of natural habitats and of wild flora and fauna and the conservation of wild birds.

6.67. LIFE is the largest programme among the special measures under the 'Environment' title of the budget. Of the Community participation of 450 million euro for the second phase (LIFE II), 435 million euro were used during the period for which it was allocated.

6.68. The Commission evaluates proposals according to different criteria for each strand of the programme and only calls on independent experts for LIFE Environment and LIFE Third Countries. Some of the evaluation documents drawn up by these experts have not been kept.

6.69. The complementarity of environmental projects financed by LIFE with those funded by other Community sources (Structural Funds, research) is still poor, and the interdepartmental consultation procedure does not wholly eliminate the risk of double funding.

6.65. *The Commission takes note of the Court's observations, in particular concerning LIFE-II.*

6.66. *The Commission accepts that there is still room for further improvements in terms of the objectives and scope of the Regulation and will therefore continue its efforts to specify the objectives of LIFE Environment in the framework of Community environmental policy and legislation.*

6.68. *The Commission has taken steps to ensure that all evaluation documents are systematically kept.*

6.69. *The Commission makes every effort to reduce the risk of double funding mentioned by the Court, but, since it is aware of this problem and in the light of the Court's remark, it will examine whether other steps might be considered in order to obviate this risk even more.*

The complementarity between LIFE and other Community sources is proven in many cases. The scope for improving this complementarity will be the subject of in-depth reflection.

THE COURT'S OBSERVATIONS

6.70. The Court identified many difficulties affecting the implementation of the second phase of LIFE (LIFE II). The main points revealed by an on-the-spot audit of a sample of projects were:

- (a) staff expenditure was borne which had not been backed up by reliable records and which included the salaries of civil servants usually already covered by public budgets;
- (b) a large number of Commission payments were affected by considerable delays;
- (c) there were shortcomings in the financial arrangements for the projects, and the beneficiaries failed to keep sufficiently transparent and detailed accounts to enable all the financial movements to be traced;
- (d) expenditure on the purchase of land for the LIFE Nature measures was substantial and there were insufficient guarantees that this land would continue to be used for nature conservation purposes once the implementation period for the measures was over.

6.71. With regard to the monitoring and control of projects, the Commission increased the number of on-the-spot visits and the findings showed several types of error at beneficiary level. The tasks of the Technical Assistance Offices (TAOs), which act as the external project-monitoring teams, were not well defined and the monitoring of the actions suffered as a result.

6.72. The efforts made to tackle the shortcomings in the management of the LIFE programme must be kept up. To this end, the Court recommends that:

- (a) the role of LIFE should be better clarified in the context of the multiannual environmental action programmes and its aims better defined and, if possible, quantified;
- (b) the Commission should examine whether it would be expedient to separate the management of the 'Nature' and 'Environment' strands;

THE COMMISSION'S REPLIES

6.70. *The Commission considers that under LIFE III it has made the improvements suggested by the Court following its findings concerning LIFE II projects.*

The following improvements have been made for LIFE III:

- (a) *as of LIFE III, the Commission has made it obligatory for staff to keep a record of the amount of time they have spent on LIFE projects (time sheets). The Commission will examine the question of taking account of officials salaries;*
- (b) *since the restructuring of the management of the LIFE programme, the number of delayed payments has gradually been reduced;*
- (c) *an effort has been made in the context of LIFE III to ensure better financial arrangements for projects;*
- (d) *the Commission is prepared to review the terms and conditions regarding land purchased by non-public beneficiaries (9 %).*

6.71. *The Commission has defined and provided a framework for the tasks and responsibilities of the technical and administrative assistance offices (TAOs) for LIFE III.*

6.72. *The Commission considers that the management of the LIFE programme has substantially improved since its restructuring.*

- (a) *The Commission intends to clarify the role of LIFE Environment in relation to the sixth environmental action programme (6th EAP).*
- (b) *The Commission takes the view that since centralised management has been introduced the programme is better managed and sectoral results are starting to be achieved.*

THE COURT'S OBSERVATIONS

- (c) the evaluation of project proposals should be carried out by outside experts, selected by a public call-for-proposals procedure, for all the strands of the programme;
- (d) the administrative provisions concerning the implementation of the actions should be reviewed in order to better define eligible costs, in particular as regards the accounting structure of projects, staff expenditure, depreciation and land purchases for LIFE Nature projects;
- (e) the Commission's on-the-spot checks should be stepped up, if need be by employing outside auditors;
- (f) the results of the projects should be disseminated.

THE COMMISSION'S REPLIES

- (c) *Whenever the Commission has considered necessary to use external experts, it applied a tender procedure.*
- (d) *The Commission considers that the recently adapted standard administrative provisions (SAP) fully comply with the new Financial Regulation and are adequate. The Commission is nevertheless ready to study the Court's recommendations in a future revision of the SAP.*
- (e) *Apart from regular technical and financial monitoring visits (by technical/financial desks and external teams) as well as financial audits by DG Environment's Financial Unit, an external audit of the final statement of expenditure is obligatory for all projects funded under LIFE III.*
- (f) *The communication strategy is being implemented and has already led to tangible results.*

ANNEX 1

Internal policies and research — Evaluation of key aspects observed in the internal policies

Observations	Action taken in 2002	Action to be implemented
1. Monitoring and control systems — Insufficient ex post audits of final beneficiaries		
<p>In 1998 the research directorates-general jointly formulated an audit strategy for the RTD framework programmes. These audits are to a large extent carried out by an external audit firm on behalf of the Commission.</p> <p>The Court found that the target defined by the five research directorates-general of auditing 10 % of the contractors during the fifth research framework programme would be difficult to achieve despite the significant increase in the audits performed. It should also be noted that the definition of 'auditable population' used by the Commission results in significantly less than 10 % of indirect RTD actions or cost statements being audited.</p> <p>While regular on-the-spot checks are already performed by the Commission officials in charge of monitoring TEN-T actions, these controls are not complemented by ex post financial and technical audits (where appropriate, carried out by the Directorate-General for Energy and Transport or external experts).</p> <p>Insufficient corrective actions in the Directorate-General for Energy and Transport for audits of indirect research contracts.</p>	<p>Implementation of the new audit strategy.</p> <p>Inclusion of TEN-T actions in the Directorate-General for Energy and Transport's audit programme for the years 2002 to 2003.</p>	<p>Achievement of 10 % target in 2003, and for FP5 indirect RTD actions as a whole.</p> <p>Adoption of audit strategy to sixth framework programme for RTD.</p> <p>Ensuring continuation of Commission's audit activity after expiry of current framework contract with external audit firm in 2003.</p> <p>Effective implementation of audit programme.</p> <p>With the entry into force in early 2002 of a framework contract covering technical assistance activities, including particular provisions for audits on TEN-T projects, more use of external resources is likely to be made.</p>
2. TEN-T system: Verification of the eligibility of costs		
<p>The definition of eligible and ineligible costs provided for in the legal basis and the Commission decisions is insufficiently specific to establish the actual costs incurred by the beneficiary.</p> <p>The definition of eligible costs for TEN-T actions differs from the definition applied to similar infrastructure projects co-financed through structural measures, and the use of different funding rates carries the risk that beneficiaries may maximise funding by wrongly allocating costs to studies.</p> <p>Studies and direct grants to investments co-financed through TEN-T often relate to larger-scale infrastructure measures similar to those funded by structural measures. However, these programmes have a much more detailed definition of the eligibility of costs. In addition, cost categories not eligible for co-financing under structural measures (such as entertainment costs, interest charges or personnel costs for national civil servants) are considered eligible under TEN-T.</p> <p>In particular, the definition of eligible costs should also include a clear delimitation of which costs are eligible for studies and for works.</p> <p>The absence of standardised cost statement forms further complicates the review and evaluation of cost claims.</p>	<p>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 costs and takes on board the Court's observations.</p>	<p>The revised text will be applicable from the Commission's 2002 financing decisions.</p> <p>The Commission is committed to improving the clarity of the definitions of eligible costs and the definition of activities covered by a decision. A more precise definition of eligible and non-eligible costs should lead to more precise cost declarations and better controls by the Commission.</p> <p>In the framework of the general review of the TEN-T procedures, the Directorate-General for Energy and Transport will examine the possibility of drawing up a more detailed standardised cost statement form, based on the existing payment claim form.</p>

ANNEX 2A

Summary of the implementation of the Internal Control Standards in directorates-general according to the AARs for 2002

Directorate-General	Standard not implemented	Implementation of minimum standard in progress	Minimum standard implemented	More than minimum standard implemented	Reservation on the implementation of ICS Yes/No	Observation on the implementation of ICS
Transport and Energy		2	10	12	No	No
Research		2	10	12	No	Yes ⁽¹⁾
Information Society	1	11	5	7	No	No
Justice and Home Affairs		12	7	5	Yes ⁽²⁾	No
Total	1	27	32	36	2	1

⁽¹⁾ As at 31 December 2002 the operational manual of the Directorate-General for Research was still incomplete, with the exception of financial circuits.

⁽²⁾ At the Directorate-General for Justice and Home Affairs, the documents describing the financial procedures were not yet formally adopted in January 2003.

ANNEX 2B

Summary of the Court's assessment of the implementation of the selected Internal Control Standards in three directorates-general at the end of 2002

Standard	Directorate-General for Transport and Energy	Directorate-General for Research	Directorate-General for Justice and Home Affairs
Objective setting (ICS 7)	Implemented (minimum standard)	Implemented (minimum standard)	Implemented (more than minimum standard)
Risk analysis and management (ICS 11)	Implemented (more than minimum standard)	Implemented (more than minimum standard)	Implemented (minimum standard)
Documentation of procedures (ICS 15)	Implemented	In progress ⁽¹⁾	In progress ⁽²⁾
Supervision (ICS 17)	Implemented ⁽³⁾	In progress ⁽⁴⁾	In progress ⁽⁵⁾
Recording and correction of internal control weaknesses (ICS 20)	Implemented	Implemented	In progress
Audit reports (ICS 21)	Implemented (minimum standard)	Implemented (minimum standard)	Implemented (minimum standard)
Internal audit capability (ICS 22)	Implemented (more than minimum standard)	Implemented (more than minimum standard)	Implemented (more than minimum standard)

⁽¹⁾ As at 31 December 2002 the operational manual of the Directorate-General for Research was still incomplete, with the exception of financial circuits.

⁽²⁾ At the Directorate-General for Justice and Home Affairs, the documents describing the financial procedures were not yet formally adopted in January 2003.

⁽³⁾ Even though the Directorate-General for Transport and Energy reported in the AAR that the minimum standard had been implemented, the Court found deficiencies in the operation of controls.

⁽⁴⁾ At the Directorate-General for Research the supervision plans were approved only in January 2003, which meant that the results of checks were not available in time for the AAR 2002.

⁽⁵⁾ While the Directorate-General for Justice and Home Affairs failed to implement ICS 17, the Director-General made a reservation in his declaration concerning supervisory arrangements.

ANNEX 3

Monitoring systems and controls

Area: internal policies and research
System: TEN-T monitoring systems

Aspects of the introduction of the monitoring system	Commission	Overall assessment
Conception	A	A
Practical transposition in procedural stages — compliance with standards — taking into account of experience	A	A
Actual operation: — compliance with standards — taking into account of experience	B	B
Results: — remedial effect — preventive effect	B	B
Overall assessment	B	B

A: 'Works well, few or minor improvements required'.

B: 'Works, but improvements necessary'.

CHAPTER 7

External actions

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INTRODUCTION

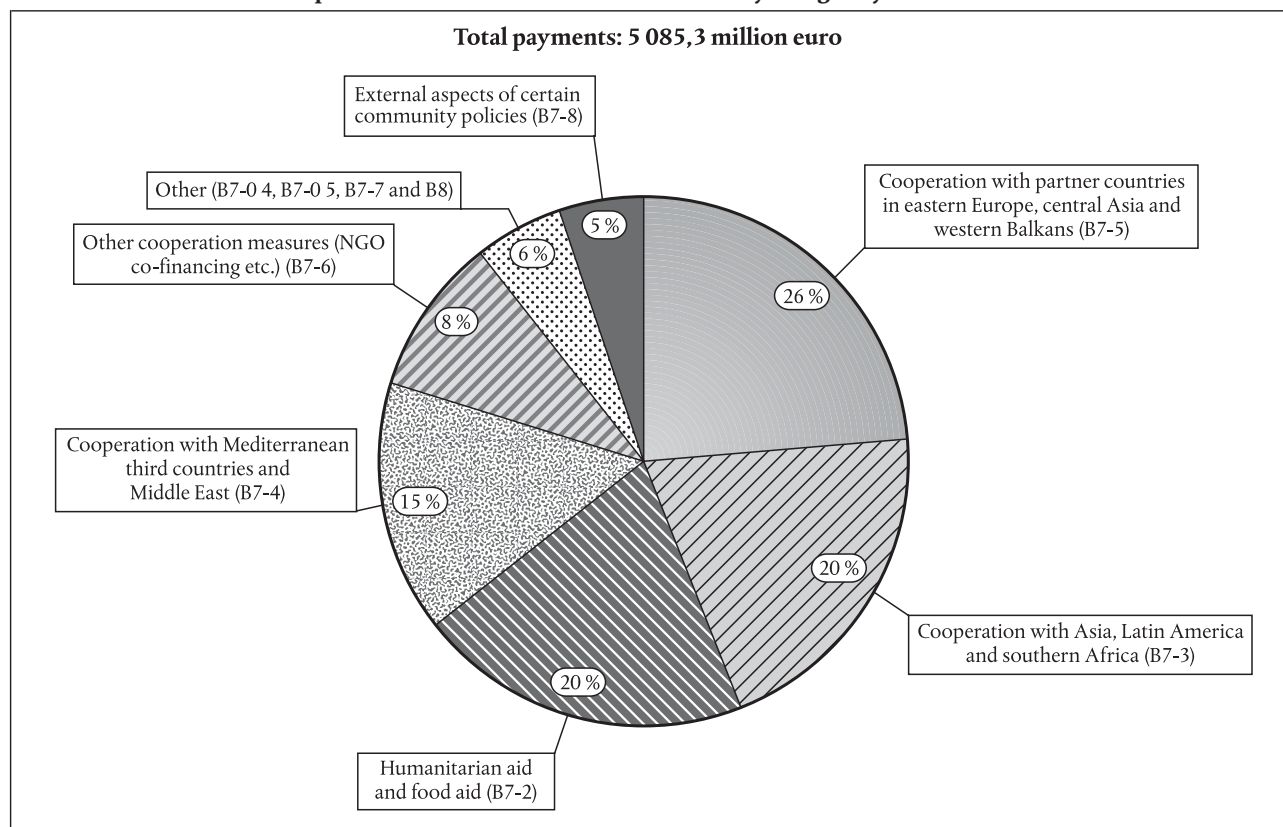
7.1. This chapter deals with the external aid financed from the general budget. The main areas of interest are food aid/food security, humanitarian aid, NGO cofinancing and financial and technical cooperation with Asia, Latin America, the Mediterranean countries, the western Balkans, the New Independent 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 multiannual 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 2002 for financial perspective heading 4 (see paragraphs 2.36 to 2.37 for observations on budgetary management).

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Scope and nature of the audit

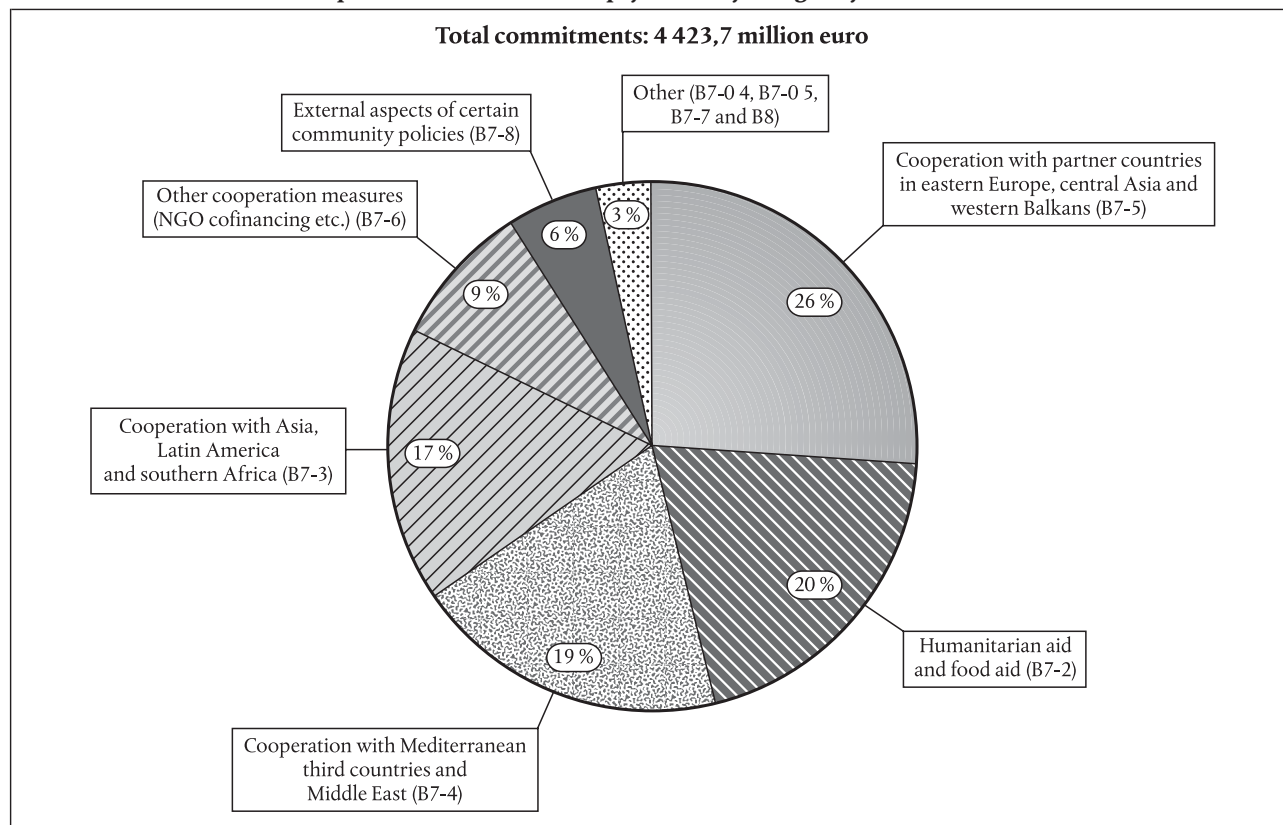
7.2. The overall objective of the specific assessment was to provide a conclusion as to the legality and regularity of transactions in the External Actions field (Heading 4 of the general budget financial perspective). The audit comprised a review of the supervisory systems and controls which are supposed to ensure the legality and regularity of transactions, supported by tests of transactions 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. This audit was carried out at the Commission headquarters, at six Delegations and at 22 implementing organisations. The areas mentioned in the previous paragraph were reviewed and tested. Reconstruction aid for Kosovo and Serbia and Montenegro is the subject of a separate annual audit of the European

⁽¹⁾ See separate report on the EDFs.

Graph 7.1 — Breakdown of commitments by budgetary area in 2002

NB: for more detailed information see Diagrams III and IV of Annex I.

Source: 2002 revenue and expenditure accounts.

Graph 7.2 — Breakdown of payments by budgetary area in 2002

NB: for more detailed information see Diagrams III and IV of Annex I.

Source: 2002 revenue and expenditure accounts.

THE COURT'S OBSERVATIONS

Agency for Reconstruction. The results of this audit have been taken into consideration for the specific assessment of heading 4. Furthermore, the assessment includes the results of the audit of a limited number of transactions under the International Fisheries Agreements.

7.3. The creation of the EuropeAid Cooperation Office at the beginning of 2001 involved a complex reorganisation of the Commission's services dealing with external relations. This process involved the redistribution of tasks and functions between Directorates-General, as well as between the Commission's headquarters and its Delegations, combined with reorganisation of supervisory systems and controls. This is a lengthy process and 2002 must be considered to be a transitional year: most of the changes of procedures and structures relating to supervisory systems and controls which were started in 2001 were in place by the end of 2002, but not all were operational throughout the year (in particular, the use of questionnaires and internal reporting on financial management).

*Supervisory systems and controls***Internal control standards**

7.4. Both the EuropeAid Cooperation Office and the Humanitarian Aid Office completed the framework for the implementation of the internal control standards (ICS) as defined by the Commission on 13 December 2000 ⁽²⁾. These comprise the definition of the functions and tasks of the various departments and units, the management of human resources, rules and instructions concerning the delegation of authorising powers, planning and programming, risk analysis, information structures, monitoring and control, as well as audit and evaluation. The introduction of these standards has been supported by issuing or updating instructions and guidelines and extensive training programmes, in particular on the administrative and financial procedures (such as the authorising of financial transactions and tendering).

THE COMMISSION'S REPLIES

7.3. *The major improvements in procedures and structures, which began in 2001, continued in 2002 and 2003.*

⁽²⁾ SEC(2000) 2203.

THE COURT'S OBSERVATIONS

7.5. At the Humanitarian Aid Office most of the procedures were operational throughout most of 2002. Although overall supervision and reporting at management level took the form of weekly management meetings of the Director and all heads of unit, certain aspects of its system were not used in practice; in particular, there was little evidence of written reports on deviations from standard rules in cases where circumstances would justify it, or of reporting of internal control weaknesses. In its risk assessment as presented in its Annual Activity Report, the Humanitarian Aid Office concluded that the most important risks arose from the characteristics of implementing partners' administrative and reporting systems. In that context, the existing Framework Partnership Agreements are being reviewed and a new system for auditing implementing partners has been introduced (see paragraph 7.9). In general, the Humanitarian Aid Office's strengthening of the internal control standards was based on its 2001 assessment of general risks. In 2002 the Humanitarian Aid Office carried out an Internal Control Risk Self-Assessment.

7.6. During 2002 the EuropeAid Cooperation Office carried out an Internal Control Risk Self-Assessment and started work on a more general Risk Assessment in the context of action 2 of the action plan related to the synthesis of the 2001 Annual Activity Report (see paragraph 7.35). The administrative and financial procedures are in place at the EuropeAid Cooperation Office, but whether and to what extent they are followed by staff responsible for authorising commitments and payments during 2002 was not sufficiently evidenced. This related in particular to the use of questionnaires, reporting on recovery orders and reporting on insufficiencies of internal controls. A reporting system was set up in 2002 for all directorates at the EuropeAid Cooperation Office and for the devolved Delegations to provide information on a regular basis to be used for the purpose, among others, of establishing the Annual Activity Report of the Director General.

THE COMMISSION'S REPLIES

7.5. *Formal written reports do not exist, but management is informed of the deviation from the rules through the comments made on the control documents that accompany the files. Accumulations of these comments are discussed in the management meeting and have given rise to guidance notes to remedy the problems noted.*

The above remark does not detract from the conclusion noted by the Court which comes from Humanitarian Aid Office's risk analysis that the administrative reporting system of the implementing partners is a source of risk. This risk is being addressed and managed by the review of the Framework Partnership Agreement and by an increase in the number of implementing partners being audited.

7.6. *Various elements show that staff responsible for commitments and payments follows the procedures. The computerised workflow system in CRIS indicates each stage of authorisation and provides an indication of problems which may arise. Without being the only information/monitoring tool, the reports of the sub-delegated authorising officers cover the extent to which the procedures are followed; for instance, derogations are notified and the reasons for the derogation are set out, figures are given for the number of invoices paid within the regulatory period, etc.*

Moreover, these reports also cover the implementation of Internal Control Standards, as well as issues related to the effective exercise of the responsibilities foreseen under the Charter Authorising officers by subdelegation.

Reports produced by EuropeAid Cooperation Office's Internal Audit Capability provide a review of controls and their implementation.

THE COURT'S OBSERVATIONS

7.7. The Court audited a random sample of 50 payments at the Commission's headquarters spread over the different areas. Apart from a limited number of formal errors (in particular on the timeliness of payments) no material errors were found. Of the selected payments, 30 were advance payments on recently concluded contracts, and 20 payments were mainly reimbursements of expenditure for projects programmes launched in previous years on the basis of financial statements produced by the implementing organisations. On the basis of these documents, the Commission's headquarters can only check that the reimbursement claim is plausible within the terms of the contract or financing agreement and the budget contained therein. At this level, it is not possible to assess whether the underlying transactions carried out by the implementing organisations are legal and regular in substance, unless the claims are accompanied by a report by an external auditor certifying the expenditure in question or have been the subject of an ex ante field audit by staff of the Commission.

THE COMMISSION'S REPLIES

7.7. Under the new standard contract applied from June 2003, the beneficiary is required to send an original version of the accounts after they have been audited by the external auditor nominated in the contract. Any request for intermediate and final payments under these contracts must be accompanied by duly audited accounts. Without these the payment request is not valid. (Some beneficiaries still present a complete set of supporting documents and in these cases they are checked.)

In the field of grants, the Commission's standard grant contract provides for two sets of control measures, in order to assure that transactions carried out by implementing organisations are legal and regular.

The audit requirements have been made stricter in the revised Practical Guide. The grant beneficiary must provide an audit report together with the request for final payment when the grant is of more than EUR 100 000, as well as with requests for interim payments when the cumulated prefinancing exceeds EUR 750 000. These audit reports must certify the expenses incurred in conformity with the contract requirements (see Article 15(6) of the General Conditions).

The Humanitarian Aid Office's transactions are checked at least three different stages:

- *the Technical Assistants in the field monitor the operations and report if they have been carried out and if the objectives have been reached,*
- *the desk officers at headquarters, both in the operational unit and financial unit, scrutinise the narrative report and the cost declaration. Where necessary samples of supporting documents will be requested,*
- *finally audits are conducted on a systematic basis of systems of internal control and of the documentation supporting the costs reimbursed by the implementing organisations. These audits are cyclical.*

The combination of these controls gives the authorising officer the reasonable assurance concerning the legality and regularity of the transactions.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Audits as an element of supervisory systems and controls

7.8. Both the EuropeAid Cooperation Office and the Humanitarian Aid Office used audits of projects or programmes (often carried out by private audit firms) as a supervisory instrument for many years, in particular for deciding on the release of payments.

7.9. In 2002 the Humanitarian Aid Office started the implementation of a more comprehensive audit approach, under which the implementing partners (mostly NGOs) are systematically audited. In 2002 some 50 NGOs were audited or were in the process of being audited, covering about 330 projects. Financial verifications of operations managed by members of the UN 'family' (e.g. Unicef, UNHCR, WFP) were not carried out during 2002 pending the signing on 29 April 2003 of a new Financial and Administrative Framework Agreement between the European Community and the United Nations.

7.10. The EuropeAid Cooperation Office increased the number of audits carried out in 2002 in the general budget field to some 240, but this was a modest number in comparison with the approximately 3 500 programmes and projects currently being implemented. These audits were carried out by private sector audit firms on behalf of the Community, and included both those launched by Commission's headquarters and Delegations under framework contracts, and those launched by intermediaries to fulfil obligations in contracts with the Community. A serious weakness was the absence of an overall approach to the use of audits. In particular no clear guidelines existed on when audits should be carried out or how frequently, and whether release of payments should be based on regular annual audits or on ad hoc audits. There was no clear indication of the way in which the different audits carried out by, or on behalf of the Community, should complement each other as part of an overall strategy. Given the modest number of audits and the limited information available at senior management level on the use of audit results, it is difficult to see how the system of contracted audits could provide sufficient evidence to the Commission as to the legality and regularity of the underlying transactions at the level of implementing organisations.

7.11. The operational Directorates are responsible for the auditing of the programmes and projects they are in charge of. In 2002 the external audit unit at the

7.9. In the course of the negotiations that lead to the EC-UN Financial and Administrative Framework Agreement (FAFA), the Commission services considered and reviewed the operation of the verification clause. Since the agreement was signed with the UN Headquarters, work is underway to coordinate the adherence of the autonomous agencies of the UN 'family' to the FAFA. In anticipation of this the UN 'family' has been included in the 2003 work programme and verification missions have already been undertaken.

7.10. The Commission agrees that external audits are one important tool in assessing the legality and regularity of financial transactions and is taking steps to strengthen and clarify the strategy for their use in external assistance management. In December 2002 the Office adopted the annual external audit programme 2003, details of which are given in the reply to point 7.12. This includes the development of an audit strategy.

The introduction of a computerised system for registering information on the audit work on external programmes (CRIS Audit) should, in time, improve the monitoring of audits and eventually the ability of Management to take action on the results of the audits, particularly as regards audit activities in delegations. The benefits of this application, which is now being field tested, will only be visible in 2004.

THE COURT'S OBSERVATIONS

EuropeAid Cooperation Office had primarily a coordinating role in developing the audit methodology, establishing guidelines, providing support and advise, and to improve the overall quality of audits and their follow-up.

7.12. In December 2002 the EuropeAid Cooperation Office adopted a comprehensive 'external audit programme' which essentially lays down what audits the operating Directorates and Delegations plan to carry out during 2003, and defines certain measures to be taken to develop an audit strategy and methodology.

Internal Audit Capability as an element of supervisory systems

7.13. The Internal Audit Capability (IAC) set up in 2001 became operational in early 2002 and has performed a considerable amount of work in the short period of its existence. The IAC is responsible for the internal audit function at both the EuropeAid Cooperation Office and the Humanitarian Aid Office. The service established its mission statement, an audit manual and work programmes for 2002 and for 2003. In 2002 the IAC mainly focused on the assessment of the EuropeAid Cooperation Office's internal control standards and on an assessment of the Humanitarian Aid Office's workload. The IAC's findings were consistent with the Court's findings in establishing that the implementation of the EuropeAid Cooperation Office's internal control standards had not yet been completed in 2002 (see paragraph 7.6). However, its work programmes did not yet include evaluation and testing of the systems put in place to ensure the legality and regularity of transactions at central level and at the level of the Delegations.

THE COMMISSION'S REPLIES

7.12. The annual external audit plan for 2003, aims at the development and implementation of a methodology for 'audit of external operations' and work was set in hand to develop a coherent and comprehensive audit strategy.

It is composed of two parts: a first that focuses on the support function of the 'external audit' unit of the Office and a second that lays down a list of projects and programmes to be audited.

The horizontal actions by the 'external audit' unit include the development of a methodology for external audits and the setting up of a training programme for officials at headquarters and in delegations. These actions include the development of a comprehensive and coherent audit strategy.

The implementation of the 2003 audit programme should address many of the concerns expressed by the Court.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Supervisory systems and controls at the level of the Delegations

7.14. The Court visited six Delegations and seven countries (Nicaragua/Honduras, Egypt, Tunisia, Bangladesh, the Russian Federation, and Bosnia and Herzegovina) 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.

The Commonwealth of Independent States and the western Balkans

7.15. The management of projects/programmes was devolved to the Delegation in the Federation of Russia in February 2002. It is the largest Delegation responsible for the management of the Tacis programme. The Delegation in Bosnia and Herzegovina, where devolution was already introduced in 1999 before the Commission adopted a global policy of devolution, is the largest Delegation responsible for the management of the Community Assistance for Reconstruction, Development and Stabilisation (CARDS) programme.

7.16. In both Delegations the supervisory systems and controls pertaining to the legality of contracting and payments processed at the level of the Delegations were found to be generally satisfactory.

7.17. The Court examined as part of the assessment of the supervisory systems and controls a sample of 30 payments and 10 tendering procedures for each of the Delegations. No significant errors were found. The main difficulty identified was long delays in tendering contracts and sometimes in making payments.

7.18. In Russia, where projects are implemented mainly through service contracts, the main risk identified concerned the system introduced by the EuropeAid Cooperation Office in September 2002 of having payment claims checked exclusively by external auditors, instead of by the Delegation itself. The auditors are not contracted by the Delegation but by the implementing firms employed under service contracts. While the Commission through its Delegation has the right to reject the choice of contractor, in practice it does not have clear criteria for taking this decision, nor does it have sufficient information to take the decision. Moreover, no standard terms of reference have been developed by the Commission for these audits.

7.17. The Commission accepts that, while there have been significant improvements in a number of areas, there are still delays in tendering and payments procedures. While these are sometimes for reasons beyond the Commission's control, further efforts to improve and streamline procedures should help address these problems. In addition as the Court has recognised, it will still be some time before the new administrative systems — particularly deconcentration — settle down and deliver the full benefits.

7.18. Audit certificates that have to be introduced together with payment claims give supplementary assurance. They do not intend, however, to entirely replace controls to be carried out by the Commission. It is envisaged that the Commission will in the future (either directly or through contracted auditors) verify the correctness using a risk-based sample of the claims certified by auditors.

THE COURT'S OBSERVATIONS

7.19. In Bosnia, an effective system has been built up over several years to monitor the integrated refugee return programme, the largest and most complex area of CARDS support to Bosnia. This monitoring is carried out by external consultants and covers both the operational aspects of the programmes and the verification of the legality and regularity of payment claims through site visits.

7.20. In Bosnia, the use of external auditors for closure audits is at the discretion of the Delegation. In 2002, 35 contracted audits were carried out. One of the four audit reports reviewed by the Court identified substantial errors (about 1 million euro). These errors are being followed up by the Delegation.

Asia, Latin America and Mediterranean countries (MEDA)

Delegations

7.21. Three of the four Delegations audited (Nicaragua/Honduras, Egypt and Tunisia) were devolved in 2002 and the prescribed supervisory systems and controls in place throughout the year. In Bangladesh the Delegation was devolved in 2003.

7.22. In each country visited by the Court, between four and six transactions were audited, 24 in total, of which 22 related to projects and two to Delegations imprest accounts. At the level of the Delegations no significant irregularities in payments were found. On the basis of a selection of payments made to the projects by the Commission, a more detailed sample of about 270 payments at project level was audited. In addition to the audit at the level of the Commission's headquarters and of the Delegations, the supervisory systems and controls of the implementing organisations were assessed (see paragraphs 7.31 to 7.33).

7.23. The review of the supervisory systems and controls at Delegation level indicated that the procedures carried out by the devolved Delegations resembled those which had previously been carried out in Brussels. Internal questionnaires ensure that individual staff members are aware and take responsibility for the checks they are expected to carry out, but in Nicaragua/Honduras this procedure was not operational throughout the year.

THE COMMISSION'S REPLIES

7.20. *In the case referred to by the Court a supplementary audit was required in light of the substantial amounts involved and therefore the need to operate a full audit (the first audit took place during the project life). The final payment has been suspended pending final audit findings.*

7.23. *In Nicaragua/Honduras checklists were not used in the initial devolution period (transitional period) but their subsequent widespread use was attested by the last on-the spot visit by headquarters staff.*

THE COURT'S OBSERVATIONS

7.24. In the countries visited by the Court eight external audits of EuropeAid's implementing organisations were reviewed. Furthermore, a sample of 19 audits was selected from all audits completed in 2002 in Asia, Latin American and MEDA countries (see Annex 1, table (b), for a summary of the Court's assessment of these external audits). The audit reports were generally of a good quality. However, standardised terms of reference were not always used, in some cases because they were drawn up by the implementing organisations rather than by the Commission. Only in two audits out of eight reviewed during audit missions were transparent procedures followed for the selection of the auditors. In five cases there were no proper terms of reference. The audits did not usually include a review of the contracting procedures as this is not part of the standardised terms of reference, even though this is an area with a high risk of error.

7.25. There was no overall policy for external audits at any of the Delegations visited. The use of and procedures for the appointment of external auditors are provided for in the project financial agreements. Such provisions are often worded vaguely, leaving the implementing organisations with a wide scope for taking a variety of approaches to the selection and remuneration of external auditors.

THE COMMISSION'S REPLIES

7.24. The Commission's replies to points 7.24 to 7.31 also cover Annex 1, table (b).

With the revision in 2003 of the Practical Guide to EC External Aid contract procedures and of the standard service contract, including their annexes, two major improvements have been made in relation to certification audits:

- *auditors have to be members of an internationally recognised supervisory body for statutory auditing, and*
- *the extent of the audit to be carried out is defined by (a) the reference to International Audit Standards and (b) the prescribed form of the certificate itself.*

These elements are designed to provide guarantees as to the quality and comparability of audit services rendered and the level of reliance Commission services may have in the regularity of payment claims and their underlying documentation.

In connection with the further definition of an overall control and audit strategy, the approach relating to certification audits will be developed further as well. Instructions on quality review of certification audits and on their use within a risk-based selection of audits supervised by Commission staff will be established in order to create a comprehensive control model. The model would efficiently and effectively combine easy and workable controls built into the projects with risk-oriented controls carried out by Commission staff.

The training programme for present and future audit task managers will improve the application of the Terms of Reference. Moreover, the EuropeAid Cooperation Office works on improving the standard Terms of Reference. However, an audit should always be designed in function of its objectives taking into account the particularities of the programme or project to be audited. In this context audit task managers will have to adapt standard Terms of Reference in a way that they consider most suitable for the specific needs.

7.25. As announced in the External Audit Programme 2003, the Commission is working on the development, adoption and implementation of a methodology for 'audit of external operations'. Once adopted, it will provide for a comprehensive and coherent source of organisational and methodological guidance for all actors involved in 'audit of external operations' at the Office's headquarters and the delegations.

THE COURT'S OBSERVATIONS

7.26. In the case of one project managed by international organisations, no external auditors were required by the contract. In another project, also involving an international organisation, the Delegation did not ensure that the findings of the audit reports were acted upon. The international organisations concerned relied on government organisations for the implementation of the projects, without carrying out any detailed reviews themselves, although they operate in an environment known to have a high risk of corruption.

7.27. Most audits did not find ineligible costs. However, the auditors definition of ineligibility was not always clear, which may demonstrate a weakness in the terms of reference. One audit report showed expenses considered to be ineligible, but no explanation was given nor was this specifically commented upon in the audit report. In another audit, items were classified as ineligible because they did not follow certain requirements of the national public administration, although this would not necessarily make them ineligible for the purposes of the project cofinanced by the Community.

7.28. Most audits did not comment specifically on the underlying accounting systems. Only in a limited number of cases, for example one in Bangladesh, did the auditor state that the accounting system was sufficient to process and generate the required information.

7.29. Funds provided to projects by the national government were also often excluded from the scope of the audit or led to a qualification in the audit report because it was not possible to determine the value of contributions in kind.

7.30. There is a lack of evidence of follow-up by the Commission of findings in audit reports. When there was evidence of follow-up, this was not always satisfactory.

Project implementing organisations

7.31. On the basis of the projects audited at the level of EuropeAid's project implementing organisations, the Court observed weaknesses in their internal controls, including a lack of segregation of duties and a failure to detect irregular transactions.

THE COMMISSION'S REPLIES

7.26. *The implementation of a project co-financed by an international organisation is undertaken as per the general agreement between the European Commission and international organisations. The Commission stresses that, contrary to other types of contracts, no external audits are required in the case of international organisations to which the provisions of the verification clause included in the EC-UN and EC-World Bank Framework agreements apply.*

7.27. *The Commission accepts the Court's observation concerning the uneven quality of the audits examined. With a view to ensuring the quality of the final audit reports, the Commission intends to issue by the end of the year improved standardised Terms of Reference for so-called 'certification audits', though it can never be excluded that some audit firms may not prove fully adequate to the task. The Commission has started a training programme in the area of external audit that will improve the knowledge of the officials in Delegation in dealing with audits.*

7.28. *The audits examined by the Court were certification audits, not system audits. The opinion covers the presentation of financial statements. However, most auditors would comment on the systems if serious weaknesses were identified. Being certification audits these comments would normally be given to the auditee, and not necessary to the Commission.*

7.30. *The Commission is taking measures to ensure adequate follow-up to the audit recommendations. With the devolution process to the Delegations, this is considered as an important component of the monitoring of project implementation.*

7.31. *Measures have been taken to address the concerns of the Court in particular through the adoption in 2003 of standard contracts and the strengthening and clarification of the system of contracted audits (see point 7.7). Moreover a new audit programme has been established to provide more information on the working methods of intermediaries.*

THE COURT'S OBSERVATIONS

7.32. A significant number of errors was found in the transactions examined at the level of the projects. The most frequent type of error (eight out of 22) consisted of the non-respect of contractual requirements, such as the need to follow a specific tender procedure or the application of a specific method for translating local expenditure into euro. Further disclosure in the implementing organisations reporting, for example detailing the exchange rate calculations, would assist the Commission in detecting these problems, which are mainly due to a lack of understanding of the contractual requirements on the part of the implementing organisations.

7.33. Other types of irregularity were less common but nevertheless significant. In five projects out of the 22 audited, some of the transactions checked were not backed by adequate supporting documentation. In a further five projects, examples of ineligible expenditure were noted. In one case transfers between project bank accounts were included in the financial report as expenditure for the purpose of accelerating the flow of funds and in another case the implementing organisation paid for services which were never rendered.

European Agency for Reconstruction in Kosovo

7.34. The Court has carried out its annual audit of the European Agency for Reconstruction in Kosovo, the results of which are laid down in a separate Specific Annual Report ⁽³⁾. The main findings are that in 2002 the Agency strengthened its system of internal control with the introduction of accounting system used by the Commission, and that the audit of transactions revealed a limited number of formal errors only.

Analysis of Annual Activity Reports and the declarations of the Authorising Officers by delegation

7.35. The Court reviewed the Annual Activity Reports and the declarations by the Director-General of the EuropeAid Cooperation Office and the Director of the Humanitarian Aid Office. This review concentrated on the parts of the reports which dealt with the Commission's follow-up to recommendations given by the Court of Auditors, the Commission's internal auditors, and the Financial Controller, and of the actions formulated

THE COMMISSION'S REPLIES

7.32. *The Commission is aware of the need to ensure implementing organisations understand and follow contract provisions accurately. The transfer of management responsibilities to delegations should allow better monitoring of implementation on the ground.*

⁽³⁾ Specific Annual Report in the process of being published.

THE COURT'S OBSERVATIONS

in the Commission's action plan (attached to its annual report on 2001 ⁽⁴⁾) as well as on the internal control standards. The Court examined whether and to what extent the declarations 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.

7.36. It was found that the information presented in the reports was accurate and that it was a fair reflection of the activities carried out on the follow-up and on the internal control standards.

7.37. Action 2 of the Commission's action plan stipulated that the external relations services should examine the possibilities for 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 to external aid and in particular budget support, has been the object of an analysis carried out by EuropeAid Cooperation Office in 2002. This will be completed jointly with the other members of the External Relations family during 2003 to ensure a coherent approach.

7.38. On the internal control standards, it is stated correctly by both the Humanitarian Aid Office and the EuropeAid Cooperation Office that in 2002 many systems have been set up or improved, including the creation of an important number of manuals and guidelines. The reports also indicate which systems are to be completed in 2003.

7.39. For both the Humanitarian Aid Office and the EuropeAid Cooperation Office the respective Director and Director-General declared that they had obtained reasonable assurance as to the quality of the supervisory systems and controls set up to ensure the legality and regularity of the underlying transactions without expressing any reservations. However, in the case of the EuropeAid Cooperation Office, it seems questionable whether the information available to the Director-General was sufficient in this context because:

THE COMMISSION'S REPLIES

7.39. *Based on the various instruments and tools available or to be developed for the purpose, the formulation of reservations in the declaration of the Director-General relies on his best judgement. The definition of a Commission-wide concept for 'materiality', applicable to the deficiencies detected, is also part of the framework within which the Director-General formulates his judgement on potential reservations.*

The flow of information between headquarters and the delegations takes many forms and is not confined to information systems and reports by delegations to Brussels. This also applies to supervision of their work. All this ensures the authorising officer by delegation has sufficient information to form an opinion.

⁽⁴⁾ Synthesis of annual activity reports and declarations of Directors-General and Heads of services; communication to the European Parliament and Council (COM(2002) 426 final, 24.7.2002).

THE COURT'S OBSERVATIONS

- (a) the system of contracted audits was not yet capable in 2002 of providing sufficient assurance on the legality and regularity in substance of underlying transactions at the level of implementing organisations (see paragraph 7.10); and
- (b) the reports provided by the Directorates and Delegations contained very limited information on the legality and regularity of underlying transactions at the level of implementing organisations.

Conclusions

7.40. Administrative procedures and organisational structures have been adjusted appropriately by both the EuropeAid Cooperation Office and the Humanitarian Aid Office to cater for the introduction of the new Financial Regulation which entered into force on 1 January 2003. New ex ante and ex post checks on budgetary transactions were introduced at various levels within the Commission in 2002, before the function of a centralised financial controller was abandoned at the end of the year. However, a balanced combination of checks, reviews, inspections, audits by external firms and internal audits had not yet been established by EuropeAid Cooperation Office in 2002 as part of a coherent overall strategy to ensure control over the legality and regularity of operations financed by the Community at the level of implementing organisations (see paragraph 7.10).

7.41. Not all supervisory systems and controls functioned fully satisfactorily during 2002 at the central level of the Commission or at the level of the Delegations (see Annex 1, table (a), for a summary of the Court's assessment).

7.42. The Court's audit revealed few errors affecting the transactions at the level of the Commission's headquarters and at the level of its Delegations (see paragraphs 7.7, 7.17 and 7.22). However, the Court's audit revealed weaknesses in the internal controls, and a relatively high number of irregularities, at the level of EuropeAid's project implementing organisations (see paragraphs 7.31 to 7.33).

THE COMMISSION'S REPLIES

At the time of signing the declaration, the Director-General considered that the information in his possession was sufficient to enable him to have reasonable assurance as to the legality and regularity of transactions effected by EuropeAid in 2002, including the actual implementation of projects and programmes.

7.40. *The Commission accepts the need for a clearer strategy on audits and has taken steps in this direction. In particular the strategy on audits carried out under the direct supervision of headquarters or delegations requires further development taking into account audits to be carried out at the initiative of the project or the programme and usually in view of a payment to be made. The standard (grant and service) contracts used for these audits contain provisions governing their obligation, regularity and content. The model financing agreement with beneficiary countries contains similar provisions. The new approach on audit complements the new ex ante and ex post checks on budgetary transactions (see also reply to point 7.25).*

7.41. *The major improvements in procedures and structures, which began in 2001, continued in 2002, and 2003.*

7.42. *Measures have been taken to address the concerns of the Court in particular through the adoption of standard contracts and the strengthening and clarification of the system of contracted audits (see point 7.7). Moreover a new audit programme has been established to provide more information on the working methods of intermediaries.*

The most frequent types of errors the Court refers to concern the non-respect of contractual requirements, such as the need to follow a specific tender procedure or the application of a specific method of translating local expenditure into euro.

THE COURT'S OBSERVATIONS

7.43. Expenditure on external actions is geographically highly dispersed and mainly executed by a wide range of projects implementing organisations. The Commission's supervisory systems and controls were not yet sufficiently developed to provide it with assurance as to the legality and regularity of the underlying transactions at the level of EuropeAid's projects implementing organisations (see paragraph 7.40).

Recommendations

7.44. The Commission should develop a common approach for the use of independent external auditors. This should be designed to provide Commission management with an assurance that expenditure at the level of implementing organisations is legal and regular. The Commission or its Delegations, and not the implementing organisations, should have the final say in selecting the external auditors and should provide them with detailed terms of reference and reporting requirements for the assignments. The auditors should be required to assess the internal controls of the implementing organisations and if appropriate make recommendations for improvements. Audit reports should be available in time for such improvements to be made without delay, and for Delegations to take appropriate actions regarding any findings.

THE COMMISSION'S REPLIES

7.43. *All the necessary supervisory and control systems were in place in 2002 to give reasonable assurance as to the legality and regularity of transactions effected by EuropeAid in 2002.*

7.44. *The Commission is using independent auditors at two distinct levels.*

'Certification audits' provide assurance that expenditure, at the level of implementing organisations, is legal and regular. Some improvements have been made to increase their value (see point 7.18) Further improvements to the system are being made in particular to improve the quality control in relation to such audits.

The use of external auditors for audits under the supervision of the EuropeAid Cooperation Office or of the delegations already fulfils the requirements defined by the Court. These audits, where applicable, should also provide evidence as to the reliability of audit certificates and the effectiveness of the audits relating thereto.

Both instruments should be considered as complementary.

Without prejudice to the need and the value of systems audits in view of issuing an audit certificate, the timing for an audit on the functioning of internal control systems is different to the timing of a certification audit. Usually such an audit should be launched in an early phase of the project's lifecycle in order to formulate recommendations to be implemented in time.

The EuropeAid Cooperation Office will, however, consider the Court's recommendation on the occasion of the development of its methodological framework.

It should be noted that the EuropeAid Cooperation Office's new framework contracts for the mobilisation of external auditors by headquarters or delegations actually provide a distinct part for systems.

The Commission welcomes the Court's suggestion and will examine ways to develop this common approach based on shared principles that still allow each service the flexibility to meet its operational needs. It will also review the possibilities and practicalities of having the external auditors assess the internal controls of implementing organisations that do not fall into the scope of framework partnerships as determined by Article 163 of the implementing rules.

THE COURT'S OBSERVATIONS

7.45. The reports of Directorates and Delegations should include a specific section highlighting key elements which could contribute to the judgement of the Director General as to whether the control procedures have ensured the legality and regularity of underlying transactions, particularly at the level of implementing organisations (including, for instance, information about the coverage achieved by external audits carried out on behalf of the Community, the findings in audit reports and the follow-up to such findings).

THE COMMISSION'S REPLIES

7.45. *The Commission will take the necessary steps to implement this recommendation.*

FOLLOW-UP TO PREVIOUS OBSERVATIONS

Tacis Cross-Border Cooperation Programme

7.46. In 2001 the Court adopted Special Report No 11/2001 ⁽⁵⁾ concerning the implementation and impact of the Tacis Cross-Border Cooperation programme over the period 1996 to 2000. The programme funds projects in Russia, Ukraine, Belarus and Moldova which have a cross-border impact with neighbouring Member States ⁽⁶⁾ and candidate countries ⁽⁷⁾. The main recommendations were that:

- (a) coordination mechanisms between the Tacis CBC programme, the Interreg programme and the Phare programme should be significantly strengthened (see paragraphs 7.50 to 7.51);
- (b) consideration should be given to increasing the budget of the Tacis CBC programme and funding made available for bordering regions in Phare countries to finance linked cross-border projects (see paragraphs 7.52-7.53);
- (c) greater emphasis should be placed on infrastructure and investment support (see paragraph 7.54);
- (d) the programme should give more priority to projects which increase the living standards in the eligible regions (see paragraph 7.56);
- (e) a higher proportion of funds should be allocated to the Small Project Facility and its management should be decentralised (see paragraph 7.57).

⁽⁵⁾ OJ C 329, 23.11.2001.

⁽⁶⁾ Finland.

⁽⁷⁾ Estonia, Latvia, Lithuania, Poland, Slovakia, Hungary and Romania.

THE COURT'S OBSERVATIONS

7.47. In its conclusions on the report, the Council re-emphasised the importance of regional and cross-border cooperation, particularly in view of the enlargement of the European Union, and called for all parties concerned to improve the effectiveness of the programme, particularly through strengthening coordination between Tacis CBC, Interreg and Phare.

7.48. The Court's follow-up review was carried out through interviews and file reviews in the Directorates-General for External Relations and Regional Policy and the EuropeAid Cooperation Office and visits to Russia (Moscow, the St Petersburg region and Kaliningrad) and Finland. The main conclusions on how far the Commission has implemented these recommendations are described in the following paragraphs.

7.49. The Commission has taken significant steps to increase coordination between Tacis CBC and Interreg:

- (a) a guide 'Bringing Interreg and Tacis Funding Together' was jointly issued by the Directorate Generals for Regional Policy and External Relations in April 2001 and a seminar on the subject was held for beneficiary countries (Belarus, Moldova, Russia, Ukraine);
- (b) the link with Interreg projects is now one of the selection criteria used by the Commission when evaluating Tacis project proposals, and DG REGIO participates in the evaluation process; the number of Tacis projects funded from the Small Project Facility (SPF) with Interreg links rose from two out of 18 (11 %) for the 1999 call for proposals to 26 out of 43 (60 %) for the combined 2000/2001 call for proposals (see also paragraph 7.57);
- (c) representatives of Russian regions systematically attend Interreg steering and monitoring committees and are able to vote on which Interreg projects should be selected;
- (d) the representation of the Commission at Interreg Steering Committees is coordinated between the Directorate General for Regional Policy and the EuropeAid Cooperation Office.

7.50. Nevertheless, the creation of joint projects is prevented by the different legal bases which restrict the utilisation of Interreg funds to areas eligible for Interreg,

THE COMMISSION'S REPLIES

7.49. *The Commission agrees with the Court's conclusions that over the past years there have been significant improvements in the coordination between Tacis and Interreg. It also considers that in 2003 coordination between Tacis and Phare has been improved. The measures suggested in the communication 'Paving the way for the new neighbourhood Instrument' (hereafter the NNI communication) adopted on 1 July 2003 will bring this coordination much further by introducing of neighbourhood programmes on the external borders of the EU. All the remaining concerns raised by the Court regarding joint programming documents and joint structures will be addressed through these programmes.*

7.50. *The concerns on the lack of coordination which the Court raised in its Special Report on the Tacis CBC programme in 2001 have significantly contributed to*

THE COURT'S OBSERVATIONS

and Tacis CBC funds to areas eligible for Tacis CBC. In addition, while the Interreg budget for the Finnish border regions is approximately 25 million euro a year the Tacis CBC budget for equivalent size projects in Russia is only in the order of 5 million euro.

7.51. Little progress has been made in improving coordination between Tacis CBC and the Phare programme. In particular, the Phare CBC programme has not been extended to the regions of candidate countries bordering on Tacis CBC beneficiary States. As a result, no common structures exist between Phare and Tacis countries for coordinating Phare and Tacis CBC expenditure (see also follow-up report on the Phare CBC programme ⁽⁸⁾). This lack of established coordinating structures is likely to have a negative effect on the forthcoming Interreg programmes in the regions of the new Member States that border on the Tacis CBC beneficiary countries.

7.52. Up until 2003 the Tacis CBC budget remained below its original 1996 budget of 30 million euro. However, in 2003 the budget was increased to 35 million euro. This and any further increases in the budget need to be accompanied by corresponding efforts to improve the limited absorption capacity which exists in most eligible border regions. The Commission has so far taken only modest steps to do this, mainly through a regional capacity building project. Whereas in Russia Tacis-funded local support offices in the regions also make at least a small contribution to addressing this problem, no such offices exist in Ukraine where project preparation is particularly weak.

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the Commission's work on these issues since then, which has lead to the adoption of the NNI communication.

7.51. *One of the priorities for the Tacis CBC Small Project Facility (SPF) has been to support projects, which have a clear link to an Interreg, or a Phare project. The NNI communication suggests that this coordination should be taken forward and strengthened in the form of 12 Neighbourhood Programmes, which will from 2004 onwards cover the whole border between the EU/candidate countries and the new independent States (NIS) countries. The legal basis for these programmes will be Interreg, and in the case of the remaining candidate countries, it will be the Phare CBC regulation which will be revised later this year to cover the external borders of candidate countries.*

Setting up coordinating structures on the current Phare-Tacis borders at an earlier stage would certainly have made the introduction of Interreg and the Neighbourhood Programmes on the new external border easier. However, the preparation of the new programmes is progressing well, and accession countries are drawing on their experience of participating in Interreg programmes on their other borders to help develop their external programmes.

7.52. *In the indicative program 2000 to 2003, EUR 31 million was provided for TACIS CBC activities on the 2003 budget. For the action plan 2003, this amount was increased to EUR 43 million, of which EUR 35 million for typical CBC-activities and EUR 8 million for the Baltic Sea Cooperation. neighbourhood programme In 2004 to 2006, the Tacis allocation to the Neighbourhood Programme will amount to EUR 75 million (EUR 20 million in 2004, EUR 25 million in 2005 and EUR 30 million in 2006).*

A capacity-building project with a budget of EUR 1,8 million is planned from the Action Programme 2003. This project is expected to enhance the regional absorption capacity in Russia for the Tacis CBC SPF.

It will be coordinated with the various other on-going activities in this field, notably actions funded by the Nordic Council of Ministers.

⁽⁸⁾ Chapter 8, paragraphs 8.54 to 8.60.

THE COURT'S OBSERVATIONS

7.53. No matching funding has been provided by the Phare CBC funding. However, this has been partially tackled by candidate countries, notably Poland, allocating funds from their Phare national programmes to projects in their eastern regions which have an impact across their borders with Tacis countries.

7.54. Because of the limited funding, Tacis CBC infrastructure and investment support has continued to be largely restricted to border crossing projects. The two border crossings on the Russian-Finnish border (Salla and Svetogorsk) funded from the 1996 programme were finally opened in mid-2002 after significant cost overruns and delays in the supply of equipment. The capacity of the Svetogorsk border crossing was approximately twice as large as the number of trucks using it.

7.55. While most other border crossing projects have been implemented more smoothly, two border crossing projects in the Russian region of Kaliningrad have been subject to major delays. At a further key border crossing, Brest-Terespol on the Belarus-Polish border, which did not receive funding until the 2000 budget, works had yet to begin at the end of 2002, while waiting times for trucks during the period September to December 2002 averaged between 10 and 30 hours.

7.56. More attention has been given to economic development projects designed to improve living standards but the limited scale of Tacis CBC funding again means that only one or two large projects can be funded in this area each year.

7.57. The Commission has increased the proportion of Tacis CBC funding allocated to the SPF from approximately 15 % in the early years of the programme to almost 25 % in 2002. On the other hand, the Commission's management of the SPF, in contrast to most Tacis projects, has become more centralised in Brussels, and technical assistance offices in St Petersburg and Lvov (Ukraine) to assist in SPF project preparation and implementation closed down.

THE COMMISSION'S REPLIES

7.53. *In order to tackle that issue, the Commission introduced the External Borders Initiative 2003, funded with approximatively EUR 30 million. This initiative will follow two different approaches: in the accession countries, the focus is put on future Interreg programmes to be implemented upon accession whilst in the candidate countries, the aim is to prepare 2004 to 2006 Phare CBC programmes at external borders.*

7.54. *When designing a new border post, the capacity is based on the estimated future use of the border post. Assumptions are made on the projected traffic in the next 15 years. It is therefore too early to make a final judgement on that aspect. The Commission acknowledges that there were significant delays with these projects, largely because of problems with working with the Russian partners and tendering difficulties. The Commission considers that the Svetogorsk border crossing has considerable scope for expansion regarding traffic numbers and views the increase in capacity at the crossing as a positive element.*

7.55. *The delays occurring in the implementation of those projects are entirely due to the beneficiaries (State customs) who did not fulfil their obligations with regard to land availability and preparation of the project design. Those difficulties have now been resolved and works tenders dossiers are almost completed.*

7.57. *From 2004 onwards the SPF will cease to exist and the funding from its successor Neighbourhood Project Facility NPF will be allocated directly to the Neighbourhood Programmes.*

THE COURT'S OBSERVATIONS

7.58. In view of the forthcoming enlargement, which will make the Tacis CBC beneficiary countries the main part of the European Union's external land border, there is a need to give higher priority to the Tacis CBC and its coordination with the Interreg programmes of the new Member States. The current programming and implementation procedures should be reviewed and consideration given to establishing a specific Tacis CBC Regulation based on the Phare CBC Regulation, which made an effective contribution to promoting cooperation with Interreg. The Court therefore recommends that:

- (a) the Tacis CBC budget should be divided up and allocated to each of the Tacis border regions which is associated with an Interreg programme in Finland and the new Member States ⁽⁹⁾;
- (b) for each of these Tacis border regions, joint cooperation committees should be established, made up of national and regional representatives from both the Tacis country and the neighbouring Member State;
- (c) as well as selecting and monitoring projects these committees should establish joint cross-border programming documents, including common development strategies and priorities for the regions on either side of the border.

7.59. In addition, a higher priority should be given to regional capacity building in the regions eligible for Tacis CBC.

Programme to Supply Agricultural Products to the Russian Federation

7.60. The objective of the Court's follow-up review was to establish how far issues raised in its Special Report No 18/2000 ⁽¹⁰⁾ had now been tackled by the Commission, as the food supply programme had not been formally closed at the time the Court's audit was completed. The programme represented the largest single

THE COMMISSION'S REPLIES

7.58. *The concerns expressed by the Court of Auditors have to a large extent been addressed by actions envisaged in the NNI communication.*

The communication concludes that due to legal and budgetary constraints it would not be advisable to set up any new regulation at the short-term perspective. As far as the period after 2006 is concerned, the communication sets out three different legal options to be examined in the continuation. These options range from strengthening the coordination on present legal basis to creating a single new instrument capable of operating on both sides of the border.

- (a) *Following the NNI communication the Tacis Neighbourhood Project Facility will be divided up and allocated to the Neighbourhood Programmes.*
- (b) *The bordering NIS regions will be participating fully in the joint management structures of the Neighbourhood Programmes.*
- (c) *This will be done, as foreseen in the NNI communication.*

7.59. *This will be done (see reply to point 7.53).*

⁽⁹⁾ In the case of Moldova and southern Ukraine, allocations should be for cross-border cooperation with Romania, which will continue to be eligible for the Phare CBC programme.

⁽¹⁰⁾ OJ C 25, 25.1.2001.

THE COURT'S OBSERVATIONS

food aid operation ever undertaken by the Commission. In response to a request from the Russian Government in November 1998, the Council adopted Regulation (EC) No 2802/98 ⁽¹¹⁾ for the supply of agricultural products to the most needy regions of the Russian Federation. The programme delivered a total of 1,67 million tonnes of food (wheat, rye, rice, beef, pork and milk powder) with a value of approximately 400 million euro during the period March 1999 to April 2000. Counterpart funds arising from the sale of products were to be paid into a 'Special Account' and to be used to finance pensions and other social expenditure.

7.61. The main conclusions of the Court's report were:

- the Commission had not deployed sufficient staff to manage such a complex programme and decision-making was too centralised at Commission headquarters,
- the justification for the programme was questionable,
- the programme was not sufficiently targeted on the neediest regions and it was not always possible to establish whether the food was processed and consumed in the regions it was delivered to,
- there were significant payment arrears and it was doubtful whether the Commission would be able to ensure that the revenue arising from the sale of the produce would be paid into the Special Account.

7.62. The European Parliament doubted the appropriateness of the programme and regretted that the Commission was unable to enforce its policy with the Russian authorities. The Council largely shared the conclusions of the Court while also noting the difficult conditions in which the Commission had to implement the programme ⁽¹²⁾.

THE COMMISSION'S REPLIES

7.62. As pointed out in its reply to the Court's report, the programme, the largest ever food delivery programme undertaken by the EU, had achieved some very positive results. The combined effect of both the EU and American programmes made a significant contribution to the stabilisation of market prices and to the issue of affordability by the use of counterpart funds to clear pension arrears and to enable significant pension increase to be made (Article 4, Council Regulation (EC) No 2802/98).

In fulfilling its mandate, the Commission had minimised the risks attached to the programme whilst ensuring the successful delivery of foodstuffs to the regions as requested by the Government of the Russian Federation. Through contributions to pension funds and social activities, the proceeds from the sale of the food products have helped the vulnerable sections in Russian society.

⁽¹¹⁾ OJ L 349, 24.12.1998, p. 12.

⁽¹²⁾ European Parliament, A5-0113/2001; Council 5766/02 add 1.

THE COURT'S OBSERVATIONS

7.63. In August 2002 a final report on the programme was issued by the external auditors contracted by the Commission in accordance with the Regulation⁽¹³⁾. While recognising the achievement of the Commission in mobilising and delivering such a vast volume of produce, the report also largely confirmed the Court's findings.

7.64. The Court notes that the Commission has subsequently taken steps to improve its management of aid programmes to Russia by giving its Delegation in Moscow significantly more staff resources and decision-making powers. However, this food aid programme has not yet been closed because the payments to the Special Account continue to be in arrears.

7.65. The arrears are made up of two elements:

- (a) under the terms of the programme's Operational Memorandum of Understanding, the Government of the Russian Federation was in the first place to pay into the Special Account the estimated proceeds, as agreed between the Commission and the Russian authorities, of the produce supplied. The amount of arrears relating to this initial deposit was 445 million roubles (13,9 million euro) at 31 December 2002. This corresponds to approximately 8 % of the originally estimated proceeds;

⁽¹³⁾ The audit took 652 man-weeks at a cost of 1,76 million euro over an 18-month period. Volume of work, length and cost are quite substantial, given the availability of the results of the Court's audit.

THE COMMISSION'S REPLIES

The Commission recognised that more could have been done had resources been liberally available. The Commission also pointed out that it continued to press the Government of the Russian Federation to resolve all outstanding problems satisfactorily and in full compliance with the Memorandum of Understanding and the Operational Memorandum of Understanding.

7.63. *The Commission nevertheless wishes to stress that an independent evaluations of this Programme concluded that the Programme had met the twin objective of addressing issues related to availability of food as well as its affordability.*

7.64. *The Commission notes with satisfaction that the Court acknowledges the efforts made in order to improve the management of the aid programmes to Russia. Within this context, it became possible to allocate more resources to follow up the issue of the arrears of the special account linked to the programme.*

7.65.

- (a) *The Commission from the outset and throughout the life of the programme always made it clear that an operation of this size and complexity was not without risk. This was particularly true in relation to the management by Russian authorities of revenue from the sale of EU products which was to be paid into the Special Account. The risk element involved was recognised by the Council of Ministers when adopting Regulation (EC) No 2802/98. Despite the recognition of risk the Commission has taken a consistently tough line over the respect of the Programme principles as laid down by the Council.*

The Commission has, at many meetings of the Joint Working Group and in bilateral contacts at political and senior official level, pressed the Government of the Russian Federation to honour its legal responsibilities when dealing with the issue of the management of the Special Account, especially when it comes to payment of arrears. Although the application of available sanctions could be said to have been insufficient, the Commission through its firm approach minimised the distinct possibility that arrears could have been greater than the current level of 8 %. The Commission continues to exert pressure on the Russian authorities to finalise this Programme in accordance with the legal framework in which it was established.

THE COURT'S OBSERVATIONS

- (b) the Memorandum also stipulated that, in cases where the actual sales proceeds proved to be larger than the total estimated proceeds, the Russian Federation was to deposit the difference to the Special Account. This has not been done. To establish the actual sales proceeds the Commission relied on ex post checks by its auditors (see paragraph 7.63). However, the Court's Special Report questioned both whether the Commission's auditors would be able to do this and whether the Commission would be able to insist that additional proceeds identified be paid into the Special Account. The auditors were indeed unable to establish actual sales proceeds but instead used surveys of market prices to estimate that actual proceeds were 1 320 million roubles (approximately 41,4 million euro) more than estimated proceeds. The Commission has criticised the methodology used by the auditors but has nevertheless indicated to the Russian authorities that the sums involved represent several hundred million roubles in additional arrears to the Special Account.

7.66. The Commission has gone to considerable lengths to recover the arrears described in paragraph 7.65(a). Since December 2000 this has included making further disbursements from the Special Account conditional on a reduction in the arrears as well as making representations at political level. Its stance concerning the arrears described in paragraph 7.65(b) has been less clear. For their part the Russian authorities have taken the position that the beneficiary regions are responsible for the payment of the counterpart funds into the Special Account, a position that is in contradiction with the terms of the Memorandum. The legal framework established for implementing this programme does not lay down procedures to govern the settlement of disputes. The Commission should, however, continue its efforts to ensure the remaining arrears are paid.

PRINCIPAL OBSERVATIONS IN SPECIAL REPORTS

Special Report No 2/2003 on the implementation of the food security policy in developing countries

7.67. The Court's audit of the implementation of the food security policy in developing countries in the

THE COMMISSION'S REPLIES

- (b) *The figure estimated by the auditors which were contracted by the Commission is not supported by a clear calculation method. While the Commission agrees that there has been some 'price rigidity' and slowness in making price adjustments, which in principle increase the amount of arrears.*

This amount involved is difficult to determine precisely.

7.66. *The Commission's efforts have insisted that the Russian authorities comply with their legal obligations as far as arrears to the Special Account are concerned. It has also sought advice on possible legal actions by the Commission to have the Memorandum of Understanding enforced by the Russian Government. The Commission Legal Service's conclusion was that, in the absence of a dispute settlement mechanism in the Agreements signed between the European Commission and the Russian Federation, there was no basis for legal action, either at the Community level or at the international level. Moreover, it was concluded that there was also no possibility for the Commission to bring the case before a Russian civil court and that, if the action were taken to a criminal court the Commission would not be in a position to provide sufficient evidence.*

Nevertheless, the efforts made by the Commission will be pursued.

THE COURT'S OBSERVATIONS

period 1997 to 2001 focused on the steps taken by all parties involved to achieve the food security objectives set out in Council Regulation (EC) No 1292/96, i.e. the formulation of country strategies, the management of actions, the adequacy of information and coordination with other donors.

7.68. Regulation (EC) No 1292/96 introduced a long-term development approach on food security, thus moving away from short-term food aid. However, as the causes of food insecurity are many, this problem can only be dealt with effectively in the context of an overall comprehensive development policy. The food security strategies in a number of recipient countries were not integrated in coherent national development strategies, and programmes on food security were executed as development programmes separate from the mainstream programmes. It was also found that the Commission's structure complicates coordination between its services in respect of food security operations.

7.69. Reliable baseline information on the situation of food security was not available at the level of the beneficiary countries visited by the Court, and the statistics produced by the national services were mostly inadequate. The local population was rarely involved in proposing and selecting projects and very few structures existed to support local communities in managing projects.

7.70. On the basis of an external evaluation report presented to the Commission in December 2000, the Commission adopted a Communication (COM(2001) 473) to be submitted to the European Parliament and to the Council in September 2001. Although the Commission found it too early to assess fully the impact of the Regulation, this Communication and the relevant Council Conclusions 15390/01 are to be considered as further steps towards the integration of food security policy objectives and instruments into the Commission's overall development policy and cooperation. A new evaluation will be carried out in 2004.

THE COMMISSION'S REPLIES

7.68. The Commission put forward a communication in 2001 which provides an improved framework for the integration of food security issues into overall poverty reduction and development strategies. Moreover, the Commission has sought to ensure a better linkage between relief, rehabilitation and development aid.

In the latest programming exercise, food security issues have been taken into account much more systematically by recipient countries as part of their overall poverty reduction and development strategies.

The Commission's structure and toolbox are to be improved in terms of programming, appraisal and implementation of food security operations of highly complex nature. This will be the subject of the evaluation in 2004. Nevertheless, information on needs, problems and the state of implementation is received regularly through reporting, reviews, evaluations and missions.

7.69. The Commission has made efforts to assist developing countries to build capacity and establish the necessary systems.

The central institutions in the beneficiary countries are often very fragile and their capacity for formal intervention is limited. Nevertheless, the Court has found that many of the projects were technically well executed and useful for the population concerned.

THE COURT'S OBSERVATIONS

7.71. The following recommendations were made by the Court:

- (a) the concept of food security should be fully integrated in the Commission's overall development policy, and single overall strategies and programmes should be developed for and by the recipient countries;
- (b) consideration should be given, in the context of the new evaluation of food security support, to discontinuing Regulation (EC) No 1292/96 in its present form and to integrating all development actions, including those on food security, in a limited number of comprehensive Regulations. Consequently, the structure of the budget headings for food aid and humanitarian aid under B-7 (external actions) should be modified;
- (c) the Commission should consider supporting developing countries to ensure that reliable baseline information is produced on socioeconomic household situations. Indicators on food security should be developed with other donors;
- (d) the Commission should continue to focus its efforts on capacity-building and institutional support to beneficiary country's central and local services.

THE COMMISSION'S REPLIES

7.71.

- (a) *In the latest programming exercise, food security issues have been taken into account much more systematically by recipient countries as part of their overall poverty-reduction and development strategies.*
- (b) *The Commission does not share the Court's conclusion to 'discontinue Regulation (EC) No 1292/96 in its present form' at this point in time.*

Communication COM(2001) 473 and Council Conclusions 15390/01:

- *acknowledge that Regulation (EC) No 1292/96 has a distinct role (see comments under section 33) and should be maintained at this point in time,*
- *propose to carry out a second more in-depth evaluation in 2004 to look at the broader conceptual and strategic development framework in which Commission's support to food aid and food security is provided.*

The Commission takes note of the Court's recommendation. Consideration is given to that issue in the context of the in-depth evaluation, which will be finalised by the beginning of 2004.

- (c) *Financing of information systems for the Commission's food aid strategy continues to be a priority. Ownership by government is still a tricky problem. In some countries financing is provided by national budgets.*

There is a pressing need to enhance, in a sustainable manner, developing countries' capacity for poverty and food security analysis as the first step to formulate comprehensive national development strategies.

The Commission has made efforts to assist developing countries to build capacity and establish the necessary systems.

- (d) *The Commission shares the Court's analysis and the main thrust of its recommendations, which in fact form part of the Community's guiding principles for development cooperation. We must, however, recognise that the political, social and economic environment in developing countries determines the limits of what can be achieved.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Special Report No 10/2003 on the Commission's management of development assistance to India

7.72. Some 480 million euro of Community financial assistance, disbursed over the period 1990 to 2001, was provided for development cooperation activities in India. These activities included a large number of agricultural and rural development projects, as well as two sector support programmes for education and health.

7.73. The Court examined in particular how the interventions targeted the poorer sections of the population, the chances that the benefits would be sustained beyond the end of the Community-financed activity, and the extent to which donor coordination activities have taken place.

7.74. The Court found that the Commission's management was reasonably successful in targeting the poor and in addressing sustainability for the majority of the eight projects/programmes audited in India. However, in a number of interventions these aspects were only taken up in the course of the project implementation. More systematic attention to these issues from the beginning of and throughout the whole project/programme life cycle could have further improved the results.

7.75. In the Community's cooperation activities towards India, there has been a move to a sector programme approach for the health and education sectors. Such an approach can offer certain advantages over a project-based approach. These include more closely harmonised, coherent policies and strategies, wider impact, and better chances of sustainability. It also requires that donors have sufficient confidence in the capacity of the

7.72. In 30 years of development cooperation with India the Commission's strategy has evolved from a support financed through counterpart funds (e.g. Operation Flood) and rural development projects to sector programmes in health and education which support the Government's reform agenda, good governance and improved service delivery. The decision to move away from the classical rural development projects was based on the experience that individual projects, although often achieving the objectives, tended to have limited and localised impact, with little influence over policy.

EC cooperation with India has therefore benefited from a dynamic learning exercise, whereby experiences from ongoing projects have fed into the development of new strategies.

7.74. The Commission takes note of the Court's observations concerning the objectives of targeting the poorest sections of the population and sustainability.

Since 1992 the Commission uses the 'Methodological Guide' and other project cycle tools such as the logical framework approach. It is therefore now standard practice to build sustainability aspects (including exit strategies) into Community development projects and programmes.

7.75. Commission-managed programmes in health and education aim, inter alia, to encourage the Indian authorities to move towards a sector-wide approach in addressing social development issues. In this framework, efforts are made to enhance donor coordination to reduce transaction costs and to increase aid effectiveness. A key to progress in this area is increased Government ownership, which can be built up through capacity-building and dialogue. The Commission's

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beneficiary's administration to manage sector-wide programmes and to account for their implementation, results and costs. However, only the Community has so far been prepared to support a sector programme approach in India, while other donors operate through a project-based approach. As a result, it has not been possible to establish common accountability and reporting arrangements, necessary to enable adequate supervision and control, in the nationwide programmes on health and education.

7.76. For the above reasons opportunities to create synergy and efficiency through a truly coordinated sector-wide approach have not materialised, apart from a well appreciated system of joint reviews in the education sector programme.

7.77. The Community's new country strategy for cooperation with India does not fully apply the approach outlined in the Commission's recent communication on fighting rural poverty as it limits Community intervention to the health and education sectors, leaving aside other key sectors (agriculture, natural resources management) identified in that communication as needing to be addressed if rural poverty is to be tackled successfully.

THE COMMISSION'S REPLIES

guidelines on sector support programmes adopted in February 2003 attach particular importance to donor coordination. The intensification of this coordination will be a key task for the newly devolved Delegation of the Commission in India.

In the case of the Sector Programme of Support for District Primary Education Programme (DPEP), and the Support to Health and Family Welfare Support Program (HFWSP), arrangements in relation to reporting accounting and auditing are carried out in accordance with the Financing Agreement signed between the Commission and the Indian Government.

Widening these arrangements towards a common framework incorporating all donors in the sector is part of the ongoing dialogue. The establishment of such a framework will be facilitated, notably in the health sector, by a move by other key donors from a project to a sector-wide approach.

7.77. Inadequate health and education facilities are key aspects of rural poverty and it is now generally agreed by all donors in India that by strengthening these two sectors a maximum impact on poverty reduction can be achieved. By selecting these two sectors as priority areas of its new strategy (which received strong support from the EU Member States), the Commission aims to achieve maximum impact without diluting its efforts in too many different sectors or approaches. Moreover, important synergies are expected to be created with the ongoing sector programmes in health and education in the future partner States.

The Commission's development communication identifies six key sectors for poverty reduction but this does not mean that all six need to be taken on board for each new programme. The policy gives the Commission the possibility, in dialogue with the recipient country, to agree on the sectors that are most appropriate for the country in question.

THE COURT'S OBSERVATIONS

7.78. The following recommendations were made:

- 'targeting the poor' as well as 'sustainability' should be given more systematic attention throughout the life of a project/programme;
- when considering contributing to a sector programme through budget support, the Commission should ensure that the direction on public finance taken by the country concerned is satisfactory. If improvements are not realised, the Commission should consider other forms of support;
- the Commission could make its new Community country strategy more comprehensive by also addressing, important issues like agriculture and natural resources management.

THE COMMISSION'S REPLIES

7.78. *The Commission takes note of the Court's recommendations concerning the objectives of targeting the poorest sections of the population and sustainability.*

Since 1992 the Commission uses the 'Methodological Guide' and other project cycle tools such as the logical framework approach. It is therefore now standard practice to build sustainability aspects (including exit strategies) into EC development projects and programmes.

The Commission agrees with the Court's recommendation, which is being implemented under the guidelines for Community support to sector programmes adopted in February 2003.

The Commission considers that there are strong reasons for concentrating its resources on the Health and Education Sectors. In addition, the future State Partnerships that the Commission intends to develop should provide a holistic reform package which could add a rural and natural resources dimension to the education and health activities.

ANNEX 1

(a) Court's assessment of supervisory systems and controls in 2002

	Humanitarian Aid Office	EuropeAid Cooperation Office	Delegations
Overall concept	A	B	—
Procedures and manuals	A	A	A
Functioning in practice	A	B ⁽¹⁾	B ⁽¹⁾
Internal audits	B ⁽²⁾	B ⁽²⁾	B ⁽²⁾
Management reporting	A	B	B

⁽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 EuropeAid implementing organisations

Quality of audits	A
Quantity of audits	B
Definition of terms of reference	B
Commission's involvement in appointing auditors	B
Inclusion of contracting in the audits	C
Review of accounting system	C
Evidence of follow-up	B

Key to indicators

Rating of supervisory systems and controls

Works well. Few or minor improvements necessary

A

Works, but improvements necessary

B

Does not work as intended

C

(c) Key areas for follow-up by the Court of Auditors

	Humanitarian Aid Office	EuropeAid Cooperation Office	Delegations	Implementing organisations
Execution risk analysis	X	X	—	—
Reporting systems	X	X	X	X
Concept external audits and controls	X	X	—	—
Execution external audits and follow-up	X	X	X	X

'X' means 'to be followed up'.

CHAPTER 8

Preaccession aid

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INTRODUCTION

8.1. This chapter deals with the instruments for countries preparing for accession to the European Union. A specific assessment in the context of the Statement of Assurance is introduced for the first time for heading 7 of the financial perspective. This heading contains the appropriations for the preaccession instruments for the central and eastern European candidate countries ⁽¹⁾ (Phare, ISPA and Sapard). It does not contain those in favour of the Mediterranean candidate countries ⁽²⁾, which remain under heading 4. The Phare programme, implemented by the Directorate-General for Enlargement, provides support for institution-building and investment. ISPA, implemented by the Directorate-General for Regional Policy, has been set up to facilitate accession in the fields of environment and transport while Sapard, 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 and spent in 2002 (see paragraphs 2.38 to 2.43 for observations on budgetary management).

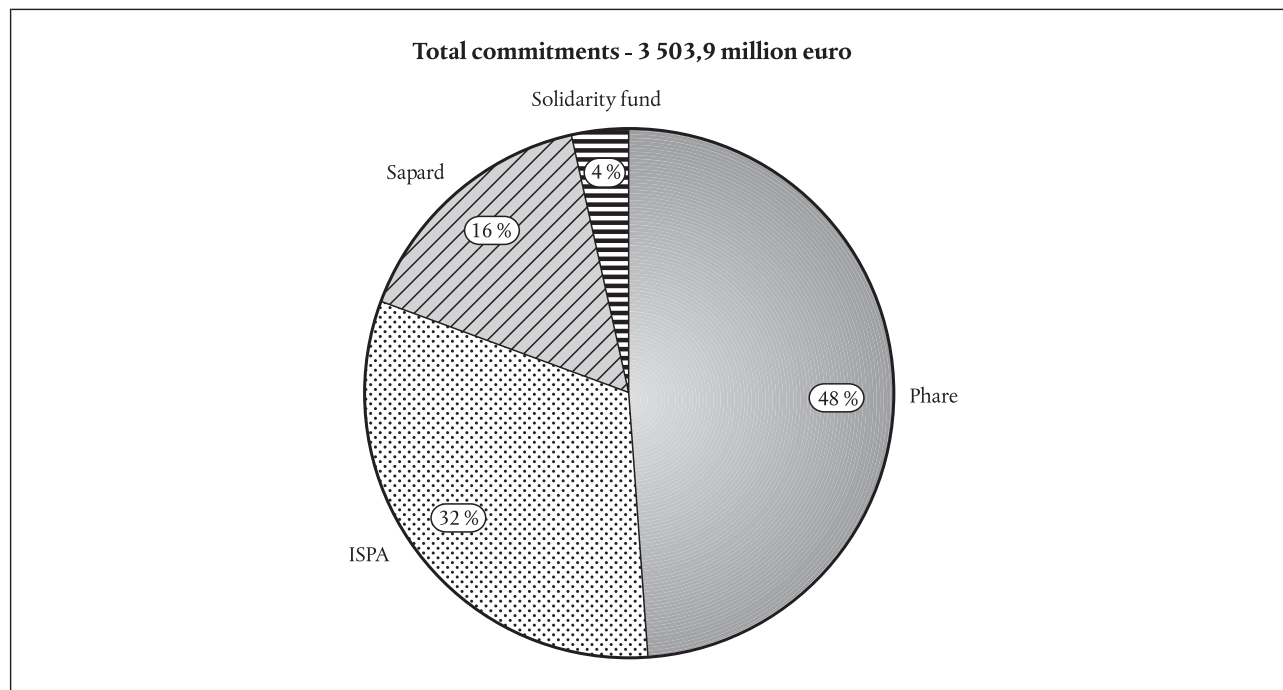
SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Scope and nature of the audit

8.2. The overall objective of the specific assessment of preaccession aid for the year 2002 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. The audit comprised an appraisal of the supervisory systems and controls pertaining to the legality and regularity of the payments and commitments, supported by tests of transactions, an evaluation of the work of other auditors and a review of the annual activity reports of the Directors-General for Enlargement (Phare), for Regional Policy (ISPA) and for Agriculture (Sapard). The audit was carried out at the Commission's central services in Brussels and at Commission delegations and national authorities in the 10 candidate countries involved.

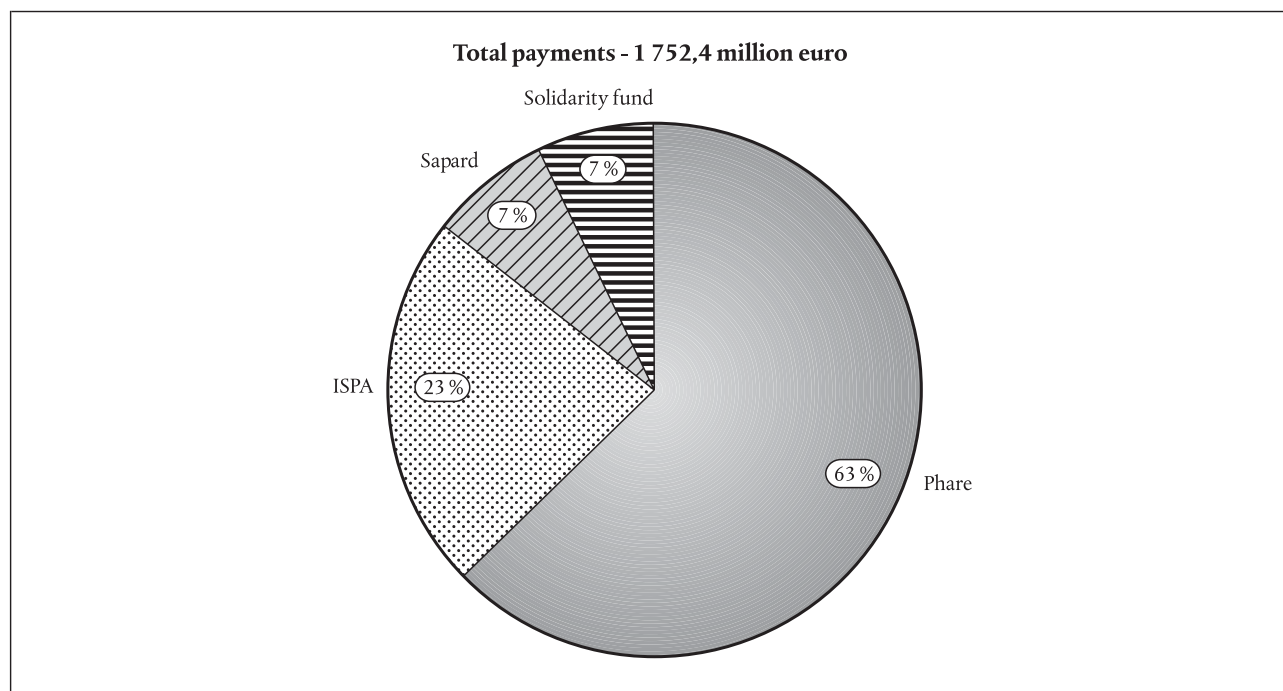
⁽¹⁾ Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

⁽²⁾ Cyprus, Malta and Turkey.

Graph 8.1 — Breakdown of commitments by budgetary area in 2002

NB: For more detailed information see Diagrams III and IV of Annex I.

Source: 2002 revenue and expenditure accounts.

Graph 8.2 — Breakdown of payments by budgetary area in 2002

NB: Sapard 2002 payments were mainly to candidate countries. For more detailed information see Diagrams III and IV of Annex I.

Source: 2002 revenue and expenditure accounts.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

*Supervisory systems and controls***Phare***The management and control systems*

8.3. The bulk of the Phare funds is disbursed in the candidate countries on a decentralised basis, whereby contracts are concluded by the implementing agencies in candidate countries following *ex ante* control by the delegations, and payments are made by the implementing agencies without such controls. *Ex post* controls by the Commission over such payments are carried out during the closure audits (see paragraphs 8.7 to 8.9). Some contracts are also concluded and managed directly by The Directorate-General for Enlargement in Brussels (centralised) and some contracts are concluded and managed by the Commission delegations in the candidate countries (devolved).

8.4. In December 2001 the Commission commenced the introduction of a fully decentralised implementation system for Phare and ISPA — known as the extended decentralised implementation system (EDIS). Under EDIS the Commission will waive the *ex ante* control of contracts and replace it with an *ex post* control. The Commission will decide on full decentralisation on an agency by agency basis following an analysis of the capacity of the implementing agencies. The EDIS process has been delayed, and by the end of 2002 only five candidate countries (Estonia, Hungary, Lithuania, Romania and the Slovak Republic) had completed the gap assessment ⁽³⁾ (see also paragraph 8.14).

8.5. The Commission delegations in the candidate countries endorse the requests from the national funds ⁽⁴⁾ for transfers of funds before these requests are sent to the Directorate-General for Enlargement. This implies that the delegations should check the payment requests. However, as most delegations do not use

8.4. *The move to the extended decentralised implementation system (EDIS) is not an obligation under Council Regulation (EC) No 1266/1999 and progress depends almost entirely upon the efforts of the national authorities. The roadmap for EDIS for Phare and ISPA was presented to candidate countries in the first half of 2001 and many other initiatives followed to assist them in this effort.*

8.5. *A document detailing those aspects that are to be checked is being drafted to ensure that in future the delegations deal with payment applications in a more systematic and unified manner.*

⁽³⁾ There are four stages leading to EDIS: (i) gap assessment; (ii) gap plugging; (iii) gap compliance assessment; and (iv) preparation for a Commission decision. The first three steps are the responsibility of the national authorities. The Commission will carry out its own verification of the system during stage iv.

⁽⁴⁾ National funds were set up in 1998 in all candidate countries to channel the flow of all three preaccession instruments. Each one is headed by a national authorising officer and it is the sole entity dealing with the request for and the receipt of funds from the Commission, the distribution of funds to the implementing agencies and financial reporting to the Commission.

THE COURT'S OBSERVATIONS

checklists for the approval of payments, as recommended by the Directorate-General for Enlargement, or document their work in any other way, it was not clear for 2002 what elements had been checked as part of the endorsement procedure.

The Commission's audits

8.6. In 1998, the decentralised system of management was introduced in the candidate countries without any system audits at that time. In order to rectify this, a programme of systems assessments was launched. In 2002 The Directorate-General for Enlargement's audit unit carried out audits of management and control systems in four ⁽⁵⁾ candidate countries. The limited number of candidate countries covered did not permit the Commission to draw an overall conclusion regarding assurance as to legality and regularity in respect of these systems. The missions made in 2002 by the financial planning and execution unit of the Directorate-General for Enlargement to nine candidate countries to see how management and control procedures concerning Phare were working, were not intended to provide such assurance. They did lead to recommendations for improving the role of some national funds and the monitoring of national co-financing and for setting up of audit plans by local authorities.

8.7. In 2001, the Directorate-General for Enlargement adopted a strategy to contract external auditors to carry out closure audits covering some 60 % of the value of the Phare programmes on a risk-based sample.

8.8. By the end of 2002, closure audits covering programmes amounting to a total of 1 876 million euro had been launched. This amount corresponds to approximately 45 % of the total value of the Phare programmes up to and including the programming year 1998. The finalisation of closure audits, however, takes considerable time. By the end of 2002 only four out of 41 final

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8.6. *The reasons for the relatively limited number of candidate countries covered are:*

- (a) *the relatively short time since the programme was launched; and*
- (b) *the fact that the candidate countries have been undergoing their own extensive systems reviews in preparation for EDIS.*

8.7. *The 60 % objective was set by the Commission for itself without having any significant experience of what such audits would show. It related only to the programmes for 1997 and earlier. It did not cover 1998 programmes and was in any case expected to take at least two years to achieve. In 2001 some delegations launched some closure audits and, following the establishment of a central framework contract in April 2002, a programme of audits was launched by the Directorate-General for Enlargement's central audit unit in May 2002. At the end of December 2002 the plan only anticipated that audits covering about half of the objective would have been launched.*

8.8. *The Court's figures in relation to the evaluation of audits launched shown here are correct, as of December 2002 but they cannot properly be compared with the targets of the strategy which had a different base as described in the reply to point 8.7.*

⁽⁵⁾ Cyprus, Malta, Poland and Romania.

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closure audit reports had been approved by the Directorate-General for Enlargement. The follow-up process is only at a very early stage.

8.9. The closure audits discovered some irregularities, 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. Although the number of reports available is still very small, the results tend to corroborate the results of the Court's audit of payments which did not reveal material errors (see paragraph 8.45).

Co-financing of Phare programmes

8.10. The Phare Guidelines (SEC(1999) 1596) 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 ⁽⁶⁾. However, until the end of 2002 the Commission had limited control over whether this requirement was complied with.

8.11. The Commission took measures in the autumn of 2002 to improve control. The national funds have to report from 1 January 2003 onwards on the co-financing situation each time they send a request for money to the Directorate-General for Enlargement. In addition, the auditors performing closure audits are now required to ask the national authorising officers to specify the national co-financing provided. However, the risk remains that errors regarding national co-financing will remain undiscovered because the auditors are not required by their terms of reference to check the declared national co-financing against supporting documents.

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As of August 2003, 73 final closure audit reports had been approved by the directorate-General for Enlargement (including those approved by the delegations as mentioned in the reply to point 8.7).

8.10. *Because it is only late in the cycle of projects that controls over part-financing can be fully exercised. 2000 Phare programmes are implemented during 2001, 2002 and 2003. This being the case, for the 2000 programmes, contracting only finished at the end of 2002, and in some cases may still be ongoing. Therefore, it was only during 2002 that the issue of control became pertinent and the Commission could address the question.*

8.11. *Auditors contracted for closure audits were instructed, where projects have been jointly part-financed, to check not only Phare funds in the first instance but also national part-financing on contracts selected for testing. Where projects had been financed by parallel part-financing, the auditors were instructed to obtain a certified (signed) declaration of the details of part-financing by the auditee or the government concerned. For the latter the auditors are requested to assess the information given but not necessarily to verify it against supporting documents. These instructions reflect a risk assessment within the auditors tasks. On the basis of this assessment further verification may be undertaken as facilitated by the framework contract terms of reference.*

⁽⁶⁾ These guidelines are binding since they are referred to in Article 8 of Council Regulation (EC) No 3906/89 (OJ L 375, 23.12.1989, p. 11) and are part of the Financing Memorandum concluded between the Commission and the candidate country concerned.

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Audits by candidate countries

8.12. According to the Memoranda of Understanding between the Commission and the national fund in each candidate country, the national funds have an annual obligation to report on planned audits and to summarise audit findings. These Memoranda of Understanding had in most cases already been signed at the end of 1998, but in most candidate countries the national funds did not fulfil this reporting obligation until the financial year 2002. Moreover, the majority of the few plans which were submitted included only a list of planned audits, without any explanation or strategy. The Commission delegations have not been active in requesting these reports.

8.13. Auditors in the candidate countries mainly comprise internal audit departments at the national funds, the implementing agencies and the ministries of finance. In general, these internal audit departments have been established only recently and are not yet fully operational. Therefore the Commission could not draw assurance from their work.

The Instrument for Structural Policies for Preaccession (ISPA)*The Commission's audits of management and control systems*

8.14. Article 9(1) of Council Regulation (EC) No 1267/1999 ⁽⁷⁾ prescribes that candidate countries should have established, by no later than 1 January 2002, an adequate management and control system ⁽⁸⁾. There is a considerable similarity between the management and control system requirements of Article 9 of the ISPA Regulation and those of Phare/ISPA EDIS (see paragraph 8.4).

8.15. The Directorate-General for Regional Policy carried out two cycles of audits in all 10 candidate countries in 2001/2002 and 2002/2003. The main objective of the audits was to assess to what extent the 10 candidate countries had established management and control systems complying with the requirements.

8.12. *During missions to a number of national funds in 2002, the national authorities were reminded of the need to report on planned audits and to summarise audit findings. In 2003, there has been a more active follow-up to the audit reporting obligations and some delegations suspended processing of requests for payment of funds pending compliance.*

⁽⁷⁾ Council Regulation establishing an Instrument for Structural Policies for Preaccession (OJ L 161, 26.6.1999, p. 73).

⁽⁸⁾ 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.

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8.16. The Court examined the extent to which the Directorate-General for Regional Policy has carried out its work in an effective manner. The files of 10 audits carried out in 2001 and 2002 were reviewed. In general, the Directorate-General for Regional policy audits provide a sufficient basis for concluding whether the management and control systems in the candidate countries have respected the requirements of Article 9(1) of Regulation (EC) No 1267/1999. The Court's work though, revealed the following.

Planning of audits

8.17. The risk assessment carried out for the second cycle of audits was not detailed enough to permit specific risk areas to be identified, which could have affected the selection of the most appropriate audit approach.

8.18. Although certain information on the systems was gathered prior to the audit visits, there is no evidence to show that this information was analysed in detail to permit specific internal control areas to be selected for testing prior to the visits.

8.19. The audit questionnaires developed for use during the audit visits did not cover all the systems and bodies involved in ISPA assistance (for instance final beneficiaries in the transport sector). In addition, they often did not provide adequate guidance as to whether any testing was necessary, or on the extent of any such testing. A complete and sufficiently descriptive audit programme which would have clearly defined the work to be carried out, as well as facilitated reviewing it, was not prepared.

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8.17. *For the second cycle of audits, the identification of specific areas to be covered in the implementation systems for ISPA and for individual countries was based on a risk assessment, which was considered adequate for the purpose.*

8.18. *The level of information, and the date of its availability, varied from country to country. The information received in time was examined before each audit mission. The main purpose of the first cycle of audits was not to carry out testing, and generally the state of progress on implementation was not sufficiently advanced. Testing was carried as part of the second cycle where interim payments had been made.*

8.19. *The questionnaires covered the national fund and the implementing agencies, and in addition for the second cycle, final beneficiaries in the environment sector, and included the key aspects of financial management and control which came within the scope of the audit. In the transport sector, a separate questionnaire was not considered necessary for the road and rail agencies, which are generally closely linked to, if not the same as, the implementing agency. The work to be carried out was described in the audit planning documentation. For subsequent audit work for which testing will be systematically carried out, the questionnaires will be further elaborated in line with the suggestion of the Court and the work to be carried out defined in more detail.*

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Execution of audit work

8.20. The work which had to be carried out during each audit visit was quite substantial. In both the 2001 and the 2002 audits the time available was not sufficient for all the work planned to be carried out (in the case of the 2001 audits for instance the systems of some bodies involved in ISPA management were not reviewed).

8.21. In some cases the audit work carried out was not adequately documented. For example, the applicable audit questionnaires had not been filled in. It was therefore not possible to judge whether:

- (a) the audit work was thorough and complete;
- (b) all audit findings were adequately substantiated; and
- (c) all significant findings were included in the audit report.

Reporting

8.22. The audit findings are in most cases clearly described in the audit reports sent to the candidate countries, and the recommendations made appear reasonable. However, audit reports are sometimes sent a long time after the completion of the field work, which does not facilitate the timely resolution of the issues identified.

Sapard

8.23. The Sapard component of this audit focused on the assessment of audits by the Commission and candidate countries, monitoring and financial and progress reports. The audit included a visit to Bulgaria, the candidate country with the highest expenditure paid to final beneficiaries up to the end of 2002 (10,9 million euro).

Audits by the Commission

8.24. Following the provisional conferral of management for five candidate countries in 2001, the Commission decided to grant provisional conferral in 2002 for

8.20. *The audit work on ISPA started in the second half of 2001 with a newly established audit team. Although the audit plan was ambitious in view of the time and resources available, the Commission considered it was important to review rapidly the set up of the systems and the results achieved were adequate for this purpose.*

8.21. *The audit reports themselves are very complete. In some cases the questionnaires were used as a checklist to ensure coverage of all points but were not completed. It is accepted that it is good practice for the questionnaires to be completed for the audit file and this is being applied for subsequent audit work.*

8.22. *The period for sending the completed reports to the candidate countries was in some cases longer than desirable because of the number of audits carried out in a limited period and the complexity of the work. However, the provisional conclusions of an audit were always given to the authorities at the end of the audit mission.*

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the remaining five ⁽⁹⁾ countries. The audits undertaken by the Commission on which these decisions were based led it to conclude that satisfactory systems had been put in place. The Court reviewed the Commission's files for the two countries with the largest budget allocations for the whole programming period 2000 to 2006 (Poland and Romania), and concluded that the documentation by the Commission of the audit evidence, including that relating to staffing, was satisfactory.

8.25. In its 2001 Annual Report ⁽¹⁰⁾, the Court recommended that the Commission should carry out audits shortly after the provisional conferral of management which should cover all levels of control between the Commission and the final beneficiaries. These checks are necessary to ensure that the new systems, which the Commission had approved on paper, were in fact put in place and working properly. However, in 2002, the Commission only did so for four countries (Bulgaria, Lithuania, Poland and Romania) and with limited scope. Thus, for six countries, the Commission did not ensure that the systems were in fact working as approved. This factor should have been taken into account when approving systems for further measures ⁽¹¹⁾.

8.26. The Commission's audits for the four countries where compliance was checked on-the-spot, included checking the requirement that adequate personnel with suitable experience was available and assigned to the tasks. However, the effectiveness of the checks undertaken was limited because the Commission did not ensure that it was sufficiently informed of staff changes. The Commission therefore had no assurance after the provisional conferral of management that adequate competent staff were available in key positions, with the consequent risk that the implementation of the programme would be adversely affected.

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8.25. The four countries concerned account for 80 % of the total aid allocated under the Sapard programme. In addition, the planned financial allocation for the measures approved in those four countries accounts for more than 60 % of the funding already approved. Account must be taken of both the amount of funding approved and the number of measures approved. For example, even though Bulgaria requested approval for only three measures, these represent two thirds of the total Sapard aid for the country.

Since the decision on Hungary was adopted only on 26 November 2002 and the Hungarian authorities had not yet replied to the letter setting out our comments, the mission could not be organised before the end of the year.

Additional assurance was obtained from clearance audits in Bulgaria and Estonia and from the receipt of a certification report from Lithuania.

8.26. The national funds are required to inform the Commission on their own initiative of changes affecting the personnel of the Sapard Agencies (Articles 4(7) and 5(4) of the Annex to the Multiannual Financing Agreement — MAFA). Where the Commission receives other information that there have been changes in key staff, candidate countries are asked to explain the circumstances surrounding those changes. As soon as the information was received, Commission staff were sent to Bulgaria, Poland and Romania to check that the systems put in place following those changes were operating smoothly.

The Commission is of the opinion that this provides reasonable assurances that the risks to the Fund are being kept at an acceptable level.

⁽⁹⁾ Czech Republic, Hungary, Poland, Romania and Slovakia.

⁽¹⁰⁾ OJ C 295, 28.11.2002, paragraph 6.32, first recommendation.

⁽¹¹⁾ The first series of conferral of management decisions only covered around half of the measures provided for in the rural development plans. When procedures for further measures have been completed by candidate countries, they must be examined by the Commission and approved by another conferral of management decision.

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8.27. The Commission undertook clearance of accounts audits in 2002 for the only two countries which had expenditure in 2001 (Bulgaria and Estonia). The Court reviewed whether these audits provided the Commission with information on the legality and regularity of underlying transactions, which is the case. However, insufficient checks were performed for the advance payments made to candidate countries, which amounted to 140 million euro up to 31 December 2002. In particular, the Commission's audits did not include testing the procedures laid down in the Sapard legal basis for depositing funds in the Sapard euro account, checking that normal commercial conditions were obtained⁽¹²⁾ and checking the procedures relating to the booking of interest in the accounts. These checks are important as the Court's audit provided evidence to show that normal commercial conditions were not obtained in practice.

8.28. In its 2001 Annual Report⁽¹³⁾, the Court reported that the Commission had performed insufficient checks to determine whether the systems set up prevent double funding of projects using aid from Phare or from national sources, and whether these systems cover the economy and cost-effectiveness of projects, as foreseen in the Sapard legal basis⁽¹⁴⁾. In its answer to the Court's report, the Commission replied that these matters would receive close attention in subsequent audits. The Court found no evidence that the Commission had complied with this undertaking.

8.29. In particular, in 2002 there were no *ex post* checks by the Commission and the candidate countries to detect double funding. The surveillance systems could thus not identify cases where Sapard projects were also receiving funding from national programmes of candidate countries. The risk is real since the Court's audit in Bulgaria identified the absence of such checks for projects receiving funding from both EU and national programmes. The Commission is thus not sufficiently informed on potential overlaps, which is an important aspect of legality and regularity.

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8.27. *The decision on the certification of the accounts of the Sapard Agencies, adopted on 2 October 2002, covers five countries: Bulgaria, Estonia, Latvia, Lithuania and Slovenia. The first two had incurred expenditure. In the other three countries, checks covered the 'euro-account' and interest earned by the national fund. The balances on the accounts (which represented advance payments), the interest earned and its booking in the accounts were thus subject to audit. This work will be repeated in 2003.*

The question of normal commercial conditions for the interest earned on the euro account has been closely examined as part of the clearance audit for 2002 carried out in 2003.

8.28. *Following the Court's 2001 Annual Report, the Commission has insisted that candidate countries' manuals of procedures contain such checks. Future Commission audits will examine whether these checks are reliable and working satisfactorily.*

8.29. *The Commission checks the measures adopted by the candidate countries regarding possible double payments and will insist on the relevant ex post checks.*

⁽¹²⁾ As required by Article 2(h) of Commission Regulation (EC) No 2222/2000 of 7 June 2000 and the Multiannual Financing Agreements signed between the Commission and each of the applicant countries.

⁽¹³⁾ OJ C 295, 28.11.2002, paragraph 6.20.

⁽¹⁴⁾ Article 4(1) of section B of the Multiannual Financing Agreement specifies that expenditure shall be eligible for Community support under Sapard only if the use of Sapard assistance is in accordance with the principles of sound financial management, and, in particular, of economy and cost-effectiveness.

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Audits by candidate countries and monitoring

8.30. The certifying bodies in candidate countries play a key role in providing the Commission with information on the surveillance systems. Whilst their annual reports for 2001 were comprehensive, certain areas, such as recruitment procedures and key staff changes in the institutions involved (except for the internal audit units in the case of Bulgaria), conditions for interest on the Sapard euro account, and overlaps of Sapard with Phare and/or national programmes, were not covered. The Commission's clearance audit did not lead to observations or recommendations on the scope of the certifying bodies' reports.

8.31. Through its participation in Monitoring Committees, the Commission is informed on the legality and regularity aspects of policy setting, e.g. eligibility criteria, and on whether management procedures such as preparation of the mid-term evaluation perform effectively. However, information on the results of checks carried out, including audits, was not submitted by the Sapard managing bodies to the Monitoring Committee as required by the Multiannual Financing Agreement (MAFA). In the absence of this information, possible problems cannot be identified at an early stage, and necessary proposals for changes in the Programme cannot be addressed by the Monitoring Committee. The Commission should have identified this and advised the Monitoring Committees' secretariats accordingly.

8.30. The missions currently under way regarding certification for 2002 are attaching great importance to these matters. In particular, a questionnaire has been drawn up on the basis of the Court of Auditors Annual Report for 2001 in order to take stock of the situation regarding the pertinent criticisms that have been raised. Where necessary, the attention of the national authorities has been drawn to the need to comply with the relevant recommendations. However the Commission does not consider that certifying bodies should cover key staffing changes in the candidate countries.

8.31. Since early 2003, as a general rule the Commission has verified during the preparatory phase of each Monitoring Committee that agendas include an item allowing discussion of the checks carried out (including their findings). To date none of these checks reported at the Committees have indicated the existence of problems, including those which might warrant programme changes.

*Annual activity reports***The Directorate-General for Enlargement**

8.32. The Director General's 2002 activity report for the Directorate-General for Enlargement includes three reservations:

- (1) backlog of system audits, refers mainly to the fact that decentralisation was made without such system audits;
- (2) backlog of closure audits;
- (3) estimation of 'creances sur intermediaires', refers to the reporting of advances for intermediaries, not yet used at the year end (see paragraph 1.31).

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8.33. The 2001 activity report included two more reservations; difficulties of obtaining proofs regarding possible irregularities and programmes committed before the Director-General's arrival. These two reservations are reclassified as observation and scope limitation in the 2002 activity report.

8.34. The reservations are in line with the Court's assessment (see paragraphs 8.6 to 8.9).

8.35. The problem of co-financing is mentioned in the context of internal controls and closure audits. There is no overview of national co-financing (see also paragraphs 8.10 to 8.11) and there is a risk that co-financing requirements will not be met by the candidate countries. The Court considers this problem important enough to merit a full reservation in the 2002 annual activity report.

8.35. *There is always some risk that part-financing requirements may not be met but the risk that this will not be detected is limited.*

The Directorate-General for Enlargement did consider whether this issue justified a reservation but decided against it for the reasons explained carefully in paragraph 4.1(c)(i) of the annual activity report — namely that the issue has not matured yet and that it will in any case be possible to take remedial steps prior to project expiry dates. In this context the Directorate-General for Enlargement still believes that the issue does not satisfy the requirements for a reservation according to the guidelines issued by the Secretary-General.

The Directorate-General for Regional Policy

8.36. The results of the Directorate-General for Regional Policy audits were correctly reflected in the Director-General's 2001 annual activity report and declaration that 'in most countries significant further work is required to obtain full compliance with the provisions'. In the 2002 activity report, he mentioned that 'the systems audits... generally show good progress in the establishment of financial management and control systems compliant with the requirements of Regulation (EC) No 1267/1999'. Thus, in the 2002 annual activity report it was not made explicit that the requirements of Article 9 for the candidate countries to establish adequate management and control systems by 1 January 2002 had not been achieved. A summary of the main audit findings was presented in the activity report and there it was noted that: 'in many cases the framework of agreements remained to be completed, written procedures were still to be finalised, procedures for the treatment of irregularities had to be fully developed, additional staff had to be recruited, and internal audit was not yet operational.'

8.36. *Chapter 5 of the annual activity report for 2002 correctly indicates that good progress had been made by beneficiary countries with regard to establishing compliant systems, in comparison with the situation in the previous year, but indicates some of the remaining weaknesses identified by the audit work carried out.*

It was clear therefore that compliance with Article 9 had not been fully achieved.

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The Directorate-General for Agriculture

8.37. Sapard is addressed in paragraph 2.6 of the Directorate-General for Agriculture's 2002 annual activity report. It does not provide a complete overview of the situation in 2002. Concerning the implementation of Sapard, the report does not mention that only 14,5 million euro were disbursed to final beneficiaries, and that the execution rate of payments (total payments made to final beneficiaries related to the total funds available) as at 31 December 2002 was only 2 % (see paragraph 2.39). The report states that the Commission gave priority to sound financial management and proper control. This is only partly true, as the audit resources were allocated primarily to conferral of management without also undertaking compliance audits after conferral of management to ensure that the systems worked in practice. The Commission's analysis does not identify the weaknesses reported by the Court (see paragraphs 8.25 to 8.31)

Audit of contracting and tendering procedures for Phare and ISPA

8.38. The Court examined representative random samples of 53 Phare and 13 ISPA contracts concluded in 2002, to assess whether the contracting authorities had carried out the contracting and tendering procedures for service, supply and works contracts in accordance with the EU regulatory framework ⁽¹⁵⁾, and whether the Commission's delegations were carrying out the required *ex ante* controls in an effective manner.

8.39. In line with their obligations to perform *ex ante* controls, the Commission delegations were significantly involved in most of the procurement processes, including individual cases where the evaluation report was not endorsed, demonstrating that *ex ante* approval by the delegations is an indispensable element of control. In general, the delegations have closely followed the whole evaluation process, although there is in some cases no comprehensive document in the file describing the work performed, the issues raised and how these

8.37. *It is not the intention of the Directorate-General for Agriculture's annual activity report to provide complete information on Sapard. Last year such information was presented in the Sapard annual report.*

Conformity audits began in September 2003.

8.39. *The Commission agrees that the ex ante controls performed by the delegations constitute an important element of control. These controls by delegations during the approval process have been visible and effective, in line with PRAG and the instructions 'Deconcentration-ISPA'. The Commission agrees that in addition to all documentary evidence, a comprehensive explanatory note should be available in each file summarising the decision reached ⁽¹⁾.*

⁽¹⁵⁾ Article 113(a) of the Financial Regulation, Financing Agreements with the beneficiary countries, manual of Instructions and the practical guide.

⁽¹⁾ *Practical guide to Phare, ISPA and Sapard contract procedures.*

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issues were resolved. In the case of ISPA, reliance was placed on this ex ante control by the Directorate-General for Regional Policy's Director-General in his 2002 declaration.

8.40. The evaluation reports provide a detailed view of the whole process with the exception that in the case of the more complicated evaluation criteria, there were in some cases insufficient justification of the individual evaluators' opinion. Proper justification would enhance the transparency of the evaluation process and clarify the basis for the proposal to award the contract.

8.41. Three Phare contracts, with a total value of 2,2 million euro or 2,3 % of the total value of contracts examined (97,5 million euro), were concluded following decisions to derogate from the standard procurement procedures (two cases) or were not awarded to the cheapest bidder (one case), without sufficient justification.

8.42. Two ISPA contracts, with a total value of 19,2 million euro or 9,3 % of the total value of contracts examined (208 million euro), were not concluded in accordance with the regulatory framework. In one case the tender was awarded to the lowest bidder although the price was extremely low in comparison to the other bids. The Evaluation Committee should have formally requested a detailed explanation for the low price offered. If the price could not have been justified, then the bid should have been disqualified. In the other case the tender was split into two to allow the use of an existing framework contract procedure, thus avoiding a new contract being awarded using an open tender procedure.

8.43. In five contracts in the Court's sample, the lowest bidder was rejected for administrative or unclear technical reasons. The practice of asking for clarifications varies widely between evaluation committees, as does the guidance given by delegations. In the light of some of the latest rulings of the Court of Justice, the

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The Commission has, on the basis of on-the-spot audits carried out at seven delegations by its Internal Audit Unit, clarified in the course of 2002 what is expected from the delegations as well as making known 'best practices' between delegations. In particular, it has circulated checklists for the assessment of documents submitted by the national authorities.

8.40. *In case of ISPA, evaluators are requested to provide full justification of the final result of the evaluation. Incomplete evaluation reports are rejected by the delegations.*

The PRAG and FIDIC rules are generic and apply to many situations. This means that judgement must be exercised by delegations in regard to their application (which could differ significantly depending on particular circumstances). Support, such as training, is provided by the Commission, as appropriate. The Commission is committed to a transparent evaluation process and to the proper recording of decisions of the Evaluation Committee.

8.41. *In the cases referred to by the Court, the Commission considers that the decisions were justified, although it recognises that documentation of the justification was insufficient.*

8.42. *The Commission considers that in the first case referred to by the Court, the bids were not abnormally low. The offer price was similar to the costs indicated in the relevant technical studies. In the second case, the splitting of the contract was justifiable for technical reasons. However to avoid any doubt in the future, the authorities have been recommended to follow open tendering procedures whenever possible and specifically for project supervision.*

8.43. *The Commission accepts it is good practice for an Evaluation Committee to seek clarification where it is possible and necessary, even though it is not a specific obligation. Please refer also to the reply to paragraph 8.41. The Commission confirms that according to the practical guide (PRAG) clarification should be sought where necessary and practically*

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evaluation committees should seek clarification where it is practically possible and necessary. When ambiguity probably has a simple explanation and can be easily resolved, it is good administrative practice to seek clarification. This was confirmed by the Court of First Instance ruling in Case T-211/02.

Audit of payments (Phare, ISPA and Sapard)

8.44. The audit included an examination of a representative random sample of 106 payments (88 for Phare, 11 for ISPA and seven for Sapard) made in the year 2002. Although the sample included some payments on contracts managed in a centralised or devolved manner, the main part of the sample concerned payments made by the implementing agencies in the candidate countries to the final beneficiaries on contracts managed in a decentralised manner. In 2002 there was little physical implementation of ISPA and Sapard projects at country level. The majority of the payments audited for these programmes is first or second advance payments with a very low risk of errors. The audit of 106 payments did not reveal material errors. However, for ISPA three errors in the payments made by the Commission were found. In addition, the requirement to carry out an environmental impact assessment (EIA) ⁽¹⁶⁾ was not respected for a number of ISPA projects examined as a full EIA was not submitted at the time of project approval.

Conclusions

8.45. The Court's audits on the payments in the field of preaccession measures did not reveal material errors. However, there is a need to improve the supervisory systems and controls in order to limit the risk of affecting the legality and regularity of underlying transactions.

8.46. The audit detected the following weaknesses in Phare supervisory systems and controls:

- in the key control of endorsing the payment requests of the national funds it is not clear what checks are performed by the delegations,
- there is limited overview of national co-financing, increasing the risk that co-financing requirements may not be met by the candidate countries,

⁽¹⁶⁾ Regulatory requirement (Annex I to Council Regulation (EC) No 1267/1999 establishing an Instrument for Structural Policies for Preaccession).

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possible. The Commission is regularly organising training sessions in the candidate countries where this message is reinforced and training provided on its application.

8.44. *In some cases when design and build contracts are used, it is not possible to carry out a full environmental impact assessment (EIA) before the project is submitted for approval. Moreover, conditions in the Financing Memorandum require that an EIA be completed, when needed, before the commencement of works.*

8.45. *The Commission is tightening up its controls, carrying out further training measures and issuing instructions to delegations.*

8.46. *A checklist for use by the delegations when endorsing payment requests is currently being prepared.*

While there may be a risk that part-financing commitments are not met, there is only a limited risk that this would not be detected and a correction made (see point 8.34). There is an overview of national part-financing, as now with each payment request the national authorities have to identify the national funds allocated to the programme.

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- there is a backlog of closure audits,
- the reporting on audits carried out by the candidate countries is incomplete or lacking,
- the internal audit functions in the candidate countries are not yet fully operational.

8.47. The audit of ISPA found that the methodology for the audits carried out by the Directorate-General for Regional Policy to assess management and control systems did not deal adequately with risk assessment at the planning stage and the development of audit programmes to be used for the execution of the work. The Court notes the Commission's conclusion that the candidate countries have in general not yet established management and control systems which fully respect all the requirements of Article 9 of the Council Regulation (EC) No 1267/1999.

8.48. The audit of Sapard found that the Commission considered that the supervisory systems which were set up for Sapard would fulfil their function. Through monitoring and clearance of accounts audits, the Commission was informed that most aspects of the systems operated satisfactorily. However, it did not ensure that the systems which were approved on paper were working properly in practice, due to insufficient audits on those systems, and it was not informed on certain key issues, notably double funding and the procedures relating to interest earned on the Sapard euro account.

8.49. The audit of the tendering and contracting procedures for Phare and ISPA found that the Commission delegations were significantly involved in most of the

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As of August 2003 audits have been launched in respect of 49 % by value of 1997 and previous programmes compared to the original final target of 60 %. Leaving aside the part-financing issue discussed in points 8.9 and 8.34, there have been only minor findings from closure audits. In the light of its experience to date, the Commission is not convinced that this shortfall truly represents a significant weakness. It is currently reflecting whether, in the interests of cost-effectiveness, it should adjust its strategy and targets.

The Commission has taken steps to ensure the fulfilment of obligations in this regard, for example that the programmes' final declaration must contain details on audits and their findings.

This is being addressed in the context of EDIS and the monitoring of Chapter 28 obligations.

8.47. *The approach followed by the Commission was appropriate for the objectives of the audits and included a risk assessment for the second cycle of audits. For each cycle of audits there was an enquiry planning memorandum and individual mission planning memoranda together with questionnaires setting out the work to be done. In future audit work for which systematic testing is envisaged, a more detailed description of the work to be undertaken will be provided.*

8.48. *With regard to the question of interest earned by the euro account, such interest and its entry into the account were closely checked as part of the certification procedure.*

Following the Court's 2001 Annual Report, the Commission has insisted that candidate countries' manuals of procedures contain checks on double-funding. Future Commission audits will examine whether these checks are reliable and working satisfactorily.

8.49. *Regarding the two ISPA cases the Commission does not consider them to be errors for the reasons given in the reply to point 8.42.*

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procurement processes. This shows that at this stage *ex ante* approval by the delegations is an indispensable element of control. The Phare contracts were, taken as a whole, concluded in a legal and regular manner. For ISPA, the audit revealed two significant errors.

Recommendations

8.50. The Court recommends that:

- concerning Phare, the Commission should strengthen the procedure for endorsing payment requests, reduce the backlog in closure audits, improve the control of national co-financing and improve the reporting and analysis of audits carried out by the candidate countries,
- concerning ISPA, the Commission should improve the methodology for the audits carried out by the Directorate-General for Regional Policy,
- concerning Sapard, the Commission should plan and undertake a programme of systematic audits on the spot in candidate countries to ensure that systems are working as approved. These compliance audits should include checking staffing, double funding and cost-effectiveness of projects. The Commission should ensure that these issues are also covered by audits of the certifying bodies,
- concerning the Phare and ISPA tendering and contracting procedures, the Commission should improve the instructions for seeking clarifications in tender evaluations and simplify the selection criteria in tendering. The checks carried out by the delegations at each stage of the procurement process should be better documented. The transparency of the evaluation process should be improved by providing better justification of the evaluators' opinion on the more complicated evaluation criteria.

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8.50. Each of these recommendations is being actively addressed (see the replies to points 8.45 and 8.46).

The Commission actively keeps its audit methodology and under review will take account of relevant points raised by the Court for future audit work on ISPA.

Future conformity audits will include detailed checks on the different matters raised by the Court. At the seminar on 7 and 8 November 2002 on the certification of the accounts of the Sapard Agencies, the Commission presented 'Guidelines for the Sapard certification audit — Model of report for the certifying bodies', which cover most of the points raised by the Court. The certification reports for the 2002 accounts took account of those guidelines.

A programme of systematic compliance audits is planned. It will cover the issues raised. However the Commission does not believe that certifying bodies should cover staff changes in the financial accounting clearance exercise.

As regards clarifications during tender evaluations, the practical guide (PRAG) clearly states the reasons and the procedures for requesting clarifications. Extensive guidance on clarifications and the clear message to request clarification to ensure a fair and informed evaluation is provided by the Commission during training sessions. The potential complexity of the different tenders is presented through examples, case studies and exercises to staff of delegations and contracting authorities. The Commission has, on the basis of on the spot audits carried out in 2002, clarified what is expected from delegations and in particular circulated checklists for the assessment of documents submitted by national authorities.

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FOLLOW-UP TO SPECIAL REPORT NO 5/1999
CONCERNING THE PHARE CROSS-BORDER
COOPERATION (CBC) PROGRAMME

8.51. The subject of the Court's Special Report No 5/1999 was the implementation and impact of the Phare cross-border cooperation programme over the period 1994 to 1998. This programme funded projects intended to have a cross-border impact in regions of the Phare beneficiary countries which border on the Member States ⁽¹⁷⁾. The current annual budget of the Phare CBC programme is 163 million euro, which represents approximately 10 % of the total Phare budget.

8.52. The Council in its conclusions reiterated the importance of the programme in preparing countries for membership of the European Union. It called for improved coordination between Phare CBC and Interreg and the need to finance projects which genuinely involved cross-border cooperation.

8.53. The main conclusions which required corrective action by the Commission were as follows:

- (a) implementation had been delayed so that the programme had only had a modest impact at project level at the time of the audit in 1998;
- (b) some of the projects had only a limited cross-border impact;
- (c) some of the projects focused on national priorities rather than being specifically in the interests of the local population in the border region;
- (d) there were few joint projects with Interreg;
- (e) joint plans covering both sides of borders had not been drawn up;
- (f) the 1998 Phare guidelines did not take adequate account of the specificities of the CBC programme;

⁽¹⁷⁾ Typical projects included border-crossing facilities, wastewater treatment plants, economic development schemes and small 'people-to-people' projects.

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- (g) programme management procedures of both the beneficiary countries and the Commission were too centralised;
- (h) the programme did not contribute to solving the problem of regional disparities within Phare countries, the funds being allocated only to regions bordering on the Member States and not to other borders.

8.54. The follow-up exercise was based on interviews with Commission staff in the Directorate-General for Enlargement and the delegations and officials in the CBC implementing agencies together with a review of documentation. The main conclusions are:

- (a) the Commission has largely succeeded in fully committing and contracting funds before the legal deadlines. The growing number of completed projects means that the programme as a whole is now having visible results. The programme also has an institution building effect by helping beneficiary regions prepare for managing Interreg funds. However, delays still occur particularly at project preparation and contract tendering stages;
- (b) overall, the projects' cross-border impact and that of the programme as a whole has improved, particularly as a result of the joint programming documents drawn up by Member States and candidate countries in accordance with the revised Phare CBC Regulation of December 1998 ⁽¹⁸⁾ (see also paragraph (e)). However, the real cross-border impact of individual projects continues to vary;
- (c) in general, there has been an increase in the involvement of regional and local representatives and a corresponding rise in the number of projects at this level;
- (d) the Commission has taken further steps to reduce the differences between the Interreg and Phare CBC programme to increase the number of joint projects (see also paragraph (e)). However, the fact that the Interreg programme is governed by the part of the

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8.54.

- (b) *The cross-border value of individual projects is a function of the degree of cooperation between authorities on either side of the border. Although such cooperation has increased considerably thanks to the setting-up of joint coordination structures and joint programming, this is a long-term process requiring several more years to fully develop.*
- (d) *With the amendment on 6 September 2002 of Regulation (EC) No 2760/98, Phare CBC has been aligned as much as possible with Interreg. The remaining differences pertain to the existing legal and budgetary separation between external and internal funding sources,*

⁽¹⁸⁾ Commission Regulation (EC) No 2760/98 of 18 December 1998 concerning the implementation of a programme for cross-border cooperation in the framework of the Phare programme (OJ L 345, 19.12.1998, p. 49).

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Financial Regulation covering the Member States and the Phare CBC programme by the part of the Financial Regulation governing external actions in third countries has continued to be a real impediment to closer coordination of the two instruments ⁽¹⁹⁾;

- (e) the introduction of the joint planning document (see paragraph (b)) has been a significant step forward in improving both the impact of the Phare CBC programme and cooperation with Interreg;
- (f) the Commission has followed a flexible approach to interpreting the Phare guidelines to ensure that the specific objectives of the CBC programme are not unduly constrained by Commission policy regarding the Phare programme as a whole;
- (g) the significant further deconcentration of the Commission services in recent years represents a positive development in the management of the Phare CBC programme;
- (h) the allocation of Phare CBC funding between different border regions in the candidate countries remains a significant concern, both in relation to regional disparities but also to other issues, notably preparation for the accession. The following paragraphs set out the Court's observations on this subject.

8.55. The extension of the Phare CBC programme to border regions between Phare countries has also made it possible to start to address some of the specific disadvantages faced by these border regions. However, the comments in the budget require that at most one third of the Phare CBC funding be allocated to the borders between candidate countries. Romania, being a relatively large candidate country without borders to Member States, already consumes a large part of these funds. Therefore, the amounts committed to these border regions in other candidate countries have been rather limited. For example, the annual CBC allocation to the Polish-German border is 44 million euro, as compared with just 5 million euro for the Polish-Czech border. No funds at all were allocated to the Polish-Lithuanian border. For the Czech-Slovak border funding was only allocated for 1999, the first year following the revision of the Regulation, after which funding was stopped even though joint structures had been established and planning documents had been drawn up.

⁽¹⁹⁾ In particular, the 'territorial principle' means that only projects physically located on EU territory can be funded by Interreg and in candidate countries by Phare CBC. The two programmes also have different procurement procedures.

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as has been acknowledged in the communication 'Paving the way for a new neighbourhood Instrument' ⁽²⁾.

- (h) See reply to point 8.56.

8.55. *In the four Baltic candidate countries (Estonia, Latvia, Lithuania and Poland), a multilateral transnational approach has been followed. A single Baltic Phare CBC Joint Programming Document was drawn up. As a result, Phare CBC funds have not been allocated per border (e.g. Polish-Lithuanian border or Lithuanian-Latvia border, etc.) but rather per country (EUR 4 million each).*

As far as the Czech-Slovak border is concerned, given the requirement that at most one third of the Phare CBC funding be allocated to the borders between candidate countries, the Commission found itself faced with the challenge of having to spread limited funding over a wide area, while at the same time having to ensure that Phare assistance was concentrated so as to achieve sufficient impact. In this context, the borders between countries that were formerly part of the same nation (i.e. Czech Republic-Slovakia) were given a lower priority.

⁽²⁾ COM(2003) 393 final of 1 July 2003.

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8.56. Of greater concern is the fact that, although the revised Phare CBC Regulation provided for the possibility of subsequently further extending the regions eligible for Phare CBC to other neighbouring countries (meaning, in practice, the Tacis and CARDS beneficiary countries ⁽²⁰⁾), the Commission did not actually take up this possibility. The result of this has been that:

- (a) while the 10 years of experience gained by the regions in candidate countries bordering on Member States has provided a good basis for managing Interreg programmes from 2004, regions in candidate countries which have not been eligible for Phare CBC (very largely in the less developed eastern regions of the country) will have had no such experience. Although candidate countries have allocated some funds for projects in these regions from their Phare national programmes, this has been done in an ad hoc way and without any joint institutional and planning framework. This framework characterises Phare CBC and Interreg programmes and is one of their major benefits. The Commission did eventually seek to put funding for these borders on a more systematic footing by introducing in 2003 the external border facility for 30 million euro, but this somewhat belated initiative was not supported by such a framework;

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8.56. Given the provision included in the revised Regulation, from June 2001 the Commission explored the feasibility of extending the geographical scope of Phare CBC to the Phare countries' 'external' borders with adjacent western new independent States (NIS) (Tacis CBC) and western Balkans (CARDS) countries. This attempt — conducted when the negotiations over Chapter 21 'regional policy' were still on going — was hindered by the uncertainty concerning the implementation of Interreg programmes at the future EU external borders in the 2004 to 2006 period. Under these circumstances, the Commission refrained from launching fully fledged Phare CBC programmes at each candidate country's external borders (a procedure requiring a considerable amount of scarce candidate country administrative resources), with the risk that the long-lasting processes initiated might not be continued upon accession. This prudent approach proved to be appropriate in light of the decision taken towards the end of 2002 to have multilateral instead of bilateral Interreg programmes at external borders in 2004 to 2006 (through grouping several borders within a single programme. This decision has been further modified by the 'Neighbourhood programme' approach introduced with the Communication 'Paving the way towards a new neighbourhood Instrument'.

- (a) Although Phare CBC has not been applicable to candidate countries' external borders, a sizeable amount of funds has been allocated from Phare national funds for actions with cross-border value (investments in border crossing and transport infrastructures, small projects grant schemes, etc.) ⁽³⁾ of 6 September 2002, the Commission encouraged Phare countries' authorities to make use of their Phare national programme funds to support actions of a cross-border nature at their 'external' borders. In order to reinforce this orientation, a specific amount of EUR 30 million (external borders initiative 2003) has been allocated for the 2003 Phare programming exercise. For acceding countries, this ad hoc allocation will further help prepare for Interreg 2004 to 2006 at future EU external borders.

⁽²⁰⁾ The Tacis countries concerned are Russia, Ukraine, Moldova and Belarus, and the relevant CARDS countries are Albania, Croatia, the former Yugoslav Republic of Macedonia, and Serbia and Montenegro.

⁽³⁾ C(2002) 3303-2.

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- (b) the lack of matching funding and an organised cross-border cooperation framework in the neighbouring border regions of candidate countries reduced the effectiveness of the Tacis cross-border cooperation programme ⁽²¹⁾.

8.57. Within the given available level of funding the Court recommends that:

- (a) the Commission should provide institution building support to border regions in candidate countries which have not been eligible for Phare CBC but will be eligible for Interreg;
- (b) consideration should be given to modify the Phare CBC Regulation, which after the next enlargement will continue to apply to Bulgaria and Romania, to allow CBC funding in all border regions;
- (c) to increase the impact of recommendation (b), a specific Tacis CBC Regulation based on the Phare CBC Regulation should be considered ⁽²²⁾. For detailed recommendations on this point, see Chapter 7, paragraph 7.58;

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- (b) As indicated in the replies to point 7.61 the effectiveness of the cooperation between Phare CBC and Interreg is notably due to the Phare CBC Regulation which, notwithstanding its external aid character provides for effective alignment with Interreg procedures: fixed allocation of funds per border, decentralised management with ownership by national/regional authorities, joint multiannual programming documents, joint coordination structures. Matching funds alone are not sufficient for effective cross-border cooperation. For this reason the Commission adopted on 1 July 2003 the Communication 'Paving the way for a new neighbourhood Instrument' to address the issues.

8.57.

- (a) Both the Phare 2003 national programmes and the 'Phare 2003 External borders initiative' provide for institution-building support to help acceding countries to prepare for Interreg programmes in future 'internal' and 'external' borders.
- (b) The modification of the Phare CBC Regulation to extend, as of 2004, its geographical scope to the Bulgarian and Romanian borders with adjacent NIS and Balkan countries and to the Bulgarian-Turkish border, is already underway.
- (c) With the Commission's adoption of the Communication 'Paving the way for a new Neighbourhood Instrument' of 1 July 2003, in 2004 to 2006 the Commission will introduce Neighbourhood programmes covering the external border of the enlarged EU. These programmes will improve coordination between various instruments (Interreg, Phare CBC, Tacis CBC, CARDS, MEDA) and increase the effectiveness of cooperation without the need for new legislation.

⁽²¹⁾ A follow-up report on the Tacis CBC programme is contained in Chapter 7, paragraphs 7.49 to 7.62, of this Annual Report.

⁽²²⁾ While the overall Tacis Regulation provides for a CBC programme, this programme is not supported by a specific Regulation providing for the institutional and planning framework as is the case for the Phare programme.

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- (d) the Commission should consider drawing up a similar CBC Regulation for countries which are beneficiaries of the CARDS programme, since no strategy or programme has yet been developed in this area, although the CARDS Regulation does refer to the possibility of funding cross-border projects ⁽²³⁾.

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- (d) *See the response to recommendation (c). CARDS is also covered by the new Communication.*

PRINCIPAL OBSERVATIONS IN SPECIAL REPORTS

8.58. The Court completed two audits in 2002 on pre-accession instruments, the findings of which have been published in Special Reports. The principal observations are summarised below.

Phare and ISPA funding of environmental projects in candidate countries ⁽²⁴⁾

8.59. The European Court of Auditors carried out an audit to assess the effectiveness of Phare and ISPA aid to the environment sector. The audit covered projects financed during the period 1995 to 2000 and examined their implementation up until the end of 2001. All the supreme audit institutions in the candidate countries of central and eastern Europe participated in the audit.

8.60. The Court's audit found that the Commission's assistance to support institution-building in the environment sector had been only partially successful. The audit confirmed the view expressed by the Commission in its 2001 and 2002 enlargement strategy papers that there was still a need for candidate countries to further strengthen their administrative capacities in the environment sector if they were to be able to comply with the environmental *acquis*.

8.59. *As regards ISPA, the audit covers only the years 2000 and 2001 (ISPA did not exist prior to 2000).*

8.60. *The Madrid Council Conclusions in 1995 indicated administrative capacity to implement the acquis as a key area of concern. In the absence of any specific acquis on overall public administration reform and in the context of subsidiarity, the Commission adopted an adaptive and innovative strategy in an area at the limit of its competence. By any historical standards, the Phare-assisted pace of change was rapid. The Commission notes the Court's agreement that further institution-building is required and assistance will continue beyond accession, through the delivery of both the 2002 Phare action plans, which mobilised EUR 1 billion, and through the transition facility.*

⁽²³⁾ Until 2000, Albania and the former Yugoslav Republic of Macedonia benefited from Phare CBC Programmes with Greece, but these programmes were not continued when these countries became eligible for CARDS rather than Phare funding.

⁽²⁴⁾ Special Report No 5/2003 (OJ C 167, 17.7.2003).

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8.61. This situation partly reflected the limited scale of funding committed to institution-building, despite the particular challenges faced by institutions in this sector, as well as the modest impact of the Twinning and technical assistance projects that had been funded.

8.62. Candidate countries did not have enough institutional capacity to develop environmental and financing strategies at a sufficiently early stage. This resulted in an inadequate identification of priority projects and the most efficient ways of financing them. The Commission had sought to reduce ISPA grant levels below the 75 % ceiling and has cooperated effectively with the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD) and other international financing institutions to achieve this. Nevertheless, the Court considered that there was still further scope for reducing grant levels so as to allow an increase in the number of projects financed.

8.63. Limited institutional capacity also caused problems in project preparation and contract tendering for environmental infrastructure projects. The Commission did not always address these issues effectively with the result that by the end of 2001 only one ISPA construction contract had been signed. However, in the case of the earlier Phare infrastructure projects examined it was found that, once tendering had been completed, actual implementation progressed relatively smoothly in most cases.

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8.61. The observation on limited funding committed to institution-building in this sector is based exclusively on the study of the know-how transfer aspects of institution-building (about 30 % of Phare annually) and thus quite overlooks the impact of the 35 % of Phare invested in regulatory infrastructure annually after 1999. Furthermore the observation hides the historical fact that for three years of the audit period Phare was demand driven and the candidate countries preferred infrastructure projects to either addressing administrative capacity or investment in institutions. This was completely changed by the Commission opinion and the Luxembourg Council Conclusions in 1997. These accession-driven developments made it possible to massively increase Phare (and later ISPA) allocations to projects and to progressively increase both capacity building and investment in institutions, which became 65 % of overall annual allocations after 1999.

8.62. The preparation of strategies began in 1999 and, before ISPA was launched, there was a sufficient number of sound and mature projects prepared that complied with the ISPA Regulation, addressed the most urgent investment needs in the environment sector and enabled the Commission to absorb the entire commitment appropriations for ISPA.

Moreover, the strategies are revised, whenever necessary, to take account of progress in the implementation or to remedy weakness.

The Commission considers that the scope for reducing the grant levels is extremely limited. Grant levels are — on average — already low if the particular difficult economic conditions in ISPA beneficiary countries are taken into account.

8.63. The Commission agrees that the institutional capacity for project preparation and implementation needs strengthening. Since the beginning of ISPA, a number of measures have been taken by the Commission to enhance capacity, in particular for tendering and contracting, and these activities were expanded in 2002 and 2003. As tendering for large infrastructure contracts is complex and takes time (at least nine months), it is not surprising that only one contract was signed in 2001 (most financing memoranda, a condition for commencing works, were only countersigned early in 2001).

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8.64. The report's recommendations identified a number of further steps to be taken by the Commission to address the continued significant need for institution-building, to target scarce grant financing more effectively and to increase absorption capacity.

Twinning as the main instrument to support institution-building in candidate countries ⁽²⁵⁾

8.65. A strong administrative capacity is vital for the candidate countries of central and eastern Europe in order to be able to adopt and implement Community law (*acquis communautaire*), one of the criteria for accession. The Commission launched Twinning in 1998 as the main instrument to assist candidate countries in strengthening their administrative capacity.

8.66. Member State administrations and public institutions have unique knowledge and specific experience concerning the implementation and enforcement of Community law. The Twinning Instrument provides for the transfer of this knowledge and experience through the provision of Member State civil servants to the candidate countries.

8.67. The European Court of Auditors carried out an audit to assess whether the use of the Twinning instrument by the Commission, the Member States and the candidate countries had been efficient and effective.

8.68. Upon completion of Twinning projects, candidate countries are expected to be able to meet the requirements of the relevant Community law. However, in general, Twinning performed below this overall expectation. Significant progress was made in the adoption of Community law, but rather less in its implementation and enforcement. The so-called 'guaranteed' results were often only partially achieved and subject to significant delays. It was too optimistic to expect that a fully functioning, efficient and sustainable candidate country organisation could be established within the timeframe of a single Twinning project.

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8.64. *With a few exceptions, the Commission's own findings and assessment agree with the Court's recommendations, and as early as 2000 the Commission launched a number of initiatives to address these shortcomings. These efforts have produced results, as is shown by the acceleration of payments, which doubled between 2001 and 2002. The speeding up of payments was noted positively by the European Parliament.*

8.68. *The concept of 'guaranteed results' was the key feature of Twinning. Both project partners commit themselves to work towards a commonly agreed result in a joint project implementation process. The Commission indicated from the outset that Twinning projects should focus on limited and well-defined institutional targets. This realistic approach, however, conflicted at times with the high level of ambition of the beneficiary countries. It is not, therefore, disputed that the earlier projects in particular were over-ambitious, and at times failed to achieve their targets. However, even these ambitious projects acted as a catalyst in setting the reform process in motion, and compared to the results achieved by technical assistance from 1990 to 1996, Twinning has a good track record. Multiple Twinning projects were and continue to be delivered within key sectors and it is the cumulative impact that the Commission*

⁽²⁵⁾ Special Report No 6/2003 (OJ C 167, 17.7.2003).

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8.69. The interaction of the numerous public administrations involved in Twinning created administrative complexity that diminished efficiency and effectiveness. Too much time was spent on purely administrative issues to the detriment of the main task, namely advising candidate countries on institution-building. The lengthy periods between needs assessment and project realisation, as well as the complicated payment systems, were two examples of the difficulties identified.

8.70. There was a tendency, moreover, to over-emphasise Twinning at the expense of other mechanisms also eligible for EU support. This resulted in some deviation from the original aim of Twinning and in its insufficiently selective and coordinated use.

8.71. While the instrument certainly contributed towards strengthening the candidate countries' institutional and administrative capacity with regard to the requirements of EU accession, there was considerable room for further improvement. The Court had recommended that:

- (a) the rate of delivery should be increased by a real results-orientated approach. The basic components needed for effective implementing capacity should

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and Member States took into account in the negotiations. Finally, the positive feedback from administrations involved in Twinning was essential in building Member State's confidence and thereby helped secure closure of the negotiations in Copenhagen. This widely acclaimed success was the ultimate guaranteed result delivered by Twinning.

8.69. *There was a learning process here. Two of the most important, non-measurable but visible results of Twinning are network-building and changes of attitudes and behaviour. During those four years of implementation, Twinning brought together specialists from Member States' and candidate countries' administrations who were seldom international experts, creating a network of technical expertise throughout Europe. This is a fundamental process for building an enlarged Europe and for bringing Europe closer to its citizens. Most of the Member State experts and the candidate country civil servants were involved for the first time in an EU project and had for the first time the responsibility of managing EU funds. In many of the cases, the links formed continued after the closing of the respective project, both between Member States and candidate countries as well as between different Member State administrations.*

8.70. *This could be dealt with at the programming stage. The identification and design of institution-building Twinning projects is the result of a well-balanced process and dialogue between the Commission and the candidate country under the final scrutiny and approval of the Phare Management Committee. Regarding more precisely the 'overemphasising of Twinning' one should recall that in 1998 and 1999 Twinning as a new Instrument was indeed emphasised to get the process started.*

8.71. *Through Twinning the Commission pioneered an unprecedented transfer of know-how on complex and technical issues from the diverse administrative traditions in Member States to the equally diverse candidate countries. It was also essential in mobilising political will and resources in the candidate countries.*

- (a) *Rate of delivery: While the recommendation of the Court is supported. Twinning projects are not assimilated to supply or investment agreements. Meeting the*

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be better identified and the objectives for individual projects should be defined more realistically and precisely;

- (b) the different stages, from needs assessment up to project realisation, should be completed more quickly and be less bureaucratic;
- (c) payment procedures should be simplified and speeded up;
- (d) the use of fixed-price or lump-sum contracts requiring specified deliverables should be considered;
- (e) the use of Twinning should be the result of a conscious choice between different instruments: the Commission should increase its efforts to ensure the most appropriate mix of the different instruments available for institution-building;
- (f) the Commission should create a network of preaccession advisers (PAAs) to safeguard the store of specific knowledge, to spread good practice and to reduce the risk of errors recurring.

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Twinning objectives is often dependent upon external, political factors.

- (b) *Time-frame of stages in the project: the Twinning manual now provides for a general deadline of six months between selection and start of the project. All other procedural deadlines, including those set for Twinning Steering Committee proceedings do not exceed 10 working days.*
- (c) *The Commission has already taken steps to ensure simplification of payment procedures by increasing the amount of advance payments.*
- (d) *The recommendation to use fixed-price or lump-sum contracts requiring specified deliverables would not be practical in all situations since the financing of Twinning projects is based on recovery of expenses incurred by administrations or mandated bodies.*
- (e) *The identification and design of institution-building Twinning projects is the result of a well-balanced process and dialogue between the Commission and the candidate country under the final scrutiny and approval of the Phare Management Committee. Proper programming is of the utmost importance and this has been duly stressed in the Phare programming guidelines at least since 2000.*
- (f) *Preaccession advisers (PAA) network: The Commission welcomes this suggestion and is prepared to refine its database where all the professional data and contacts of PAAs are already available so that a network could be set up.*

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 primarily to pay the salaries, allowances and pensions of persons working for the Community Institutions, as well as rent, property, purchases and miscellaneous administrative expenditure. In the Commission's case, these appropriations also enable subsidies to be given to associations and organisations that assist in the implementation of various aspects of the European Union's activities.

*Specific assessment in the context of the Statement of Assurance***Introduction**

9.2. 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:

- evaluating the operation of the supervisory systems and controls at the Commission's Directorate-General for Personnel and Administration, and at Parliament, which respectively account for 52 % and 20 % of the total administrative expenditure of the institutions,
- testing the operation of key controls relating to the remuneration of staff at the Commission and at Parliament,
- considering the statement and annual activity report produced by the Commission's Director-General for Personnel and Administration who has the main responsibility for administrative expenditure,
- substantively testing a number of transactions from across the whole domain of administrative expenditure.

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Evaluation of supervisory systems and controls*Inherent and control risks*

9.3. Overall inherent risk is low in the field of administrative expenditure. This is because of the absence, firstly, of 'delegation risk' (administrative expenditure is directly managed by the Institutions and Community Bodies, unlike the majority of programme expenditure, which is carried out on behalf of the Commission by national bodies or agencies) and, secondly, of 'subsidy risk' (the vast majority of administrative expenditure involves 'arm's length' transactions related to the employment of staff and the purchase of works, goods and services rather than subsidies or project funding and is hence less risky).

9.4. As regards the control risk, the results of 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 arrangements. However, certain weaknesses in the supervisory systems and controls operating in 2002 have been noted. These weaknesses are referred to hereafter.

*Operation of the systems***Commission**

9.5. In 2002 prior approval of transactions by the Financial Controller's department (Financial Control) was still the principal supervisory system. However, in conformity with the provisions of Article 47 of the Financial Regulation, as amended in 1998, prior approval of every single transaction was no longer required. Financial Control tested a sample of transactions on the basis of risk analysis. An assurance about the legality and the regularity of underlying transactions taken as a whole cannot be drawn by the Commission from the results of testing carried out by Financial Control, as:

- follow-up to potential errors was limited to the particular transaction sampled (when an error was found in a batch of transactions only the

9.5. THE COMMISSION'S REPLY

The Directorate-General for Personnel and Administration's effort for the expenditure effected by the Informatics Directorate was certainly the most visible (on the individual fiches and by an overall analysis), the proportion of Financial Control's tests having been the largest for this department's expenditure. Other services also took the remarks into account in their operations, albeit in a more informal way and generally through the replies given to the remarks.

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transaction in question was sent back to the authorising officer for correction, without examining if the error had also occurred in other transactions of the same batch),

- except for expenditure effected by the Informatics Directorate, the results of testing were not used to spur management into correcting weaknesses in the internal control system.

9.6. The Commission's reform provided for the operation of Financial Control during 2002 to be complemented by the setting-up of supervisory systems and controls at the level of the authorising officers. As a part of this a risk analysis based on self-assessments by authorising officers by sub-delegation and other management staff was carried out. However, for several of the management systems in the Directorate-General for Personnel and Administration there was no confirmation of these assessments by means of an audit. Further, although the Director-General mandated an adviser to monitor the implementation of the Internal Control Standards (ICS), there was no comprehensive analysis of whether the standards were implemented adequately and across all systems.

9.6. THE COMMISSION'S REPLY

The Directorate-General for Personnel and Administration has opted for a risk assessment with the Heads of Unit (and not only with the authorising officers by sub-delegation). Given the great variety of the activities in the Directorate-General for Personnel and Administration environment, not necessarily all of them financial or with important financial implications, an in vitro risk assessment of, say, the amounts per budget heading would give little information on the underlying risks. In fact, the risk assessment covers not only financial expenditure, but also activities that have no or little direct financial impact, but nevertheless with operational and reputational risks that need to be addressed. In that sense, the risk assessment aims at being complete and is as reliable as a risk assessment can possibly get since it is done with the persons responsible concerned, the line managers.

This does not mean that the risk assessment should not be further refined and updated in the light of new events. The Commission will welcome all suggestions by the Court that may improve its risk assessment methodology. The risk correspondents' network, with the explicit support of the Directors, should indeed take the ownership of the risk assessment, but the report's comments do not reflect the considerable effort expended for the risk assessment. This effort implied a concrete cultural change for the Directorate-General for Personnel and Administration and looked at the Directorate-General for Personnel and Administration's activities from a different angle.

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9.7. Adequate measures were not taken in 2002 in order to improve the documentation of financial and operational procedures (ICS 15), particularly within Directorate C ('Buildings policy — management of services'), and in order to ensure an effective implementation of ICS 16 (segregation of duties), 17 (supervision) and 18 (recording exceptions).

9.8. The system of internal controls relating to staff remuneration paid in Brussels showed:

- there should be documental evidence of a systematic analysis of the reasons for monthly variations in the total amount paid (e.g. 73,3 million euro in September, 76,7 million euro in October and 75,3 million euro in November),
- inadequate supervision of the records entered in Sysper, the computer system dealing with the staff personal data. The task of checking the documents produced and recording the entitlements to specific allowances they support has been assigned to

If there is no evidence that the risks are properly managed by line management, Internal Audit Service and Internal Audit Capacity concentrate on the first instance on the highest risks as identified by the assessment and the Directorate-General for Personnel and Administration will subsequently adopt its risk analysis.

Subsequently to the Internal Control and Risk Self-Assessment, the Directorate-General for Personnel and Administration has analysed the risks and weaknesses, and on 16 April 2003 adopted an action plan for the further improvement of the internal control system.

9.7. THE COMMISSION'S REPLY

As regards Internal Control Standards 16, the four cases where the segregation of duties was not completely achieved were resolved: social security for auxiliary staff, representation expenses of Commissioners, security service in Luxembourg and the medical service in Brussels.

As regards Internal Control Standards 17 and ex-post controls: ex post controls were in place in the Informatics Directorate, as stated in the Annual Activity Report.

As regards Internal Control Standards 18, a note on recording exceptions was addressed to all subdelegates on June 2003. The issue was also a standing item on the reporting template.

9.8. THE COMMISSION'S REPLY

Though the system has indeed some weaknesses, as identified in the Internal Audit Capacity report, the following qualifications need to be made:

- *the Commission accepts the recommendation regarding the analysis of the monthly variations,*
- *upon recruitment and retirement, the determination of rights and obligations and the corresponding data entry in the computer system are checked by a second official, and subsequent corrections are checked again by a third person,*

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a team of officials. The work done by each member of the team, involving about 12 000 records of new or changed entitlements a year, is not reviewed to make sure that no errors or irregularities have occurred.

- *for the rights and obligations of officials in employment, only one person establishes and checks the data entry, though sensitive dossiers are coordinated at the unit level,*
- *for several years, all data entered (including the modifications) by the unit or sector responsible for establishing the rights, have been checked by another unit or sector when the Sysper decisions are entered into the computer system that calculates the salary ('VAP'). It is only this second data entry which leads to the payment of the individual entitlements. Moreover, data entered into VAP are always checked by another person, and this is true also for the corrections,*
- *in the course of 2003, VAP will be replaced by a new system which will interface directly with Sysper. The procedure for checking data entered into Sysper will therefore have to be reviewed. A working group has been established to make sure that a procedure is defined whereby data will always be checked by a second person, in full compliance with the Financial Regulation.*

9.9. The Court examined the results of an audit of remuneration carried out by the internal audit capability (IAC) of the Directorate-General for Personnel and Administration. As this audit concerned the 2001 budget year its results are not relevant to an assessment of the legality and regularity of transactions underlying the 2002 accounts. However, certain systems weaknesses noted by the IAC still existed in 2002, as the results of the Court's examination of the remuneration system show (paragraph 9.8).

9.10. Among the audit reports issued by the Internal Audit Service (IAS) in 2002 one, concerning the building infrastructure managed by the European Commission, relates to administrative expenditure. The audit was carried out mainly in 2001. Although no illegal or irregular transaction is reported, IAS considers that a range of improvements is necessary before assurance can be provided that the system of internal control is fully functional.

9.9. THE COMMISSION'S REPLY

As stated in the reply to point 9.8, remaining system weaknesses will be tackled, in the course of 2003, since the automatic transfer of Sysper data into the new Information Technologies application for salary payments ('NAP') requires a revision of the control procedures for these data.

9.10. THE COMMISSION'S REPLY

Following the Internal Audit Service report, Directorate C agreed a protocol defining the corrective measures. Its implementation is part of the Office for Infrastructure in Brussels' work plan.

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9.11. **Table 9.1** shows 'indicators' relating to the quality of the operation of the Directorate-General for Personnel and Administration's supervisory systems and controls in 2002.

Parliament

9.12. The Financial Controller's work was effective in detecting and correcting a considerable number of errors. The Court's substantive testing, however, found further errors, which are reported below.

9.13. The examination of the supervisory systems relating to staff remuneration did not give rise to any significant observation.

Results of testing carried out on a sample of transactions of the financial year 2002

9.14. Apart from the findings set out below, no material errors were noted in the sample of transactions tested.

Additional pension scheme for Members of the European Parliament

9.15. As noted by the Court already in 1999 ⁽¹⁾, problems existed concerning the additional pension fund ⁽²⁾ set up for the benefit of Members and former Members of the European Parliament following a decision of 12 June 1990 by the Bureau of the European Parliament. The Court wishes to draw attention to the following two aspects:

⁽¹⁾ Opinion No 5/99 of the Court of Auditors of the European Communities on the Additional Voluntary Pension Scheme and Fund for Members of the European Parliament (not published).

⁽²⁾ The fund has the form of a 'SICAV' (*Société d'Investissement à Capital Variable*) created in Luxembourg by a Luxembourg 'ASBL' (*Association Sans But Lucratif*) whose members are present and former Members of the European Parliament.

9.12. THE EUROPEAN PARLIAMENT'S REPLY

Both the Court and the Financial Controller carried out substantive testing on a statistical sampling basis. It is inevitable that individual errors apprehended in one sample may not have been present in a different sample. For that same reason, errors were also discovered by Financial Control other than those reported by the Court. The key point is that Financial Control identified and reported, on a timely basis, the risk that such errors could occur.

Table 9.1 — Budgetary year 2002: indicators relating to the quality of the operation of the Directorate-General for Personnel and Administration's supervisory systems and controls

Areas of administrative expenditure (values in million euro)	Financial control system			Authorising officers' system			Internal audit capability system		
	Operating methods	Were any systems weaknesses reported?	Court evaluation of the quality of the supervisory system operation	Operating methods	Were any systems weaknesses reported by authorising officers?	Court evaluation of the quality of the supervisory system operation	Operating methods	Were any systems weaknesses reported by IAC?	Court evaluation of the quality of the supervisory system operation
Personnel expenditure (3 466)	monetary unit sample of transactions	No	B	Appropriate controls based on the Internal Control Standards	No	B	Risk analysis based on self-assessments/Risk respondents network/Specific audit on pay systems	Yes	B
Other expenditure covered by provisional commitments (247)	monetary unit sample of transactions	Yes	B	Appropriate controls based on the Internal Control Standards	No	B	Risk analysis based on self-assessments/Risk respondents network	No	B
Other expenditure covered by specific commitments (1 267)	monetary unit sample of transactions	Yes	B	Appropriate controls based on the Internal Control Standards	No	B	Risk analysis based on self-assessments/Risk respondents network/Specific audit of private law contracts	Yes	B
Other expenditure in relation with the specific missions of the institutions (197)	monetary unit sample of transactions	No	B	Appropriate controls based on the Internal Control Standards	No	B	Risk analysis based on self-assessments/Risk respondents network	No	B

A: works well, few or minor improvements required.

B: works, but improvements necessary.

C: does not work as intended.

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Legal framework

9.16. During 2002, a total of 8 179 999 euro from Parliament's budget Item 1 0 3 3 was paid as a contribution to the additional (voluntary) pension scheme. The remarks to budget Item 1 0 3 3 indicate that the appropriation 'is intended to cover the institution's contribution to the voluntary supplementary pension scheme for Members ⁽³⁾'. Two thirds of the contributions to the scheme are directly charged to Parliament's budget Item 1 0 3 3, with one third being paid by the Members of the European Parliament.

9.17. According to Article 190(5) of the Treaty, the regulations and general conditions governing the performance of the duties of its Members are laid down by the European Parliament after seeking an opinion from the Commission and with the approval of the Council. Parliament's contribution to the additional pension scheme should be based on an act of secondary legislation adopted in conformity with Article 190(5) of the Treaty.

9.18. In its opinion issued in 1999 the Court recommended that the Parliament examine the legal framework of the scheme. As yet no action has been taken. After having noted the reply of the Parliament, the Court maintains its opinion that, if the present scheme is to continue, a sufficient legal basis has to be created as soon as possible.

9.18. THE EUROPEAN PARLIAMENT'S REPLY

Article 199, first subparagraph of the EC Treaty (ex-Article 142 of the EEC Treaty) stipulates that, 'the European Parliament shall adopt its Rules of Procedure, acting by a majority of its Members'. The European Parliament is thus directly empowered by the Treaty to take its own internal operational measures. Parliament being thus empowered, Rule 22(2) of the Rules of Procedure states that, 'the Bureau shall take financial, organisational and administrative decisions on matters concerning Members and the internal organisation of Parliament, its Secretariat and its bodies'. The decision to establish the additional (voluntary) pension scheme naturally comes within the responsibilities assigned to the Bureau by this provision. Finally in this context, it is recalled that, on 4 June 2003, the EP adopted a legislative resolution on the Statute of Members of the European Parliament, which, among other matters, covers the question of Members' pensions. It thus now falls to the Council to approve or reject the draft Statute. Contacts with the Presidency of Council are under way (October 2003).

⁽³⁾ The full text of the remarks reads: 'Rules governing the payment of expenses and allowances to Members of the European Parliament, and in particular Annex IX thereto. Bureau decision of 12 June 1990, as last amended by the Bureau decision of 13 November 1995. This appropriation is intended to cover the institution's contribution to the voluntary supplementary pension scheme for Members. Revenue available for reuse is estimated at EUR 300 000.'

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Accumulated actuarial deficit

9.19. As at 31 December 2002 the asset value of the fund amounted to around 117 million euro and the total provisions for pensions and similar obligations to around 158 million euro, which left a negative actuarial balance of around 41 million euro (around 8 million euro at the end of 2001) ⁽⁴⁾

9.20. In 1999 the Court stressed the need to clarify without delay, and before the adoption of a 'Statute for Members', Parliament's role in the rules and modalities of the scheme ⁽⁵⁾. The Court reiterates that there should be clear rules established in the scheme to define the liabilities and responsibilities of the European Parliament and of the members of the scheme in the case of a deficit.

Payments of 'secretarial expenses' relating to the employment of assistants of Members of the European Parliament

9.21. A total of around 175 000 euro was paid as a 'secretarial allowance' relating to the employment of various Members' assistants, although the supporting documents required by the relevant Bureau rules either were not submitted to Parliament's administration, or did not provide sufficient evidence that the funds had been used in strict compliance with the rules. In the meantime the Parliament's administration has taken steps so as to correct the anomalies identified by the Court.

9.19 and 9.20. THE EUROPEAN PARLIAMENT'S REPLY

The amount quoted reflects the value of the pension fund as at a specific date, which followed a difficult period on the financial markets. Pension fund valuation is normally a medium- or even long-term operation. In response to the deterioration of the position on the financial markets, the Bureau decided on 13 May 2002, on a proposal from the Steering Committee of the ASBL (non-profit organisation) to increase the contributions by 3 % from 1 January 2003, with 1 % being borne by Members and 2 % by Parliament, in accordance with the contributions breakdown provided for in the Rules. In the meantime, the financial markets have picked up and the situation is now different from that described in point 9.19 and continues to be closely monitored.

9.21. THE EUROPEAN PARLIAMENT'S REPLY

A comprehensive review of all files was conducted in 2002. They were added to as necessary, particularly in the instances referred to by the Court, with additional detailed supporting documents being supplied by the Members concerned.

⁽⁴⁾ The Court receives annually the accounts from the pension fund scheme for information. The accounts are audited by a private audit firm.

⁽⁵⁾ Paragraph 22 of Opinion No 5/99 reads: 'There should be clear rules established in the Scheme to define the liabilities and responsibilities of the European Parliament and the members of the Scheme if a future actuarial evaluation were to indicate a deficit. Rules should also cover the treatment of surpluses. It is essential that this question should be settled before the proposed new Statute for Members of the European Parliament comes into effect. In the view of the Court it would be difficult to justify a situation in which a continuing contingent liability remained, with Parliament to meet any part of a deficit emerging on the occasion of a future actuarial valuation'.

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9.22. In its Special Report No 10/98 the Court noted that, because of a lack of transparency, the regulatory framework applicable in 1998 did 'not provide the budgetary authority with reasonable insurance against the risk of inappropriate use of the secretarial allowance' ⁽⁶⁾. The rules were amended in April 2000 so as to reinforce the control of the secretarial allowance. The findings set out above show that if the new rules are not applied strictly, the risk of inappropriate use of the secretarial allowance remains.

Committee of the Regions

9.23. The Committee contracted a firm to carry out publishing and printing tasks without first consulting the Office for Official Publications of the European Communities and without informing the Office's Management Committee. This was contrary to a Decision of the five EU institutions and both Committees of 20 July 2000 on the organisation and operation of the Office for Official Publications of the European Communities ⁽⁷⁾. Furthermore, only a limited call for tender was launched in the case of a publication, despite the value of the contract necessitating an open tendering procedure. The Financial Controller did not approve the contract and the corresponding financial commitment, but was overruled. Payments to the firm in 2002 totalled 46 148 euro. A further 16 620 euro was committed for payments to be made in 2003.

9.22. THE EUROPEAN PARLIAMENT'S REPLY

The verifications carried out prior to payment have been strengthened to ensure the strict application of Article 14 and avoid any risk. Payment to an assistant is possible only where the contract and the application are accompanied by a copy of a declaration of membership of a social security scheme; the relationship between the salary mentioned in the contract and the amount stipulated on the application needs to be coherent; every payment must be based on supporting documents such as a contract, hotel bills, train tickets, etc.

9.23. THE COMMITTEE OF THE REGIONS' REPLY

After consultation with the Financial Controller and the Joint Services of both Committees (which had experience in tendering procedures), a tendering procedure was launched to the Belgian printing companies on the AMI list originating with DG EAC of the European Commission and other Belgian companies for a contract to print COR Newsletters for a three-year period. The Publications Office was discarded as a provider due to the specificities of these Newsletters, which demand printing at very short notice and permanent contacts with the provider.

While admitting that the COR did not respect the need for an open tendering procedure, it must be said that the call of tender was based on an existing AMI list established by the European Commission for printing companies.

Due to the legal commitments to the selected company, the authorising officer proposed to the President, as superior authority, to overrule the withholding of approval by the Financial Controller. Following advice from the Administration, the President overruled the refusal by the Financial Controller and the commitment was approved.

⁽⁶⁾ Special Report No 10/98 concerning the expenses and allowances of the Members of the European Parliament together with the replies of the European Parliament (OJ C 243, 3.8.1998, paragraph 1.37).

⁽⁷⁾ Decision No 2000/459/EC, ECSC, Euratom (OJ L 183, 22.7.2000, p. 12).

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Annual report and declaration by the Commission's Director-General for Personnel and Administration

9.24. As an authorising officer by delegation, the Director-General for Personnel and Administration has produced an Annual Activity Report and a Declaration for 2002. In accordance with the Commission requirements, he provides information on the follow-up to 2001 action plans and on the progress made in implementing internal control systems. His Declaration provides the Commission with reasonable assurance as to the legality and regularity of the transactions underlying the 2002 accounts.

9.25. The Annual Activity Report gives a clear and thorough view of the Directorate-General for Personnel and Administration's activities and achievements in 2002. Only a part of the Directorate-General for Personnel and Administration's activities is directly concerned with the financial procedures relating to the use of budget appropriations. Hence, only the parts of the Annual Activity Report specifically dealing with such procedures are relevant for a statement on the legality and regularity of the transactions underlying the 2002 accounts. The comments set out below only refer to these parts of the Annual Activity Report.

9.26. The Director-General recognises that weaknesses persist and new requirements have to be fulfilled in order to comply fully with the internal control standards set up by the Commission. He does not mention which specific internal control measures recommended by the Internal Audit Capability for the area of the payment of remuneration have not yet been implemented.

9.27. As a complete description was not drawn up of the procedures in operation ensuring, within each directorate, the legality and regularity of transactions, the Court considers that the authorising officers by sub-delegation were not in a position to provide the Director-General with precise information about the operation of their internal control systems.

9.26. THE COMMISSION'S REPLY

The Commission wants to refer to the action plan mentioned under point 9.6, and for the salary question in particular, to a Protocol signed by the responsible department on 20 December 2002 concerning the follow-up to the recommendations.

9.27. THE COMMISSION'S REPLY

Although the description of the procedures is one of the Internal Control Standards, and one of the objectives is to complete it as soon and cost-effectively as possible, the following points need to be made:

- *even a full description of all procedures is only one of a series of measures that may result in a reasonable assurance of the Director-General about the operation of internal controls,*
- *a manual of financial procedures, in this context no doubt the most important area, exists and is available on the Intranet,*

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- another important measure was the training of nearly all authorising officials by subdelegation (i.e. those with important budgets) in late 2002 about the new financial regulations, and more generally about the expenditure cycle,
- an important source of information are the thrice yearly reports addressed to the Director-General by all subdelegates, and which are analysed by the Resource directorate,
- this reasonable assurance was also established through preparatory meetings between directors and the Annual Activity Report preparation team, and subsequently through bilateral meeting between the Director-General and the directors.

Overall conclusion and recommendations

9.28. Paragraphs 9.15 to 9.23 above set out the Court's observations on certain transactions. The Court's audit found no important failures of the systems or other material errors affecting the legality and regularity of administrative expenditure. The Court recommends that, in the framework of the enforcement of the new Financial Regulation, attention be specifically paid to the reinforcement of the authorising officers' supervisory systems and controls.

9.28. THE COMMISSION'S REPLY

The recommendations of the Court are well taken. In particular:

- *documenting procedures and developing guidance will continue, in particular as regards the new Financial Regulation,*
- *the segregation of duties, though fully in place at this moment, will be constantly monitored,*
- *the system of ex post controls of financial transactions, put in place as of 1 January 2003, will be reviewed in the light of the experience over the first half of 2003,*
- *special attention will be given to the management of recoveries and decommitments,*
- *the format and contents of the reports by subdelegates will be reviewed in the light of 18 months of experience,*
- *subdelegates will be reminded and informed of their duties in respect of recording and correcting internal control weaknesses and of exception reporting (in this respect two notes were issued on 23 June 2003), ex ante controls (inter alia, through an assessment of the work-flows), legality and regularity.*

THE COURT'S OBSERVATIONS

*Follow-up to Special Report No 13/2000 on the expenditure of the European Parliament's political groups***Introduction**

9.29. The Court examined the measures taken by the Parliament in response to the Court's Special Report No 13/2000 ⁽⁸⁾ on the expenditure of the European Parliament's political groups, together with the associated recommendations made by the budgetary authority within the discharge procedure ⁽⁹⁾.

9.30. The Special Report identified a lack of clear rules governing the eligibility of expenditure and weaknesses in internal controls, and specifically:

- inadequate rules governing contributions to political parties,
- risk of double financing,
- problems over the legal status of the political groups,
- poorly defined accounting and reporting rules,
- inadequate rules and management of external audit of the financial statements, and
- significant weaknesses in the definition, status and management of employment contracts.

9.31. Recommendations made to improve these issues centred around establishing clearer and more precise rules, and appropriate management procedures and controls. Parliament responded by issuing new rules on the use of the appropriations, and allocated the expenditure to a single budget Item (3 7 0 1). The draft regulation on the legal status and funding of European political parties prohibits donations to the parties by the political groups of the European Parliament. The Court found that in general the new rules constituted a

9.31. THE EUROPEAN PARLIAMENT'S REPLY

On the whole the Court's remarks are positive, noting 'considerable improvement'.

⁽⁸⁾ OJ C 181, 28.6.2000.

⁽⁹⁾ Decision of 10 April 2002 concerning discharge in respect of the implementation of the general budget of the European Union for the 2000 financial year — Section I — European Parliament (OJ L 158, 17.6.2002).

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considerable improvement, particularly as they were extended to issues not previously covered ⁽¹⁰⁾. However, a number of weaknesses persist, as set out in the following paragraphs.

Risk of double financing

9.32. The rules state that expenditure covered by Item 3 7 0 1 may not substitute for expenditure already covered by other allowances. However, the Court found that the system did not adequately deal with this issue, resulting in a risk of double financing of expenditure.

Legal status

9.33. Still no provision identifies the specific status and the rights and responsibilities of the political groups. Similarly there is no definition of the rights and responsibilities of national delegations and single Members when dealing with so-called 'decentralised expenditure'.

Accounting and reporting

9.34. The certified financial statements of the political groups have been made public on the Internet since December 2002. While the rules provide that the accounts of the political groups are maintained in

9.32. THE EUROPEAN PARLIAMENT'S REPLY

Parliament's administration will examine together with political groups the possible improvements in order to prevent any double financing of the same expenditure from different budget items. The groups' rules contain provisions aimed at avoiding that double funding takes place. Groups only fund activities if they are carried out on behalf of the group. The external auditors of the groups verify this.

9.33. THE EUROPEAN PARLIAMENT'S REPLY

The legal status of the political groups is dealt with in new Article 29a of Parliament's Rules of Procedure, adopted by Parliament on 23 September 2003.

As regards decentralised expenditure, the proposed new rules governing use of budget Item 3 7 0 1 are designed to provide further clarification. The group chairmen remain responsible for the use of Item 3 7 0 1 funds. Decentralised expenditure is authorised by the group, and this expenditure therefore falls under the responsibility of the group.

9.34. THE EUROPEAN PARLIAMENT'S REPLY

As for the divergence of the accounting systems used by the groups criticised by the Court, the political groups will organise a meeting of their accountants in order to come up with a harmonisation of the accounting systems used.

⁽¹⁰⁾ E.g. subscriptions and subsidies to third parties, changes and mergers between groups and employment contracts.

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accordance with a common accounting plan, there is no definition of the basic accounting principles to be applied. In practice both cash-based and accrual accounting are used (or sometimes a mixture of both), depending on the political group involved, which makes comparison difficult. Furthermore, the financial statements do not provide the detailed information on decentralised expenditure required by the accounting plan.

9.35. Considerable progress has been made in including information on fixed assets in both the accounting records of the groups and Parliament's own inventory system. The accuracy of the information is likely to be further improved by a proposed harmonisation of the underlying information.

External audit

9.36. Parliament did not follow the Court's recommendation of appointing a single external auditor for all political groups' financial statements. Instead it issued a common audit mandate, followed by a list of audit firms from which the political groups could make a selection. The Court found that the audit engagements were insufficiently clear or detailed, and that the process was inadequately managed. As a result the content of the audit statements varied for the seven sets of accounts certified (by five different firms).

Employment contracts

9.37. While improvements were noted in the rules and procedures governing employment contracts there still remain weaknesses in this area. There continue to be many different types of contract, with many containing weaknesses. In some cases they may lead to an unnecessary risk of litigation and in other cases their compliance with national labour and tax requirements is doubtful.

9.36. THE EUROPEAN PARLIAMENT'S REPLY

Compliance with the common audit mandate must be reinforced. The groups expect further improvements once a standardised audit statement has been drawn up by Parliament's administration. The five external audit firms carried out their work in accordance with internationally recognised audit standards (ISA), as required in the calls for expressions of interest and the mandate given by the Bureau on 10 December 2001.

9.37. THE EUROPEAN PARLIAMENT'S REPLY

The administration now checks that all contracts received comply with the rules governing the payment of expenses and allowances to Members. It systematically checks that persons who have concluded a contract with a political group do not hold a Member's assistant's contract covering the same period and thus are not in receipt of payments under the secretarial assistance allowance.

Each year, the administration will remind the political groups of their obligation to forward to the Secretariat the employment contracts as well as contracts for the provision of services lasting six months or more.

THE COURT'S OBSERVATIONS

Conclusion

9.38. While the Court found that considerable progress has been made, there remain important areas where greater efforts are needed (e.g. clarifying the legal status of the groups, reinforcing controls and improving management of employment contracts). Moreover, the rules should be extended to cover mission costs, which currently represent around one third of expenditure of the groups at central level but which are not subject to common standards.

9.39. The Court continues to maintain that the centralisation of a number of administrative functions within Parliament's own administration would considerably improve management of the appropriations and reduce the administrative burden on the groups themselves. It would help to reduce the risk of double funding of expenditure, to allow Parliament to monitor its potential legal obligations and to provide a better level of consistency and clarity in employment contracts.

Principal observations in Special Report No 3/2003 on the invalidity pensions scheme of the European institutions ⁽¹¹⁾

9.40. The Court carried out an audit of the European institutions' Invalidity Pensions Scheme in order to assess the cost of invalidity pensions, identify potential savings, determine whether invalidity pensions are only granted where a real invalidity has been duly recognised, and evaluate whether the institutions have set up the management systems required for adequate monitoring of, and effective control over, the operation of the scheme.

9.38. THE EUROPEAN PARLIAMENT'S REPLY

The Court's observations have been forwarded to the groups, which note the Court's recommendation that the rules should be extended to cover mission costs for which common standards should be formulated.

9.39. THE EUROPEAN PARLIAMENT'S REPLY

The Court's observations have been forwarded to the groups, which note that the Court reiterates its opinion that centralisation of a number of administrative functions would improve management of the appropriations, especially (but not exclusively) with regard to employment contracts.

9.40 to 9.44. THE EUROPEAN PARLIAMENT'S REPLY

As it has already indicated in its reply to Special Report No 3/2003, Parliament accepts the broad thrust of the auditors' conclusions, particularly as regards prevention and the need for improved management and coordination in this area. With this mind, it has already embarked on a major reform of its system for the management of absences on medical grounds, with a view to establishing precisely the kind of holistic approach that the auditors advocate. Details of this reform were also provided in Parliament's reply to the report.

Parliament also notes with satisfaction that the Commission is embarking on a similar exercise and intends, as part of the latter, to discuss with the other institutions possible reforms to the Staff Regulations in this area.

⁽¹¹⁾ OJ C 109, 7.5.2003.

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9.41. The Court's audit revealed a complex picture. On the one hand the rate of invalidity retirement has remained stable over the last 15 years, and, in the opinion of the Court's medical adviser, invalidity pensions are awarded in a justified way. On the other hand, retirement on invalidity grounds is more common in some grades than normal retirement, and there is evidence that frustration in the working environment is a significant element in demotivating some staff who are eventually retired on ill-health grounds. A part of invalidity retirements could, moreover, be avoided if adequate administrative measures for prevention and early treatment of medical problems and the associated employment problems were taken in good time.

9.42. Shortcomings were found concerning the overall policy and management systems for absences due to illness, characterised by a medical rather than administrative approach, a lack of clarity and coordination between the various departments involved, a lack of resources, unsuitable IT management tools, and obstacles resulting from certain provisions of the Staff Regulations.

9.41. THE COMMISSION'S REPLY

The Commission welcomes the Court's opinion that invalidity pensions are awarded correctly. But it also shares the Court's point of view that measures of early prevention and family support may decrease their number. The Commission is of the opinion that the measures concerning harassment which are being investigated, the pilot experiments in family support, and also some aspects of reform (clearer definition of objectives and better career planning) will contribute to a better working climate and motivation, and thereby avoid, as stated by the Court, a number of invalidity retirements. All this notwithstanding, quick results are not to be expected in this area.

9.42. THE COMMISSION'S REPLY

Some measures of the MAP 2000 package have indeed had negative effects on coordination between the central services of The Directorate-General for Personnel and Administration (leave and medical services) and the human resource management units in the directorates-general, which have been addressed through increased awareness, resulting e.g. in an increase of the medical controls requested by the heads of units of the staff concerned.

Since the Court's audit took place, the functionalities of the SIC Congés in this area have improved considerably. Also, data warehouses have been developed on the Sermed system and on BCCA (base centrale des congés et absences) to allow for early detection and an improved follow-up (an internal multidisciplinary group was set up to this effect), adding an administrative aspect to what is and remains essentially a medical problem, where the medical approach must prevail.

An evaluation report on the management of leave and absence was produced in June 2003 and will be discussed by management in the autumn so as to identify the necessary measures to be taken.

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9.43. The result is frequent and costly delays in the opening and progress of the invalidity procedure, with the length of the process itself associated with deteriorating health and consequently with extremely low rates of reinstatement, especially in the 50 % of cases involving psychological disorders.

9.44. The total net actuarial cost of the invalidity pensions awarded each year has been estimated by the Court at about 74 million euro. The audit found scope for financial savings through the adoption of adequate administrative measures for prevention and early treatment, particularly in cases where the grounds for invalidity are psychological. Such measures should include the development by the institutions of an overall policy on absences due to illness and on invalidity, with performance indicators, strong support from senior management, clearly allocated roles and responsibilities, strong medical and administrative synergy, and with careful and resource-intensive attention given to the needs of those members of staff who need support. This policy should focus both on actions to be taken in the early stages through preventative measures that consider the organisation of work and working conditions, and on those actions required at a subsequent stage to help rehabilitation and encourage members of staff who are in poorer health to continue to work under reasonable conditions.

AUDIT OF THE SATELLITE BODIES

9.45. The Court's annual audit of the Union's satellite bodies (SBs) is the subject of specific annual reports ⁽¹²⁾. The principal data relating to the SBs are set out in **Table 9.2**.

9.43. THE COMMISSION'S REPLY

Since the Court examined the system, the Commission has improved the situation concerning delays: the medical situation of staff is systematically examined as soon as they total 350 days over the last 36 months.

9.44. THE COMMISSION'S REPLY

As regards the psychological grounds, which occur in 50 % of the cases, the Commission plans to start a service whereby a psychiatrist/psychologist would work in collaboration with the social workers and the human resource management units of the directorates-general.

See also reply to the above paragraphs.

⁽¹²⁾ In the process of being published in the Official Journal.

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Table 9.2 — Budgets and staff for 2001 and 2002 — Satellite bodies (SBs)

	Headquarters	Year of creation	Budget (million euro)		Permanent posts	
			2001	2002	2001	2002
European Centre for the Development of Vocational Training	Thessaloniki	1975	13,5	14,2	81	83
European Foundation for the Improvement of Living and Working Conditions	Dublin	1975	15,3	17,4	78	88
European Environment Agency	Copenhagen	1990	21,7	25,2	87	106
European Training Foundation	Turin	1990	16,8	16,8	130	123
European Monitoring Centre for Drugs and Drug Addiction	Lisbon	1993	9,2	10,4	55	59
European Agency for the Evaluation of Medicinal Products	London	1993	65,9	61,3	211	251
Translation Centre for the bodies of the European Union	Luxembourg	1994	27,2	23,6	140	146
Community Plant Variety Office	Angers	1994	8,6	10,5	31	33
Office for Harmonization in the Internal Market	Alicante	1994	163,6	154,7	798	715
European Agency for Safety and Health at Work	Bilbao	1995	12,0	13,2	26	31
European Monitoring Centre for Racism and Xenophobia	Vienna	1997	5,3	6,2	25	28
European Agency for Reconstruction	Thessaloniki	2000	411,2	495,3	241	316
Eurojust	The Hague	2002	—	2,8	—	6
Total			770,3	851,6	1 903	1 985

9.46. The year 2002 was marked by the creation of four new SBs. Eurojust was set up ⁽¹³⁾ to improve coordination of legal investigations and prosecutions in order to fight against serious forms of organised crime. Eurojust's accounts for the financial year 2002 are the subject of a specific annual report ⁽¹⁴⁾. The European Food Safety Authority ⁽¹⁵⁾ was administered at the administrative and financial level by the Commission during the financial year. It neither collected revenue nor incurred expenditure during the financial year 2002;

⁽¹³⁾ Council Decision No 2002/187/JHA of 28 February 2002 (OJ L 63, 6.3.2002, p. 1).

⁽¹⁴⁾ In the process of being published in the Official Journal.

⁽¹⁵⁾ Regulation (EC) No 178/2002 of the European Parliament and of the Council of 28 January 2002 (OJ L 31, 1.2.2002, p. 1).

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there is therefore no specific annual report on it. The same applies to the European Maritime Safety Agency⁽¹⁶⁾ and the European Aviation Safety Agency⁽¹⁷⁾.

9.47. In 2002 the total budgets of the SBs rose to 851,6 million euro, as against 770,3 million euro in 2001. The number of employees of all the SBs rose from 1 903 in 2001 to 1 985 in 2002.

9.48. The audits carried out on the SBs have not brought to light any anomalies likely to significantly affect the Court's opinion of their accounts. The SBs should, however, take care to programme their work more realistically, in order to avoid unnecessary carry-overs and/or calls for funds.

9.49. The Commission and the SBs should take the opportunity offered by the introduction of the new framework Financial Regulation to reconsider, adapt and improve their accounting data systems. Harmonisation of their accounting systems and practices should be a priority, particularly with a view to consolidating the SBs' accounts with those of the Commission⁽¹⁸⁾.

9.49. THE COMMISSION'S REPLY

As part of the ongoing project to modernise the Commission's accounting systems, this consolidation is first foreseen for the accounts of 2005.

The Commission understands that to consolidate these organisms it will be necessary that the consolidated entities apply the same accounting rules as are now being developed for the Commission — Article 133 of the new Financial Regulation also confirms that such bodies should adopt the accounting rules and methods as adopted by the Commission's accountant. It was thus already foreseen that these bodies would be informed of the changing requirements with regard to what information needs to be supplied by them so as to consolidate their figures — there has already been a two-day meeting held in Brussels in October 2002 between the Commission and representatives of the organisms explaining the modernisation plan and a second meeting in Lisbon in spring 2003 outlining the advantages of the accounting reform.

Additionally, the bodies have a direct input to the modernisation project by having two representatives on the Accounting Standards Committee.

⁽¹⁶⁾ Regulation (EC) No 1406/2002 of the European Parliament and the Council of 27 June 2002 (OJ L 208, 5.8.2002, p. 1).

⁽¹⁷⁾ Regulation (EC) No 1592/2002 of 15 July 2002 of the European Parliament and the Council (OJ L 240, 7.9.2002, p. 1).

⁽¹⁸⁾ See Article 185 of Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities (OJ L 248, 16.9.2002, p. 1).

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9.50. All the SBs audited by the Court for the financial year 2002 have complied with the Interinstitutional Agreement of 25 May 1999 concerning internal investigations by the European Anti-fraud Office (OLAF) ⁽¹⁹⁾ and have adopted decisions that conform, to a considerable degree, to the model set out in the annex to the agreement in question. Only Eurojust had not yet adopted a decision in this matter.

AUDIT OF THE EUROPEAN SCHOOLS

9.51. The results of the Court's audit of the European Schools are set out in a specific annual report, not published in the Official Journal, which is submitted to the Board of Governors of the European Schools. For the financial year 2002, the audit concerned the Schools' consolidated accounts, which are drawn up by the Office of the Secretary-General of the Board of Governors, as well as the accounts of the Munich School and Brussels II. The audits did not bring to light any anomalies likely to affect the Court's opinion of the Schools' accounts. At the start of the 2002 school year, the Schools had 18 302 pupils, of whom 10 803 were entitled pupils. The staff was equivalent to 1 546 full-time persons, including 1 165 teachers on secondment. The Schools' budget amounted to 187 million euro, principally financed by a Commission subsidy (106 million euro) and by contributions from the Member States (41 million euro).

⁽¹⁹⁾ OJ L 136, 31.5.1999, p. 15. In its resolutions concerning the discharges for 2001, the European Parliament requested the Court of Auditors to indicate whether all the SBs apply the provisions of this agreement without restriction.

CHAPTER 10

Financial instruments and banking activities

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INTRODUCTION

10.1. The financial instruments of the Community are the following:

- loans granted either from budgetary funds 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⁾ or in special operations.

10.2. Within the Commission, the Directorate-General for Economic and Financial Affairs handles most of the financial instruments and related banking activities. This Directorate is also responsible for liaising with the Community's specialised financial institutions, the European Investment Bank (EIB) and the European Investment Fund (EIF). The Guarantee Fund for external actions (hereinafter 'the Guarantee Fund') is intended to cover the financial risk of default on loans guaranteed or granted by the Community to or in a third country. The EEA ⁽²⁾ Financial Mechanism provides interest rebates for EIB loans and investment grants.

10.3. The Court's audit covered:

- the internal controls of the Directorate-General for Economic and Financial Affairs in relation to its banking operations,
- the application of the Guarantee Fund,
- the borrowing and lending activities of the European Coal and Steel Community (ECSC) in liquidation, and
- the EEA Financial Mechanism.

⁽¹⁾ Such as the European Bank for Reconstruction and Development (EBRD).

⁽²⁾ European Economic Area.

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ACTIVITIES IN RELATION TO BANKING
OPERATIONS*Introduction*

10.4. A directorate in Luxembourg of the Directorate-General for Economic and Financial Affairs executes and monitors the Commission's banking activities. The directorate was created during the restructuring of the Directorate-General for Economic and Financial Affairs that took place in 2002. It took over the old *Service des Opérations Financières*' responsibilities for loans and borrowings, plus the guarantee operations and relations with the EIB, which were previously handled by the Directorate-General for the Budget.

*The internal control system***Minimum requirements**

10.5. The Commission laid down minimum internal control requirements in a document ⁽³⁾ that contains and sets out a list of 24 internal control standards (ICS) and stipulates the minimum criteria to be achieved by the Commission's services in order to comply with these standards. Following its internal control self-assessment exercise for 2002, the Directorate-General for Economic and Financial Affairs declared that minimum standards, not all of which are applicable as such to banking operations, had not yet been fully implemented for half of these ICS.

10.5. *With respect to the banking operations the internal rules and the manuals of procedures have been in place, and have been controlled by internal and external auditors, for many years. The current updating exercise will take into account the requirements of the internal control standards (ICS).*

Validation procedures

10.6. Separate internal control systems were established within the Directorate in Luxembourg of the Directorate-General for Economic and Financial Affairs. Manuals of procedures contain detailed descriptions of the procedures for validating transactions, the control functions and the reports that must be made. The internal control procedures laid down in these documents have to be updated to take into account the restructuring that has recently taken place within the department.

10.6. *The current updating exercise will take into account the impact of restructuring, where appropriate.*

⁽³⁾ SEC(2001) 2037/4 of 18 December 2001.

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Internal audit

10.7. Following the restructuring of the Commission, the internal audit unit that was operating within the Directorate-General for Economic and Financial Affairs became the 'internal audit capability' (IAC). It carries out tests of the internal control systems as part of an annual work programme. It does not have a constant supervision function. The unit's last audit of banking operations and the related treasury transactions was in 1999.

External audit

10.8. The financial statements for the new Community Instrument, Euratom, balance of payments, medium-term financial assistance and food aid financial instruments are audited by a private audit company. As part of their audit, the auditors test for compliance with the existing administrative procedures. The guarantees for EIB loans do not fall within the scope of these audits. These operations are subject to EIB audit procedures, to the audit files of which the Commission has no access.

*Risk identification and management***Risk inventory**

10.9. The Directorate-General for Economic and Financial Affairs carried out several self-evaluation exercises during 2002. Amongst other things they resulted in a diagnosis of the main risks for each directorate of this Directorate-General for the activities perceived by the managers (directors and heads of unit), including the directorate in Luxembourg, to be exposed to the most risk. The Court notes, however, that this risk inventory should be extended to cover the quality and exhaustiveness of the information supplied by third parties concerning the activities managed by them on the Commission's account in accordance with the requirements laid down in the internal control standards (ICS) adopted by the Commission ⁽⁴⁾.

10.7. The 'Internal Audit Capability' (IAC) audit programme is based on a detailed risk assessment, which takes into account the annual audits carried out on banking activities by both the European Court of Auditors and an external firm of auditors, and provides for an audit of banking operations and related treasury activities in 2003.

10.8. The guarantees for European Investment Bank (EIB) loans are global guarantees extended for external lending in certain regions. The Council Decisions mandated the Bank to manage the corresponding loans according to its usual criteria and procedures. These operations are audited through the EIB's normal audit procedures. The legislation currently in force does not provide for access by the Commission to these audit files.

10.9. The third parties which manage activities on the Commission's behalf are supranational or public institutions such as the EIB Group and the European Bank for Reconstruction and Development (EBRD). The Commission considers that these institutions are reliable counterparts, and that the risk concerning the quality and exhaustiveness of the information supplied by them is relatively low.

⁽⁴⁾ See standard number 11 '... In order to set up a sound internal control system ... management must identify the main risk faced in the following four categories: ... Reliability of internal and external financial and management information'.

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Checks and verifications

10.10. Apart from the initiation of certain operations ⁽⁵⁾, which requires consultation with the Commission Directorates-General involved in the authorisation procedure ⁽⁶⁾, the directorate in Luxembourg to a large extent operates within a closed system and without adequate control counterweight. Before its reorganisation, all operations and the associated risks were subject to close scrutiny by its internal audit unit. This internal audit unit has been replaced by the internal audit capability (IAC) which, however, no longer has a permanent supervision role of the banking operations (see also paragraph 10.7). Unlike for budgetary operations, the banking operations, the related treasury transactions and associated risks are not subject to checks at the level of the Directorate-General for Economic and Financial Affairs by a unit outside the directorate in Luxembourg. Annual controls by external auditors are not designed to fill this gap.

Conclusion

10.11. In the area of banking activities, the Commission has established an internal control and management system designed to confront the particular difficulties that are specific to that area. Nevertheless, the reliability and exhaustiveness of the information supplied by third parties must be taken into account in the risk inventory of the Directorate-General for Economic and Financial Affairs. Those activities, and the treasury transactions associated with them, are not subject to ex post checks by a unit external to the directorate in Luxembourg.

10.10. *The banking operations that fall within Directorate-General for Economic and Financial Affairs-Directorate-L's responsibility (principally, the borrowing and lending operations in the name of the EC, Euratom and the ECSC in liquidation) as well as the relevant treasury operations, are audited annually by external auditors, including a check on compliance procedures.*

The forthcoming internal audit of the banking operations under the direct responsibility of the Commission will address the need for any changes in the control environment, including ex post controls.

10.11. *The data on EIB lending covered by the Community guarantee are supplied to the Commission by the EIB's accounting service which is itself subject to audit. Nevertheless, the Commission will examine with the EIB whether, and in what way, further assurance may be given on the reliability of the data. The same applies to other third parties such as the EBRD and the Council of Europe Development Bank.*

As stated in the reply to paragraph 10.10, the forthcoming internal audit of the banking operations under the direct responsibility of the Commission will address the need for any changes in the control environment, including ex post controls.

⁽⁵⁾ For example, loans granted as macrofinancial aid to non-member countries.

⁽⁶⁾ The prior approval of the financial controller was required until that procedure was abolished following the adoption of the new Financial Regulation.

GUARANTEE FUND FOR EXTERNAL ACTIONS

10.12. The Community budget is exposed to credit risk as a result of the increase in assistance for non-member countries, especially as regards the guarantees for loans granted by the EIB. The purpose of the Guarantee Fund for external actions is to reimburse the lenders in the event of a beneficiary's defaulting and to avoid direct calls on the Community budget. To the EIB, as principal lender, the Community has granted a global guarantee ⁽⁷⁾ in respect of payments due but not received in respect of credits opened by it.

10.13. The Directorate-General for Economic and Financial Affairs carries out the administrative management of the Fund and the European Investment Bank (EIB) is responsible for the treasury management. The Court's audit for the financial year ended 31 December 2002 focused on the Commission's administrative management of the Fund. The audit work carried out by the Court on the Fund's financial management is based on a specific agreement between the Court, the EIB and the Commission, signed in January 1996.

10.14. Council Regulation (EC) No 2728/94 ⁽⁸⁾ 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.

10.15. For the 2002 financial year, the outstanding capital liabilities for loans and loan guarantees for third countries, including unpaid interest due, amounted to

⁽⁷⁾ Council Decision 2000/24/EC of 22 December 1999 granting a Community guarantee to the European Investment Bank against losses under loans for projects outside the Community (Central and Eastern Europe, Mediterranean countries, Latin America and Asia and the Republic of South Africa) (OJ L 9, 13.1.2000, p. 24).

⁽⁸⁾ Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 establishing a Guarantee Fund for external actions (OJ L 293, 12.11.1994), as amended by Regulation (EC, Euratom) No 1149/1999 (OJ L 139, 2.6.1999, p. 1).

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15 358 million euro as at 31 December 2002. At the same date, the Fund's assets were 1 646 million euro, or 10,7 % of that total (see **Table 10.1**). The corresponding target amount totalled 1 382 million euro at the end of 2002. The surplus to be refunded to the budget was thus 263 million euro.

Table 10.1 — Guarantee Fund situation*(million euro)*

Financial year	Total guarantee outstanding as at 31 December ⁽¹⁾	Total Fund resources as at 31 December ⁽²⁾	Coverage (%)
1994	6 017	294,2	4,9
1995	5 882	300,9	5,1
1996	6 715	557,4	8,3
1997	7 960	861,8	10,8
1998	9 834	1 280,7	13,0
1999	12 052	1 313,1	10,9
2000	14 069	1 431,6	10,2
2001	15 577	1 774,4	11,4
2002	15 358	1 645,5	10,7

⁽¹⁾ Including default interest incurred but not paid at 31 December.

⁽²⁾ After deduction of EIB fees not paid at 31 December.

Source: Commission.

10.16. The EIB receives a handling fee for successful repayments in accordance with an implementation agreement signed in 1999 by the Community and the EIB. Currently, the handling fee is calculated at 1 % per annum on the time between the default and the reimbursement to the Community. Therefore, the longer a loan is in default, the more the EIB will receive as fee.

10.16. Concerning the handling fee, a per annum fee reflects the ongoing work on a recovery, which can be assumed to be positively related to the lapse of time between the default and the recovery.

10.17. In its annual report on the financial year 2001, the Court stated that the Commission had not been provided with an overview of the costs incurred by the EIB arising from the treasury management of the Fund. In its reply to the Court's report on the financial year 1999, the Commission had already said that it would request such an overview. In its reply to the Court's report on the financial year 2001, the Commission

10.17. The legislation currently in force does not provide for a negotiation on a 'cost plus' basis, nor is the EIB obliged to provide corresponding cost information to the Commission. Therefore, the Commission has negotiated a new degressive fee structure with the EIB for the management of the Guarantee Fund for external actions, on a commercial basis.

THE COURT'S OBSERVATIONS

stated that it had received some information on the subject from the EIB. However, the Commission was not provided with detailed and documented information on the EIB's cost structure ⁽⁹⁾.

LOANS AND BORROWINGS OF THE ECSC IN LIQUIDATION

10.18. The European Coal and Steel Community (ECSC) ceased to exist on 23 July 2002. The loans and borrowings contracted by the ECSC must be wound up in 2027 at the latest. In accordance with a Protocol annexed to the Treaty of Nice, all ECSC assets and liabilities were to be transferred to the European Community on 24 July 2002. A Council decision established the measures necessary for the implementation of the Protocol ⁽¹⁰⁾.

10.19. The Court examined the financial statements of the ECSC for the financial year closed on 23 July 2002 and submitted a report on the reliability of the financial statements of the ECSC in liquidation and the legality and regularity of the underlying transactions ⁽¹¹⁾. For the period 24 July 2002 to 31 December 2002, the Court based its examination on the audit work carried out by the private external audit company which audited these financial statements. No new loans were granted after 23 July 2002.

10.20. The Court reviewed the findings of the private external auditor and confirms that weaknesses exist affecting the security and reliability of the IT system such as the failure to change passwords, no regular control of access rights and the absence of regular reporting.

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10.20. *Shortcomings and weaknesses affecting the security of the IT system identified in the report of the private external auditors have been recognised. In particular, the recommendation on the password change policy has already been implemented for the Globus system, which is the main financial application in use. Furthermore, a regular review of access rights for the IT system is performed by the local informatics security officer.*

A plan in line with the migration process to a new office computing platform (ETP) within the Commission has been established to deal with the remaining observations and recommendations in the report of the private external auditors before the end of 2003 and, in particular, to address the reporting issue.

⁽⁹⁾ See also Council Recommendation (SN 1375/03) for the discharge of the 2001 budget (chapter 8): the Council 'considers, like the Court, that the Commission ought to be able to supply the information that led to the setting of the annual fee for the treasury management'.

⁽¹⁰⁾ Council Decision 2003/76/EC of 1 February 2003 establishing the measures necessary for the implementation of the Protocol, annexed to the Treaty establishing the European Community, on the financial consequences of the expiry of the ECSC Treaty and on the Research Fund for Coal and Steel (OJ L 29, 5.2.2003, p. 22).

⁽¹¹⁾ OJ C 224, 19.9.2003.

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THE EEA FINANCIAL MECHANISM

Introduction

10.21. Under Protocol 38 to the Agreement on the European Economic Area (EEA) ⁽¹²⁾, signed on 2 May 1992, the Member States of the European Free Trade Association (EFTA) created the EEA Financial Mechanism. This mechanism is intended to contribute to the reduction of the economic and social disparities between the regions of the EEA by providing interest rebates for EIB loans and investment grants. The Cooperation Agreement between EFTA (EEA) and the EIB was signed on 30 June 1992. The existing agreements have continued to be in force since the accession of the former EFTA States, Austria, Finland and Sweden. The Cooperation Agreement stipulates in Article 1(2) that 'priority shall be given to environment, transport, education and training. Special consideration should be given to SMEs'.

10.22. The Financial Mechanism provides subsidies and financing in the form of ⁽¹³⁾:

- interest rebates of 2 % per annum over 10 years for a volume of EIB loans totalling ECU 1 500 million, to be committed in equal instalments over a period of five years from its entry into force (1 January 1994),
- grants to projects totalling ECU 500 million, to be committed in equal instalments over a period of five years from its entry into force (1 January 1994).

10.23. The countries participating in the scheme were Austria, Finland, Iceland, Liechtenstein, Norway and Sweden ⁽¹⁴⁾. In accordance with the Acts ⁽¹⁵⁾ concerning the accession of Austria, Finland and Sweden to the EU, their contributions (some 80 % of the total grants

10.21. *The EIB bases its activities in the context of this mandate on the provisions of the Cooperation Agreement, its operational guidelines and the European Free Trade Association (EFTA) commitment letters for individual projects.*

⁽¹²⁾ Protocol 38 to the Agreement on the European Economic Area (EEA) (OJ L 1, 3.1.1994, p. 206). The Agreement was concluded between the Community and the EFTA with the aim of allowing the EFTA countries to participate in the Single Market, while not assuming the full responsibilities of EU membership. The participating EFTA countries are Norway, Iceland and Liechtenstein (following a referendum, Switzerland did not join the EEA; Austria, Finland and Sweden became Member States of the EU in the meantime).

⁽¹³⁾ Protocol adjusting the Agreements on the European Economic Area, Final Act, Joint Declaration (OJ L 1, 3.1.1994, p. 572).

⁽¹⁴⁾ Switzerland did not ratify the EEA Agreement and, as a consequence, did not participate in the Financial Mechanism.

⁽¹⁵⁾ OJ C 241, 29.8.1994, p. 37.

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and interest rebates for EIB loans) have been borne, since these countries joined the Community on 1 January 1995, by the EU budget. **Table 10.2** shows the amounts contributed by each Member State and by the EU to the Financial Mechanism.

Table 10.2 — Evolution of the EEA Financial Mechanism

Member State	Funding (million ECU/euro) 1994-1998	Repayment during 2002	Total net contribution	
			Million euro	%
Iceland	5,91	0,48	5,43	1,00
Norway	112,25	10,08	102,17	18,75
Liechtenstein	1,09	0,10	0,99	0,18
(Subtotal EFTA)	(119,25)	(10,66)	(108,59)	(19,93)
Austria (only 1994)	29,35	0,00	29,35	5,38
Finland (only 1994)	20,53	0,00	20,53	3,77
Sweden (only 1994)	40,43	0,00	40,43	7,42
EU from 1995	385,45	39,35	346,10	63,51
(Subtotal EU + A + S + FIN)	(475,75)	(39,35)	(436,41)	(80,07)
Total	595,00	50,00	545,00	100,00

Source: Financial Mechanism (differences are due to roundings).

10.24. The EEA Financial Mechanism Committee (FM Committee) takes decisions in respect of which projects to support and on what conditions on the basis of an appraisal note from the EIB ⁽¹⁶⁾. Following the decision taken by the FM Committee, the EIB concludes contracts with the beneficiaries for loans, interest rebates

⁽¹⁶⁾ Management of the grants and interest subsidies has been delegated to the European Investment Bank (Decision 4/94/SC of the EFTA States; the Commission is represented in the Committee), which selects, assesses and monitors projects presented by the beneficiary Member States according to financial, economic and technical criteria and then submits proposals to the EEA Financial Mechanism Committee. The EIB's remuneration for its tasks is 0,5 % of the amount of each disbursement.

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and grants. The European Commission (Directorate-General for Economic and Financial Affairs) manages the liquid assets of the mechanism ⁽¹⁷⁾; available funds are invested in money-market instruments.

10.25. The operational arrangements for applying the Cooperation Agreement to implement the Financial Mechanism between the Commission and the EIB stipulate that the Financial Mechanism support shall not be inconsistent with Community policies. Various maximum grant levels were determined for the Financial Mechanism. 90 % is the upper maximum level of combined Community aid and Financial Mechanism together (the same rule applies for the cohesion financial instrument).

10.26. As the EEA Financial Mechanism entered into force on 1 January 1994, the last commitment could be made in accordance with the initial arrangement until 31 December 1998. However, not all amounts committed have been disbursed because of delays or modifications. **Table 10.3** shows the situation as at the end of 2002.

10.26. *Some delays occurred in the starting phase of the European Economic Area (EEA) Financial Mechanism. Subsequently as disbursements had to be in line with the progress of the works and in conformity with the contractual provisions there have also been some delays during project implementation.*

Table 10.3 — Use of the funds of the EEA Financial Mechanism as at 31 December 2002

(million euro)

Beneficiary Member States	Greece	Ireland	United Kingdom (Northern Ireland)	Portugal	Spain	Total
Loans committed	354,37 24,3 %	106,50 7,3 %	0,00 0,0 %	315,00 21,6 %	681,00 46,7 %	1 456,87 100,0 %
Loans disbursed	354,37 24,4 %	106,35 7,3 %	0,00 0,0 %	310,34 21,4 %	681,00 46,9 %	1 452,06 100,0 %
Interest rebates disbursed	37,69 24,4 %	11,72 7,6 %	0,00 0,0 %	33,64 21,8 %	71,23 46,2 %	154,28 100,0 %
Investment grants committed	100,54 21,4 %	34,90 7,4 %	11,00 2,3 %	105,00 22,4 %	217,97 46,4 %	469,41 100,0 %
Investment grants disbursed	69,22 17,3 %	34,65 8,6 %	10,90 2,7 %	87,92 21,9 %	198,24 49,5 %	400,93 100,0 %
Target percentage per country initially determined ⁽¹⁾	24,3 %	7,1 %	2,2 %	21,0 %	45,4 %	100,0 %
Percentage per country of total disburse- ments	19,3 %	8,4 %	1,9 %	21,9 %	48,5 %	100,0 %

⁽¹⁾ Share of financial assistance of the Financial Mechanism as initially set by the Community.

Source: Financial Mechanism. Provisional data for 2002; rounding differences apply for certain percentages.

⁽¹⁷⁾ Fund Management Agreement between the Financial Mechanism Committee and the European Community, signed on 9 July 1999.

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10.27. In the context of its audit of banking activities and financial instruments, the Court examined the management of the measures at the level of the EIB and two Member States, Spain and Greece. Spain is the biggest beneficiary of the EEA Financial Mechanism and it accounts for 48,5 % of all disbursements (interest rebates and grants) ⁽¹⁸⁾. Greece accounts for 19,3 % of the interest rebates and grants disbursed from the Financial Mechanism up to the end of 2002 ⁽¹⁹⁾. The current audit ⁽²⁰⁾ concerns the management and realisation of one global loan under which interest rebates were provided by the Financial Mechanism to a Spanish State-owned credit institution, which itself provides the loans and interest rebates to 10 selected projects and, in Greece, a number of projects benefiting directly from the interest rebates and investment grants of the Financial Mechanism ⁽²¹⁾.

Observations concerning the overall management of the Financial Mechanism

Liquidity

10.28. There are still Financial Mechanism payments to be disbursed. Therefore, uncertainty exists as regards the calculation of the Member States' shares of the Financial Mechanism subsidies (see **Table 10.3**). Finan-

10.28. *The Commission is continually seeking with the EIB to improve the quality of the forecasts for disbursements. There are frequent contacts between the services involved for this purpose.*

⁽¹⁸⁾ Thirty-nine projects were subsidised, many of them with sub-projects, including three global loans with 38 projects.

⁽¹⁹⁾ Twenty-seven projects (including 36 sub-projects) were supported. The projects concern different sectors, such as loans and interest rebates for financing motorways and for the Port of Piraeus and for the development and restoration of town centres. Seventeen projects (including the sub-projects) concern the restoration, repair and improvement of monasteries as part of the national heritage, most of them on Mount Athos.

⁽²⁰⁾ The Court carried out an audit of two projects in Spain in 1999 (OJ C 342, 1.12.2000, paragraphs 7.17 to 7.30). The observations concerned, *inter alia*, the absence of public tendering and weaknesses in the application of the project control system.

⁽²¹⁾ The audit covered 8 % of loans and interest rebates supported by the Financial Mechanism in Spain and 9 % of loans and interest rebates in Greece, as well as 30 % of grants supported by the Financial Mechanism in Greece.

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cial forecasts were not reliable in the past: at the end of 2002 the backlog of disbursements (difference between disbursements forecasted and disbursements made) was 41 million euro. This also affects the management of the Fund's liquidity.

Monitoring

10.29. The Financial Mechanism subsidies may be granted in addition to funds from other Community measures, such as the Structural Funds or the Cohesion Fund (see paragraph 10.25), but the maximum ceilings must be respected. However, neither the Commission, nor the EIB nor national authorities check at the date of final disbursement that the ceilings are complied with in relation to the expenditure actually declared.

10.30. For most of the projects, the EIB employed monitoring agents to follow up the work carried out and establish the disbursement claims. They were required to report on the progress made on the project and provide the necessary information to allow the EIB to carry out disbursements. The Court saw examples where the quality of their work was not adequate. Calculations could not be reconciled or were based on estimates; final reports were not presented, disbursements were therefore delayed or were based on other information, mainly from the beneficiaries.

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10.29. *The financing limits are defined in the EFTA commitment letter for each project and introduced into the grant agreements concerned. The usual ratios to be respected at every disbursement by the EIB are EFTA grant percentages $\leq 85\%$ and EU funds (EFTA grant + Cohesion Fund + ERDF + EIB loan) $\leq 90\%$. The Commission consults internally on proposed grant approvals to coordinate them with the Structural and Cohesion Funds and avoid breaches of limits. The information supplied to the Court on disbursements to the audited projects/global loan limits shows that the EIB kept within the percentage limits in relation to planned expenditure as set out in the commitment letters. The Commission will examine with the EIB whether the checking of compliance with grant ceilings at the time of the final disbursement needs to be tightened up.*

10.30. *On the initiative of EIB and in agreement with the Financial Mechanism, monitoring agents were employed on complex projects, in Spain and Greece. In the course of project implementation, the EIB has recognised both the strengths and the weaknesses of the monitoring agents and has taken remedial action whenever required. During project implementation there have been and still are permanent contacts between the monitoring agents and the EIB. Disbursements are calculated by taking into account past expenditures of the project and a forecast of expenditures, generally of 90 days.*

Final reports issued by the beneficiaries must be available prior to the release of the last disbursement. It is usual to base disbursement calculations on information provided by the beneficiaries, such information having been verified by either the Bank and/or the monitoring agents.

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Reconciliation

10.31. The audit revealed several problems with the reconciliation of the amounts declared as expenditure for the Financial Mechanism and the accounts kept by the beneficiaries. In the absence of clear rules, the auditors could sometimes only reconcile the overall amounts but not the accuracy of the claim details.

10.31. All project promoters have an accounting system. The Bank is however, not in a position to impose a specific accounting system on the beneficiaries of which some are not commercial companies or public sector bodies but entities of a non-profit nature e.g. the monasteries of Mount Athos. All the information requested by the Court has been supplied during or after the audit.

Certification

10.32. Final payments are based on the financial claims established by the beneficiaries, or sometimes by the monitoring agents. However, certification by the competent authorities of Member States or by competent auditors should always be required, which is not foreseen by the current rules.

10.32. Certification is essentially the responsibility of the promoter in the context of the legal framework applicable to it. The Commission will examine with the EIB whether the rules in this area need to be tightened up.

*Specific observations concerning the Financial Mechanism projects***Public tendering**

10.33. The conditions for the global loan, set in the finance contract between the EIB and the Spanish credit institution ⁽²²⁾, include the obligation to apply competitive tendering, with free access granted at least to bidders from the signatory States of the Treaty on the European Economic Area and, where applicable, in compliance with the corresponding directives of the Council of the European Union. In Galicia, the concession for the installation of a wind farm required 74 % local production in Galicia (80 % including civil engineering work). During the audit it was explained that for the installation of an electric transformer, the beneficiary had to prove that the product could not be found on the domestic market in order to obtain specific permission from the regional authorities to buy the equipment in Sweden. The Commission is invited to examine the situation in order to avoid that preferences for national products are set which are not in line with the Treaty and Article 20 of the Protocol on the Statute

10.33. The EIB has already communicated a number of elements to the Commission which tend to suggest that no breach of EU regulations in fact occurred.

Nevertheless, the Commission will further examine with the EIB whether the alleged breach can be substantiated and, if so, will take the appropriate action.

⁽²²⁾ Clause 6.2 of the contract.

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of the European Investment Bank, which states that: '(4) Neither the Bank nor the Member States shall impose conditions requiring funds lent by the Bank to be spent within a specified Member State' ⁽²³⁾.

Appropriate checks and documentation

10.34. Once completed, some of the building work is of a type which can no longer be subject to verification as regards the quantity as well as the quality of the material used and the quality of the work done. The current rules do not provide for adequate independent and reliable certificates (see paragraph 10.32).

Efficiency and effectiveness

10.35. With regard to efficiency and effectiveness, the Court's audit identified some cases which illustrate that greater efforts are needed to identify suitable investments and take into account overall project realisation, particularly in order to avoid damage to the environment.

10.36. Eight of the 10 projects of the global loan examined (wind farms ⁽²⁴⁾ and a waste-water treatment plant) showed problems of efficiency. The promoters took the interest rebates available under the Financial Mechanism because they were available, but the rebates had no decisive impact on the realisation of the projects. In the case of a waste-water treatment plant visited on the spot in Spain, it was found that the planning went back to 1997 and the plant had been nearly completed when the contract on the provision of investment grants was signed. In fact, the audit visit did not reveal any

10.34. *The Commission would refer to the reply to paragraph 10.32.*

10.35. *The Financial Mechanism considered projects eligible for grants on proposal by beneficiary States. In case of interest rate subsidies supported by the Financial Mechanism, project proposals came from the intermediary bank. All projects were appraised by the Bank, approved by the Financial Mechanism Committee and by the Commission. As foreseen in the Agreement, the Bank applied to these projects its usual criteria and procedures in respect to appraising the environmental impact.*

10.36. *The effective rate of interest (irrespective if paid as interest-rate subsidy over the duration of a loan or upfront as net present value of the amount corresponding to the 2 % interest rebate) is clearly a factor influencing the level of investment.*

Nevertheless, an interest-rate subsidy is not the single determining factor for an investment decision. Even though the link between interest rate subsidy and investment cannot be quantified, this does not mean that there is no link at all.

⁽²³⁾ In another context, the Commission itself reported the failure to comply with the rules on public procurement in its annual report on the Cohesion Fund (2001) (COM(2002) 557 final, p. 39).

⁽²⁴⁾ Under Spanish law, the operation of wind farms receives aid from a subsidy on the energy produced by the wind farm.

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sustainable evidence to support the view that the Financial Mechanism subsidy had been necessary for the realisation of any of the three projects visited on the spot in Spain.

10.37. For another project in Greece ⁽²⁵⁾, success depends on the realisation of the other phases of the overall project, which had not yet started at the time of the audit due to budgetary and financial constraints.

10.38. In some cases unused building material and rubbish are left in the landscape or dumped into the sea, as was the case in front of the Dochiariou monastery (Mount Athos), where building work supported by the Financial Mechanism was carried out. In the context of the extension of the Port of Piraeus, for substantive building works, rocks from a hill on the Island of Salamis were used, causing environmental damage. So far, this environmental damage has not been made good.

Conclusion

10.39. The Financial Mechanism provided assistance to some projects in the beneficiary countries. However, a number of improvements are still necessary. Final payments should only be carried out on the basis of appropriate certificates issued by the competent authorities of the Member States. The Commission should play a more active role in order to ensure that the European rules on competition and tendering are respected and that assistance is given to projects which would otherwise not be implemented.

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10.37. *The first phase of the Greek project was considered a success. The second phase of the project has since been started.*

10.38. *The Commission takes note of the observations of the Court, specifically with regard to the Port of Piraeus. The Commission has already received some information concerning the environmental issues and the measures that are planned. It will examine with the EIB whether any further action is necessary to ensure proper protection of the environment in connection with the work on funded projects.*

10.39. *Certificates issued by competent authorities of the Member States (or rather beneficiary States) or auditors are not set out in the various agreements.*

⁽²⁵⁾ Renovation of the old town of Corfu.