

IV

(Notices)

NOTICES FROM EUROPEAN UNION INSTITUTIONS AND BODIES

COURT OF AUDITORS



In accordance with the provisions of Article 248(1) and (4) of the EC Treaty and Articles 129 and 143 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, as last amended by Council Regulation (EC) No 1525/2007 of 17 December 2007 and Articles 139 and 156 of Council Regulation (EC) No 215/2008 of 18 February 2008 on the Financial Regulation applicable to the 10th European Development Fund,

the Court of Auditors of the European Communities, at its meeting of 24 and 25 September 2008, adopted its

ANNUAL REPORTS**concerning the financial year 2007**

The reports, together with the institutions' replies to the Court's observations, were transmitted to the authorities responsible for giving discharge and to the other institutions.

The Members of the Court of Auditors are:

Vítor Manuel da SILVA CALDEIRA (President), Hubert WEBER, Maarten B. ENGWIRDA, Máire GEOGHEGAN-QUINN, David BOSTOCK, Morten Louis LEVYSOHN, Ioannis SARMAS, Július MOLNÁR, Vojko Anton ANTONČIČ, Gejza HALÁSZ, Jacek UCZKIEWICZ, Josef BONNICI, Irena PETRUŠKEVIČIENĚ, Igors LUDBORŽS, Jan KINŠT, Kersti KALJULOID, Kikis KAZAMIAS, Massimo VARI, Juan RAMALLO MASSANET, Olavi ALA-NISSILÄ, Lars HEIKENSTEN, Karel PINXTEN, Ovidiu ISPIR, Nadejda SANDOLOVA, Michel CRETIN, Harald NOACK, Henri GRETHEN.

ANNUAL REPORT ON THE IMPLEMENTATION OF THE BUDGET

(2008/C 286/01)

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GENERAL INTRODUCTION

0.1. The European Court of Auditors is the EU institution established by the Treaty to carry out the audit of EU finances. As the EU's external auditor it contributes to improving EU financial management and acts as the independent guardian of the financial interests of the citizens of the Union. More information about the Court can be found in its annual activity report which, together with its special reports on specific subjects and its opinions on proposed legislation, are available on the Court's website www.eca.europa.eu.

0.2. This document, covering the 2007 financial year, comprises the Court's 31st annual report on the implementation of the general budget of the European Union. The replies of the Commission — or other EU institutions and bodies where appropriate — are presented with the report. A separate annual report covers the European Development Funds.

0.3. The general budget of the EU is decided annually by the Council and the European Parliament. The Court's annual report provides a basis for the discharge procedure which brings the annual budgetary process to an end. A central part of this report is the Court's Statement of Assurance on the reliability of the annual accounts of the European Communities and on the legality and regularity of the underlying transactions.

0.4. Chapter 1 of the report includes this Statement of Assurance as well as further information to support it. Chapter 2 reports on the Commission's internal control system and chapter 3 covers the Commission's management of the 2007 budget. The remaining chapters — 4 to 11 — deal with the revenue side of the budget and the different areas of expenditure in the form of groups of policy areas.

0.5. Chapter 4 to 11 each contain the following elements:

- summary and analysis of the results of the audit work carried out for the Statement of Assurance in the form of specific assessments of the budgetary area concerned;
- reports on progress made in implementing recommendations of the Court and the Budgetary Authorities arising from previous audits.

0.6. The specific assessments are based mainly on an assessment of the operation of the principal supervisory and control systems governing revenue and expenditure and on the results of the Court's testing of transactions. The Court's overall appraisal of all these elements forms the basis for the Statement of Assurance.

0.7. In addition to recommendations on specific areas in the individual revenue and expenditure chapters the Court sets out more cross-cutting ones in paragraphs 1.52 to 1.54, 2.41, 2.42, 3.29, 3.32 and 3.33.

A more wide-ranging approach is taken in the Court's contribution to the current review of the EU budget, launched by the Commission in 2007. In this contribution the Court states that the review should address the quality of EU budgetary transactions — legality, regularity and value for money — as well as spending priorities and equity. The Court furthermore:

- welcomes the Commission's view that EU spending must reflect an assessment that it adds value to the Union and calls for this criterion to be more clearly articulated;
- lists key principles to be applied in designing arrangements for EU spending: clarity of objectives, simplification, realism, transparency and accountability;
- recommends the political authorities to be prepared to think radically about the design of expenditure programmes for example by recasting them in term of outputs, by considering critically the appropriate level of national, regional and local discretion in managing programmes and by making better use of the concept of tolerable risk;
- points out that there is considerable scope for simplifying and clarifying the own resources systems through which the budget is financed.

0.8. The implementation of the budget is the responsibility of the Commission. However, Member States cooperate with the Commission to ensure that funds are used in accordance with the principles of sound financial management. There is a tendency towards an increased role for Member States, and often also national supreme audit institutions (SAIs), in the supervision and control of EU funds. For example, 2007 was the first year for which Member States were required to produce an annual summary of available audits and declarations.

0.9. As outlined in the Court's opinion No 6/2007 annual summaries, as well as voluntary initiatives from Member States to issue declarations and the decisions by some national audit bodies to audit these, could stimulate improved management and control of EU funds. For 2007 the Court found that the

Commission adequately supervised the annual summaries process (see paragraphs 2.19 and 2.20). However, due to the disparity of presentation and the frequent absence of a statement of their completeness and accuracy, the summaries cannot yet be regarded as providing a reliable assessment of the functioning of the control systems.

0.10. The Court endeavours to make use of the national SAIs' audit work on national declarations, under the conditions outlined in its opinion. In general the Court aims to improve the cooperation with national SAIs, both by developing common auditing standards tailored for the EU area together with its fellow SAIs, and by bilateral cooperation with individual SAIs. A recent positive example of cooperation is the special report on

administrative cooperation in the field of VAT (No 8/2007) where reports from several national SAIs were referred to.

0.11. Since 2005 the general budget has been structured solely around Activity Based Budgeting (ABB) policy areas. This year the Court has modified the structure of its report to reflect this change as well as the introduction of a new financial framework. This year, for the first time each of the specific assessments are centered round groups of ABB policy areas outlined in table 1.2. This has resulted in the introduction of two new specific assessments, one on Education and Citizenship and one on Economic and Financial Affairs (previously covered under Internal policies), as well as the merger of two previous assessments (Pre-accession aid and External actions) into one on External Aid, Development and Enlargement.

CHAPTER 1

The Statement of Assurance and supporting information

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THE COURT'S STATEMENT OF ASSURANCE PROVIDED TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

- I. Pursuant to the provisions of Article 248 of the Treaty the Court has audited
- (a) the 'Annual Accounts of the European Communities' ⁽¹⁾ which comprise the 'Consolidated financial statements' ⁽²⁾ and the 'Consolidated reports on implementation of the budget' ⁽³⁾ for the financial year ended 31 December 2007; and
 - (b) the legality and regularity of the transactions underlying those accounts.

Management's responsibility

II. In accordance with Articles 268 to 280 of the Treaty and the Financial Regulation, management ⁽⁴⁾ is responsible for the preparation and fair presentation of the 'Annual Accounts of the European Communities' and the legality and regularity of the transactions underlying them:

- (a) Management's responsibility in respect of the 'Annual Accounts of the European Communities' includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies, on the basis of the accounting rules adopted by the Commission's accounting officer ⁽⁵⁾; and making accounting estimates that are reasonable in the circumstances. According to Article 129 of the Financial Regulation, the Commission approves the 'Annual Accounts of the European Communities' after the Commission's accounting officer has consolidated them on the basis of the information presented by the other institutions ⁽⁶⁾ and bodies ⁽⁷⁾ and established a note, accompanying the consolidated accounts, declaring, inter alia, that he has reasonable assurance that they present a true and fair view of the financial position of the European Communities in all material aspects.

(1) The 'Annual Accounts of the European Communities' are presented in volume I of the Annual Accounts of the European Communities financial year 2007.

(2) The 'Consolidated financial statements' comprise the balance sheet, the economic outturn account (including segment reporting), the cash flow table, the statement of changes in net assets and a summary of significant accounting policies and other explanatory notes.

(3) The 'Consolidated reports on implementation of the budget' comprise the consolidated reports on implementation of the budget and a summary of budgetary principles and other explanatory notes.

(4) At the level of the European institutions and bodies management includes the members of the institutions, Directors of the Agencies, Authorising Officers by delegation and sub-delegation, Accounting Officers and the leading staff of financial, audit or control units. At the level of Member and Beneficiary States, management includes Authorising Officers, Accounting Officers and the leading staff of paying authorities, certifying bodies and implementing agencies

(5) The accounting rules adopted by the Commission's accounting officer are derived from International Public Sector Accounting Standards (IPSAS) issued by the International Federation of Accountants or, in their absence, International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. In accordance with the Financial Regulation, the 'Consolidated financial statements' for the 2007 financial year are prepared (as they have been since the 2005 financial year) on the basis of these accounting rules adopted by the Commission's accounting officer, which adapt accruals based accounting principles to the specific environment of the Communities, while the 'Consolidated reports on implementation of the budget' continue to be primarily based on cash movements.

(6) Before the adoption of the Annual Accounts by the institutions, the different accounting officers sign them off, thereby certifying that they have a reasonable assurance that the accounts present a true and fair view of the financial situation of the institution (Article 61 of the Financial Regulation).

(7) The Annual Accounts are drawn up by the respective directors and sent to the Commission's accounting officer together with the opinion of the management board concerned. In addition, the respective accounting officers sign them off, thereby certifying that they have a reasonable assurance that the accounts present a true and fair view of the financial situation of the bodies (Article 61 of the Financial Regulation).

- (b) The way in which management exercises its responsibility for legality and regularity of underlying transactions depends on the method of implementation of the budget. In the case of direct centralised management, implementation tasks are performed by the Commission's departments. Under shared management, implementation tasks are delegated to Member States, under decentralised management to third countries and under indirect centralised management to other bodies. In the case of joint management, implementation tasks are shared between the Commission and international organisations (Article 53 to 57 of the Financial Regulation). Implementation tasks have to comply with the principle of sound financial management, requiring designing, implementing and maintaining effective and efficient internal control including adequate supervision and appropriate measures to prevent irregularities and fraud and, if necessary, legal proceedings to recover funds wrongly paid or used. Regardless of the method of implementation applied, the Commission bears the ultimate responsibility for the legality and regularity of the transactions underlying the accounts of the European Communities (Article 274 of the Treaty).

Auditor's responsibility

III. The Court's responsibility is to provide, on the basis of its audit, the European Parliament and the Council with a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions. The Court conducted its audit in accordance with the IFAC International Standards on Auditing and Codes of Ethics and the INTOSAI International Standards of Supreme Audit Institutions, in so far as these are applicable in the European Community context. These standards require that the Court plans and performs the audit to obtain reasonable assurance whether the 'Annual Accounts of the European Communities' are free from material misstatement and the transactions underlying them are legal and regular.

IV. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated accounts and the legality and the regularity of the transactions underlying them. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated accounts and of material non-compliance of the underlying transactions with the requirements of the legal framework of the European Communities, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the preparation and fair presentation of the consolidated accounts, and supervisory and control systems implemented to ensure legality and regularity of underlying transactions, in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and reasonableness of accounting estimates made, as well as evaluating the overall presentation of the consolidated accounts and the annual activity reports.

V. In the case of Revenue, the scope of the Court's audit work was limited. Firstly, VAT and GNI own resources are based on macroeconomic statistics for which the underlying data cannot be audited directly by the Court, and secondly, the audits of traditional own resources cannot cover imports that have not been subject to custom supervision.

VI. The Court considers that the audit evidence obtained is sufficient and appropriate to provide a basis for its statement of assurance.

Opinion on the reliability of the accounts

VII. In the Court's opinion, the 'Annual Accounts of the European Communities' present fairly, in all material respects, the financial position of the Communities as of 31 December 2007, and the results of their operations and cash flows for the year then ended, in accordance with the provisions of the Financial Regulation and the accounting rules adopted by the Commission's accounting officer.

VIII. Without calling into question the opinion expressed in paragraph VII, the Court notes that weaknesses in the accounting systems, which are partly due to the complex legal and financial framework, still put at risk the quality of financial information of certain Directorates-General of the Commission (in particular for pre-financing, the related cut-off and for invoices/cost claims) and decentralised bodies whose accounts are subject to consolidation (in particular for fixed assets of the European GNSS⁽⁸⁾ Supervisory Authority (GSA)). These weaknesses led to a number of corrections after the presentation of the provisional accounts.

Opinion on the legality and regularity of the transactions underlying the accounts

IX. In the Court's opinion, revenue, commitments and payments for 'Administrative and other expenditure' and 'Economic and financial affairs' are free from material error. In these areas the supervisory and control systems are implemented in a manner which ensures adequate management of the risk of illegality and irregularity.

X. In the Court's opinion, in the other areas of expenditure payments are still materially affected by errors, although to different levels. The Commission and the Member States and other beneficiary states need to make further efforts to implement adequate supervisory and control systems, so as to improve the management of the risk of illegality and irregularity. These areas are: 'Agriculture and natural resources', 'Cohesion', 'Research, energy and transport', 'External aid, Development and enlargement' and 'Education and citizenship'.

- (a) In 'Agriculture and natural resources', the Court found that the transactions underlying the expenditure declared for this policy group, taken as a whole, are affected by a material level of error of legality and/or regularity. On the basis of its audit work, the Court concludes that supervisory and control systems are only partially effective in providing assurance as to compliance with EU rules. However, the Court concludes that the Integrated Administration and Control System (IACS) continues to be effective in limiting the risk of irregular expenditure where properly implemented and if accurate and reliable data are entered into the system.
- (b) In 'Cohesion', the Court found that the reimbursement of expenditure to Cohesion policies projects is affected by a material level of error of legality and/or regularity. The Court concludes on the basis of its audit work that the supervisory system of the Commission and the control systems of the Member States are generally only partially effective in preventing overstated or ineligible expenditure.
- (c) In 'Research, energy and transport', the Court found that payments for the policy group are affected by a material level of error of legality and/or regularity. The Court concludes on the basis of its audit work that, despite some improvements, the Commission's supervisory and control systems are only partially effective in mitigating the risk of reimbursement of overstated or ineligible costs.
- (d) In 'External aid, development and enlargement', the Court found that transactions underlying the expenditure in the policy group are affected by a material level of error of legality and/or regularity, mostly at the level of implementing organisations. The Court concludes on the basis of its audit work that, despite the improvements at the level of the Commission, the supervisory and control systems are only partially effective in providing assurance that expenditure is eligible and supported by adequate evidence.

⁽⁸⁾ GNSS: Global Navigation Satellite Systems.

(e) In 'Education and citizenship', the Court found that payments for the policy group are affected by a material level of error of legality and/or regularity. The Court concludes on the basis of its audit work that the supervisory and control systems are only partially effective in providing assurance that expenditure is eligible and supported by adequate evidence.

XI. The Court emphasises that:

- (a) Rural development accounts for a disproportionately large part of the overall error rate estimated for the area of 'Agriculture and natural resources'; for EAGF expenditure the Court estimates the value of the error rate to be slightly below materiality whereas for EAFRD expenditure it is estimated to be significantly above.
- (b) Complicated or unclear legal requirements (such as eligibility rules) have a considerable impact on the legality and/or regularity of transactions underlying the expenditure in the areas of 'Agriculture and natural resources', 'Cohesion', 'Research, energy and transport' as well as 'Education and citizenship'.

XII. The Court has identified further progress in the Commission's supervisory and control systems, in particular concerning, on the one hand, the impact of the reservations on the assurance given in the declarations by the Directors-General; and, on the other hand, the greater consistency of these declarations with the Court's findings. However, the Court notes that the Commission is not yet able to demonstrate that its actions to improve supervisory and control systems have been effective in mitigating the risk of error in large areas of the budget.

24 and 25 September 2008

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THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

INFORMATION IN SUPPORT OF THE STATEMENT
OF ASSURANCE**Introduction**

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

1.2. The aim of the work on the reliability of the accounts of the European Communities is to obtain sufficient appropriate evidence to conclude on the extent to which revenue, expenditure, assets and liabilities have been properly registered and that the annual accounts faithfully reflect the financial position as of 31 December 2007, and the results of their operations and cash flows for the year then ended (see paragraphs 1.6 to 1.31).

1.3. The aim of the Court's audit work on the legality and regularity of the transactions underlying the 2007 accounts is to gather sufficient appropriate evidence, of a direct or indirect nature, to give an opinion on whether they are in accordance with the applicable regulations or contractual provisions, and have been correctly calculated (see paragraphs 1.32 to 1.54 of this chapter for horizontal issues and chapters 2 and 4 to 11 for details).

1.4. Once again, the Court assessed the progress made by the Commission in strengthening its internal control system and to the follow-up given to the action plans adopted within the context of the Roadmap towards an integrated internal control framework (see chapter 2).

1.5. In addition, in the absence of Commission indicators over a series of years and to complement those provided for 2007 ⁽⁹⁾, the Court presents certain indicators to monitor progress in improving internal controls both overall, and for each income and expenditure area (see annexes to this chapter and to chapters 2 and 4 to 11).

⁽⁹⁾ See paragraph 1.5 of the Annual Report concerning the financial year 2006 and chapter 2 of the present Annual Report.

Reliability of the accounts

General background

1.6. The Court's observations concern the annual accounts for the financial year 2007, drawn up by the Commission's Accounting Officer and approved by the Commission in compliance with Article 129 of the Financial Regulation of 25 June 2002⁽¹⁰⁾ and sent to the Court on 28 July 2008. The accounts comprise the 'consolidated financial statements' — covering, in particular, the balance sheet setting out the assets and liabilities at the end of the year as well as the economic outturn account — and the 'consolidated reports on the implementation of the budget' — covering the revenue and expenditure for the year.

1.7. The 2007 annual accounts are the third set of accounts prepared under the accruals based accounting rules which were introduced by the European Communities in 2005 on the basis of provisions of the Financial Regulation (in particular Articles 123 to 138). In comparison to the 2005 and 2006 annual accounts, the following major changes occurred:

- the scope of consolidation has been increased from 16 agencies consolidated in 2005 to 26 agencies in 2007 (24 in 2006);
- the information given on the different forms of recovery of undue expenditure made by the Commission has been regrouped;
- a reconciliation of the economic outturn to the budgetary outturn has been provided;
- for the first time this year, the Accounting Officers of the other institutions and bodies provided the Commission's Accounting Officer with duly signed 'transmission letters', most of them materially similar to the management representation letter⁽¹¹⁾ provided by the Commission's Accounting Officer.

⁽¹⁰⁾ 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), last amended by Council Regulation (EC, Euratom) No 1995/2006, (OJ L 390, 30.12.2006, p. 1) requires that the final accounts shall be sent before 31 July of the following financial year.

⁽¹¹⁾ These letters are used to let the management acknowledge that the financial statements are sufficient and appropriate and without omission of material facts.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

1.8. The Commission's Accounting Officer provided the Court with a representation letter confirming that subject to certain limitations the consolidated accounts are complete and reliable (see however paragraphs 1.29 and 1.31) and that most of the Commission's local systems have been validated (see however paragraphs 1.13 to 1.16).

Audit scope and approach

1.9. The transition to accruals based accounting, and the resulting significant changes in the structure and in the content of the accounts of the European Communities, require a multiannual adaptation process for the Commission. In its audit of the 2007 accounts the Court paid particular attention to the changes introduced as a result of the ongoing modernisation of the Communities accounting system⁽¹²⁾. The audit concentrated on the following elements⁽¹³⁾:

- assessment of whether measures taken within the Commission, in order to remedy weaknesses identified in the new financial reporting framework and accounting systems of certain institutions and Directorates-General⁽¹⁴⁾, contribute to the reasonable assurance that the accounts give a true and fair view. This was done, in particular, by analysing the bases for the validations (according to Article 61 of the Financial Regulation) by the Authorising Officers of the 2007 accounts falling under their responsibility, as well as by analysing the validation of the Accounting Officer for the cut-off methodology and the state of readiness of the local financial management systems which provide data for the Commission's accounts (see paragraphs 1.13 to 1.18);
- verification of the reliability of the 2007 accounts, concentrating on elements for which a modified opinion was given in the context of the 2006 Statement of Assurance⁽¹⁵⁾ (pre-financings, invoices/cost statements and cut-off). This was done by carrying out analytical reviews and substantive tests on representative statistical samples (see paragraphs 1.23, 1.24, 1.25 and 1.26).

⁽¹²⁾ See communication from the Commission — Modernisation of the Accounting System of the European Communities (COM(2002) 755 final of 17.12.2002).

⁽¹³⁾ The Court's findings on previous stages of the modernisation were presented in the Annual Report concerning the financial year 2004 (see paragraphs 1.21 to 1.45), the Annual Report concerning the financial year 2005 (see paragraphs 1.5 to 1.58) and in the Annual Report concerning the financial year 2006 (see paragraphs 1.6 to 1.36). Results of subsequent stages will be included in future Annual Reports.

⁽¹⁴⁾ See paragraph IX of the Court's Statement of Assurance concerning the financial year 2006.

⁽¹⁵⁾ See paragraph VIII and IX of the Court's Statement of Assurance concerning the financial year 2006.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Further steps taken to strengthen the transition to accruals based accounts**General achievements**

1.10. The Commission's Accounting Officer introduced a series of measures in order to consolidate the transition to modernised accruals based accounts. A pilot study was launched in July 2006 on the quality of accounting data and has been completed. As a result, the Commission's Accounting Officer finalised a series of measures which were disseminated to all Directorates-General in March 2007. Their purpose is to improve the accounting control environment at the level of individual Directorates-General. They include the development of an accounting risk analysis, the deployment of risk-based accounting review exercises, the elaboration of specific accounting manuals and the documentation of year-end accounting closure files. The project applies for the first time to the annual accounts of 2007.

1.11. These measures have contributed to a strengthening of the financial reporting framework and accounting systems. However, certain weaknesses still exist which put at risk the quality of accounting data (see paragraphs 1.13 to 1.18). Furthermore, it was noted that the guidelines on the accounting control environment, issued by the Commission's Accounting Officer, were not fully applied by a limited number of operational Directorates-General for the cut-off calculation.

1.12. **Table 1.1** contains a follow-up of the Court's reservations concerning the reliability of the accounts which were expressed in the Statement of Assurance for the 2006 financial year, as well as the other points raised by the Court, which were partly settled or which still need to be addressed in the context of the measures taken by the Commission to consolidate the transition to modernised accruals based accounts.

Validation of local systems

1.13. Many Directorates-General use their own local IT-systems for financial management purposes and for the creation of transactions which are sent to the central accounting system (ABAC) via an interface.

1.11. *Although weaknesses were identified in the quality of some accounting data, these had no material impact on the reliability of the accounts.*

1.13. *As the situation is constantly evolving, the accounting services' validation team needs to keep track of this evolution, and has introduced, as was already mentioned last year, a procedure for the validation of changes in the local systems.*

Table 1.1 — Follow-up of the reservations expressed in the Statement of Assurance concerning the financial year 2006 as to the reliability of the accounts and certain other observations made in the Annual Report concerning the financial year 2006

Reservations in the Statement of Assurance concerning the financial year 2006	Commission's replies in the Annual Report concerning the financial year 2006	Developments in 2007
<p>Errors have been identified in amounts registered in the accounting system as invoices/cost statements and pre-financing leading to an overstatement of the accounts payable by some 201 million euro and the total amount of long-term and short-term pre-financing by some 656 million euro.</p>	<p>For accounts payable the level of errors found by the Court was limited.</p>	<p>Only a low level of error in terms of financial impact as regards these items of the balance sheet have been identified. However, the frequency of these errors underlines the need for further improvement of the reliability of the basic accounting data at the level of the operational Directorates-General.</p>
<p>Certain other observations made in the context of the Annual Report concerning the financial year 2006</p>		
<p>Due in part to the complex system of financial management and despite improvements made, weaknesses in the accounting systems of certain institutions and Directorates-General of the Commission still put at risk the quality of the financial information, in particular for cut-off and employee benefits. This led to a number of corrections after the presentation of the provisional accounts.</p>	<p>The Commission stated that it will endeavour to continue improving its year-end accounting procedures. In 2006 the Commission improved the estimation of its cut-off amounts by taking several actions. As for the pension scheme for some Members of the European Parliament, in the absence of an actuarial evaluation no meaningful provision can be made in the accounts.</p>	<p>Weaknesses in the accounting systems of certain Directorates-General of the Commission and other bodies still put at risk the quality of financial information, in particular for pre-financing, related cut-off and invoices/cost statements. This led to corrections after the presentation of the provisional accounts. The provision for pension rights for some Members of the European Parliament is now recognised in the consolidated balance sheet.</p>
<p>The Commission's Accounting Officer was not able to provide validation for three local subsidiary accounting systems. Furthermore, the number and importance of issues and matters for further consideration remain much the same as for the previous year. Therefore, in the light of the continuing problems, the Director-General for Budget should have made a specific reservation on these issues.</p>	<p>Significant progress was made in 2006 in relation to the three services concerned. Their systems will be examined in 2007 in order to decide whether the improvements are sufficient to warrant their validation. In view of the progress made, a reservation in the 2006 Annual Activity Report was not necessary.</p>	<p>The Commission's Accounting Officer was still not able to provide validation to two of the local systems nor to validate a third system without qualification. As in previous years the number and importance of horizontal issues and other matters for consideration remain much the same.</p>
<p>Although the explanatory notes to the consolidated accounts contain information about possible corrections, they do not identify the amounts and areas of expenditure which may be subject to further verification and clearance of accounts procedures.</p>	<p>The right to make checks on expenditure many years after it was incurred should not imply that all the expenditure concerned remains to be accepted. Quantifiable amounts of potential recoveries are disclosed in the notes to the consolidated accounts.</p>	<p>As for the past, the amounts and areas of expenditure which may be subject to further verification and clearance of accounts procedures are not disclosed in the notes to the accounts.</p>
<p>Further measures are necessary in order to ensure completeness and reliability of the accounting data and information presented in the explanatory notes concerning the amounts recovered in response to illegal or irregular operations.</p>	<p>The accounting system is being adapted to increase the quantity of information recorded regarding recoveries. These improvements are planned to be effective for the 2008 accounts.</p>	<p>Despite the improvements noted, further measures are necessary in order to ensure completeness and reliability of the accounting data and information presented in the explanatory notes concerning the amounts recovered in response to illegal or irregular operations, in particular at the level of the Member States and for deductions from subsequent payments.</p>
<p>The reconciliation between budgetary and economic outturn still presents unexplained minor differences and the intelligibility of the accounts would be improved if such a reconciliation was included in the annual accounts.</p>	<p>The Commission accepts that the reconciliation procedure needs to be improved and will consider including a full reconciliation in the annual accounts.</p>	<p>The Commission has improved its reconciliation procedure and has included the reconciliation between budgetary and economic outturn in the consolidated annual accounts.</p>

THE COURT'S OBSERVATIONS

1.14. For the financial year 2007, the services of the Commission's Accounting Officer carried out a follow-up of the previous year's findings ⁽¹⁶⁾. In addition six further services ⁽¹⁷⁾ were subject to in-depth reviews as part of a cyclical approach aiming at full coverage of Commission's services on a medium term. Two other services ⁽¹⁸⁾ were also subject to review but their reports were not finalised in time for the Commission's Accountant Global Validation Report for 2007.

1.15. The Commission's Accounting Officer was still not able to validate the local systems of the Directorate-General for Education and Culture ⁽¹⁹⁾ and the Directorate-General for External Relations ⁽²⁰⁾, as indicated in his management representation letter (see paragraph 1.8), nor to validate without qualifications the local system of EuropeAid Co-operation Office ⁽²¹⁾ regarding the financial year 2007. The non-accounting reservation issued for the Joint Research Centre ⁽²²⁾ in 2006 was kept for

⁽¹⁶⁾ See paragraphs 1.20 and 1.21 of the Annual Report concerning the financial year 2005 and paragraphs 1.15 to 1.17 of the Annual Report concerning the financial year 2006. As at end of 2006, the Accounting Officer had still not provided its validation to three local accounting systems and a number of other issues remained for consideration.

⁽¹⁷⁾ Directorates-General for Development, Enlargement, Environment, Maritime Affairs and Fisheries, Internal Audit Service, Interpretation.

⁽¹⁸⁾ Directorates-General for Economic and Financial Affairs, Health and Consumers.

⁽¹⁹⁾ The validation report for the Directorate-General for Education and Culture was not finalised in time for the Global Validation Report. The new system Symmetry is now foreseen for 2009 with a limited pilot phase envisaged for 2008.

⁽²⁰⁾ The validation report for the Directorate-General for External Relations was not finalised in time for the Global Validation Report. The validation report transmitted end of May 2008 maintained the validation suspended.

⁽²¹⁾ During 2007, EuropeAid Co-operation Office still had a reservation on reporting consistency due to lack of systematic reconciliation with the central system. However, this issue was addressed at the end of July 2008.

⁽²²⁾ The Joint Research Centre has implemented by the end of 2007 a new interface to upload contract information into the ABAC Contracts system. Data has been uploaded for new contracts from 2007, but none yet for 2006 and 2005 contracts.

THE COMMISSION'S REPLIES

1.14. *The accounting services' validation team follows up matters raised in previous reports in order to ensure that recommendations made are being implemented, thus ensuring that the quality of local financial management systems is constantly improving.*

It is intended that the first complete cycle of verification of the respect of validation criteria in all Directorates-General and Services will be completed by the end of 2008 or the beginning of 2009.

The report for the Directorate-General for Economic and Financial Affairs was transmitted to the Court on 4 June 2008. The report for the Directorate-General for Health and Consumers was transmitted to the Court on 2 September 2008.

1.15. *Work is still ongoing with the aim to reach the validation for the Directorates-General for External Relations and for Education and Culture.*

The qualification to the validation for the EuropeAid Co-operation Office has now been removed as this Directorate-General was able to provide sufficient evidence regarding its consistency of reporting, and that a systematic reconciliation of CRIS with ABAC had been put in place.

The missing interface between the Joint Research Centre (JRC) local IT system, JIPSY, and ABAC for the transfer of the JRC's contracts to the central database of ABAC Contracts has been put in place, and all contracts for 2007 have been put in the central database. JRC has still to upload the contracts for the remaining period from 2005 until end 2006, which is planned to be done before the year's end.

The non-validation of the RELEX system concerned a local accounting system (BCC-NT/Rai-Web) which was not in conformity with the validation criteria. The ABAC IT system was deployed to all Commission delegations within the timeframe foreseen, and, as from January 2007, the administrative expenditure of the delegations is now managed within the ABAC system. The situation is therefore improved compared to 2006.

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THE COMMISSION'S REPLIES

the financial year 2007. The number and importance of horizontal issues and other matters for consideration remain much the same as in previous years ⁽²³⁾.

1.16. The Court's audit confirmed that the decisions of the Commission's Accounting Officer were well founded: the issues and matters outstanding were important.

Strengthening of cut-off procedures

1.17. Since the transition to accruals accounting, the Commission's Accounting Officer invited the Commission services to carry out an *ex-post* testing of their cut-off methodology, where relevant ⁽²⁴⁾, combining data from budgetary sources and from general accounting in order to check the adequacy of methods. Out of the nine Directorates-General examined ⁽²⁵⁾, six were partially concerned by this testing representing under 20 % of the total cut-off amount, one Directorate-General improved its procedures by testing and correcting its cut-off procedures ⁽²⁶⁾, others tested their methodology but corrective actions were postponed ⁽²⁷⁾ and some Directorates-General ⁽²⁸⁾ still have not yet carried out *ex-post* testing of their cut-off methodologies. This may lead to inaccuracies in the accounting data.

1.18. Some Directorates-General (representing approximately 20 % of the total cut-off amount) establish their cut-off of accrued charges according to a *pro rata temporis* method ⁽²⁹⁾. However, if the contract dates in the accounting systems used as a basis for the cut-off calculations are incorrect or changes therein are not updated, they affect adversely the reliability of the accounts.

1.17. *The Accounting Officer considered the accounting data to be sufficiently accurate for the final accounts.*

1.18. *The quality-control plan of the main Directorate-General concerned focused on activity dates. 935 contracts have been reviewed, including all contracts with long duration. As a consequence, remaining activity date errors relate to short duration contracts having a much lower impact on cut off than last year's. In the Court's sample of 20 transactions for this Directorate-General, there are 3 errors due to wrong activity dates. This is an improvement compared to last year.*

⁽²³⁾ Notably general issues regarding cut-off procedures, late clearing and errors in recording pre-financing, timeliness of transactions' posting, ABAC contracts, registration of guarantees, varying knowledge on accrual accounting principles across the services, data consistency between local systems and ABAC.

⁽²⁴⁾ *Ex-post* testing is only required when the *pro-rata temporis* technique is used and the interval between two progress reports is long.

⁽²⁵⁾ See also paragraph 1.18 of the Annual Report concerning the financial year 2006.

⁽²⁶⁾ Directorate-General for the Information Society and Media.

⁽²⁷⁾ E.g. Directorates-General for Research, Education and Culture and EuropeAid Co-operation Office.

⁽²⁸⁾ E.g. Directorates-General for Energy and Transport and Enlargement.

⁽²⁹⁾ The *pro rata temporis* method is an estimation technique allowing to attribute proportional values to the length of time involved.

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Consolidated financial statements as at 31 December 2007**General remarks**

1.19. During 2007, the Commission took measures to ensure the complete and correct registration of new pre-financing payments and related guarantees, as well as of new open invoices/cost statements, and the cut-off.

1.20. The Court's audit of loans, inventories, long-term receivables, cash and cash equivalents, employee benefits, provisions and financial and other long-term liabilities and reserves did not produce any significant findings. However, a number of errors were identified concerning other elements which are presented hereafter.

Consolidated balance sheet as at 31 December 2007**Pending issues in the accounts as regards the European satellite system**

1.21. The European GNSS⁽³⁰⁾ Supervisory Authority (GSA), a EU Agency created in 2004⁽³¹⁾, officially took over responsibility⁽³²⁾ from the former Galileo Joint Undertaking (GJU) on 1 January 2007. The new body was originally intended to operate as a public private partnership; following a decision of the Council made in November 2007 the Galileo programme is now to be financed from the EU budget. At the end of 2007, despite the signature of agreements⁽³³⁾ between the interested parties (GJU, European Space Agency, Authority), ownership of the projects' assets from the GJU to the Authority had not been completely transferred and no list of Galileo assets held by the European Space Agency had been established. The Court therefore did not express an opinion on the reliability of the Authority's accounts for the year ended 31 December 2007.

1.21. *At the end of 2007, despite the signature of agreements between the interested parties (GJU, European Space Agency, GSA), ownership of the projects' assets had not been completely transferred from the ESA to the European Communities. As there is some uncertainty and delay in the transfer of assets, for reasons of prudence, the European Communities have not recognised the assets of the programme in their balance sheet. It is intended that the assets will be recognised once these transfer issues have been resolved.*

⁽³⁰⁾ GNSS: Global Navigation Satellite Systems.

⁽³¹⁾ Council Regulation (EC) No 1321/2004 (OJ L 246, 20.7.2004, p. 1), extended by Regulation (EC) No 1942/2006 (OJ L 367, 22.12.2006, p. 18).

⁽³²⁾ The Authority GSA shall manage the public interests relating to the European GNSS programmes and act as the regulatory authority for the programme during the development and operational phases and will play a key role for the achievement of the Galileo Programme.

⁽³³⁾ The Commission lodged a proposal to amend the founding Regulation No 1321/2004 on 19 September 2007. This proposal does not clarify the new role of the Authority and refers without any further detail to delegation agreements to be concluded by the Authority and the European Space Agency (ESA) regarding the management of the programme's funds and the ownership of its assets.

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Risk capital operations

1.22. In the consolidated financial statements of the European Communities, all risk capital operations (218 million euro as at 31 December 2007) are classified as 'long term investments' (assets available for sale). They are held at historic cost less any provisions for impairment, as their fair value cannot currently be reliably measured. While such a valuation method is acceptable in the circumstances, it is not applied consistently. The Court found that impairments are only based on write-offs while provisional estimates for impairments were available to the manager of the operations (European Investment Bank) but had not been communicated to the Commission ⁽³⁴⁾.

1.22. *Reporting and accounting standards have evolved significantly over the period of the MEDA mandates which cover these risk capital operations (RCO). The EIB and the Commission have been following developments and are currently reviewing the situation together, looking for the most cost-effective solution and also taking into account information available according to the contracts signed with final beneficiaries many years ago (hence not including current reporting standards). This review has confirmed that the current valuation exercise of the Risk Capital Operations is a very time-consuming and challenging exercise due to the high number and the complex cascade structure of the RCO transactions. The EIB has also underlined that the valuation of the RCO transactions is based, to the extent it is possible, on relevant international accounting principles, notably IAS 39.*

Pre-financings and related guarantees

1.23. The Court's audit of a representative statistical sample of 150 pre-financings registered in the accounting system identified a low level of error in terms of financial impact as regards this item of the balance sheet. However, the frequency of these errors underlines the need for further improvement of the accuracy of the basic accounting data at the level of the operational Directorates-General. The most common types of errors are:

- pre-financing entries were not recorded in line with the different management types as presented in the notes to the financial statements;
- pre-financing amounts remained open although they had been used by the beneficiaries before the year-end.

1.24. Furthermore, additional audit work on the identification and validation of pre-financings revealed problems of completeness/accuracy for the balance sheet:

- some payments were booked as expenses in the economic outturn account whilst they should have been booked as pre-financings in the balance sheet;

1.24.

⁽³⁴⁾ See also paragraph 1.26 of the Annual Report concerning the financial year 2006.

THE COURT'S OBSERVATIONS

- some pre-financings remain in the balance sheet although the relevant information, such as audit certificates, were available in order to proceed with their clearing by recording the corresponding expenses in the economic outturn account. Furthermore, an inconsistent treatment of clearing of pre-financings has been observed. The Directorate-General for the Information Society and Media proceeds correctly to the clearing of pre-financings in the case of cost claims not accompanied by audit certificates whilst the Directorate-General for Research, in the same circumstances, leaves the pre-financing open.

Accounts payable

1.25. The audit of a representative statistical sample of 150 invoices/cost statements from the population of accounts payable registered in the accounting system identified a low level of error in terms of financial impact as regards this balance sheet item. However, the frequency of these errors underlines the need for further improvement of the reliability of the basic accounting data at the level of the operational Directorates-General. Most of the errors concern invoices or cost statements recorded for the wrong amounts.

1.26. Significant delays were identified in the treatment of some invoices and cost-claims. This has an impact on the accounts in so far as delays in the eligibility analysis of invoices prevent the triggering of the clearing of pre-financings. This may lead to an inaccurate liability position towards third parties and the booking of an expense amount, based on a cut-off estimate, instead of an amount supported by invoices already received.

Consolidated economic outturn account

1.27. The recording of payments under the wrong management type has an impact on the accuracy of the breakdown of expenses by management type in the notes to the economic outturn account as well as in the segment reporting (see also paragraph 1.23).

THE COMMISSION'S REPLIES

- *The Commission agrees with the Court that it is best practice to clear open pre-financing amounts with the minimum of delay and its goal is to have all services do this as soon as sufficient supporting documentation is available. In the meantime, year-end bookings ensure that the criticised practice does not affect the reliability of the accounts.*

Furthermore, the Directorate-General for the Information Society and Media and the Directorate-General for Research are cooperating to find a common way for dealing with this question in line with the recommendations made by the accounting services.

THE COURT'S OBSERVATIONS

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Off-balance sheet disclosures

1.28. Although the explanatory notes to the annual accounts contain information about the fact that some transactions are likely to be corrected at a later date by the Commission's departments or the Member States, the amounts and areas of expenditure which may be subject to further verification and clearance of accounts procedures ⁽³⁵⁾ are still not identified in the notes.

Other issues**Recovery of undue payments**

1.29. Following a recommendation of the Court, more information concerning the recovery of undue payments has been presented in the notes to the financial statements. However, the notes to the financial statements do not yet contain complete and reliable information on the financial correction activities made by the Member States. They provide this information in particular in respect of withdrawals, recoveries and pending recoveries in the area of Structural Actions ⁽³⁶⁾. As a result of the high proportion of ineligible expenditure repeatedly indicated in the Court's Annual Reports, and in order to be compatible with the presentation of a true and fair view, the Court considers that appropriate information should be presented in the notes to the accounts on these correction mechanisms.

1.30. Based on the examination of the certifying bodies work ⁽³⁷⁾ the Court reiterates ⁽³⁸⁾ its doubts as regards the accuracy of the receivables from Member States in the area of agriculture. Further the Court notes that the different policies applied to the date of recognition of debts by the Paying Agencies result in an inconsistent presentation of the global value of debts (see paragraphs 5.44 and 5.45).

⁽³⁵⁾ See paragraphs 1.10 and 1.11 of the Annual Report concerning the financial year 2002, paragraph 1.11 of the Annual Report concerning the financial year 2003, paragraphs 1.12 and 1.13 of the Annual Report concerning the financial year 2004, paragraph 1.57 of the Annual Report concerning the financial year 2005 and paragraph 1.34 of the Annual Report concerning the financial year 2006.

⁽³⁶⁾ See also section 6 on the recovery of undue payments in the Annual Accounts of the European Communities concerning the financial year 2007, Volume I, pp. 75-80.

⁽³⁷⁾ Commission Regulation (EC) No 885/2006 (OJ L 171, 23.6.2006, p. 90), Annex III.

⁽³⁸⁾ See paragraph 5.61 of the Annual Report concerning the financial year 2006.

1.28. *The Financial Regulation and the sectoral regulations regarding agriculture and the structural funds give the Commission the right to make checks on all expenditure for many years after it is incurred. The accounts should not imply that, because of this right, all the expenditure concerned remains to be accepted. Where the amounts of potential recoveries are quantifiable, they are disclosed in notes 5.3 and 5.4 to the consolidated accounts.*

1.29. *Chapter 6 of the 2007 annual accounts gives an overview of the procedures in place for the recovery of undue payments, and presents a best estimate of the total amount of such recoveries, including recoveries made by Member States regarding agricultural expenditure.*

Only summary information was provided in the notes to the accounts on Member States' recoveries of Structural Funds because of the timing of the submission of this information and the need to clarify some of the data with the Member States. However, the Commission provided more detailed information to Parliament in July 2008 in the second quarterly report on the Action Plan for strengthening the Commission's supervisory role in structural actions expenditure, and it is publishing the figures in an annex to the Annual Report on the Structural Funds for 2007, as it did last year for the 2006 information. Under the action plans, the Commission is making efforts to improve the reliability and completeness of the information received from Member States, by, amongst other things, carrying out on-the-spot audits in Member States.

1.30. *The Commission considers the information which it received on receivables from Member States in the area of agriculture to be sufficiently reliable for clearance and accounting purposes.*

The Commission has provided additional clarifications concerning debt recognition by the paying agencies in its revised guidelines for financial year 2008. The 'different policies' referred to by the Court are the result of the different national legal systems for the recovery of undue payments.

See also replies to paragraphs 5.44 and 5.45.

THE COURT'S OBSERVATIONS

1.31. Furthermore, the notes to the accounts do not disclose the recoveries made by deduction from a subsequent payment (offsetting).

Legality and regularity of transactions underlying the 2007 accounts

New structure of the DAS specific assessments

1.32. Following the introduction by the Commission of Activity Based Budgeting (ABB) and Activity Based Management (ABM), the Court decided to redefine the specific assessments in which it divides the budget for DAS purposes in terms of suitable groups/clusters of ABB policy areas (see **Table 1.2**).

The Court's approach

Sources and methods

1.33. The Court uses an assurance model which draws on two principal sources of evidence:

- (a) an assessment of the operation of the supervisory and control systems applied in the collection and disbursement of funds from the EU budget by EU institutions, Member States, regions, third countries, etc., aiming to provide representative information on the implementation and functioning of key controls in respect of their ability to prevent or detect and correct errors;

THE COMMISSION'S REPLIES

1.31. *As indicated in the notes to the accounts, the information systems did not allow for the identification of this information in 2007. The systems have since been adapted by the Commission during 2008 so that all recoveries made by deduction from a subsequent payment can be identified and explained.*

1.33.

Table 1.2 — Expenditure outturn in 2007 by Annual Report chapters

(million euro)

Sections (S) and titles (T) corresponding to the 2007 budgetary nomenclature allocated per chapter of the Court's Annual Report	Payments made in 2007
Annual Report chapters	
Revenue ⁽¹⁾	38,1 ⁽⁷⁾
Taxation and customs union (T.14)	
Agriculture and natural resources ⁽²⁾	51 044,3
Agriculture and rural development (T.05)	
Environment (T.07)	
Fisheries and maritime affairs (T.11)	
Health and consumer protection (T.17)	
Cohesion ⁽¹⁾	42 015,2
Employment and social affairs (T.04)	
Regional policy (T.13)	
<i>Part of T.05 and T.11 are included in this chapter of the Annual Report concerning the financial year 2007</i>	
Research, energy and transport ⁽¹⁾	4 483,8
Research (T.08)	
Energy and transport (T.06)	
Information society and media (T.09)	
Direct research (T.10)	
External aid, development and enlargement ⁽³⁾	6 198,9
External relations (T.19)	
Development and relations with ACP States (T.21)	
Enlargement (T.22)	
Humanitarian aid (T.23)	
Education and citizenship ⁽⁴⁾	1 453,0
Education and culture (T.15)	
Communication (T.16)	
Area of freedom, security and justice (T.18)	
Economic and financial affairs ⁽⁵⁾	489,9
Economic and financial affairs (T.01)	
Enterprise (T.02)	
Competition (T.03)	
Internal market (T.12)	
Trade (T.20)	
Administrative and other expenditure ⁽⁶⁾	8 230,1
Parliament (S. I)	
Council (S. II)	
Commission (S. III)	
Court of Justice (S. IV)	
Court of Auditors (S. V)	
Economic and Social Committee (S. VI)	
Committee of the Regions (S. VII)	
European Ombudsman (S. VIII)	
European Data-protection Supervisor (S. IX)	
Grand totals	113 953,3

⁽¹⁾ Expenditure relating primarily to Financial Framework heading 1, 'Sustainable growth'.

⁽²⁾ Expenditure relating primarily to Financial Framework heading 2, 'Preservation and management of natural resources'.

⁽³⁾ Expenditure relating primarily to Financial Framework heading 4, 'EU as a global player'.

⁽⁴⁾ Expenditure relating primarily to Financial Framework heading 3, 'Citizenship, freedom, security and justice'.

⁽⁵⁾ Expenditure relating to Financial Framework headings 1 and 3

⁽⁶⁾ Expenditure primarily relating to Financial Framework headings 5, 'Administration', and 6, 'Compensations' — see paragraph 11.1 for further details.

⁽⁷⁾ This figure refers to 'operational expenditure' and not to the value of the 'revenue'.

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- (b) checks based on representative statistical samples of underlying transactions relating to revenue and to expenditure, down to the level of the final beneficiary, aiming to provide direct evidence on the legality and regularity of payments.

Under the assurance model a judgement is made on the level of confidence that can be derived from the operation of supervisory and control systems as well as from direct testing of the legality and regularity of underlying transactions in order to arrive at the high level of assurance necessary to provide a robust conclusion.

THE COMMISSION'S REPLIES

- (b) *Under the legislation applicable ⁽¹⁾, the Commission operates a control cycle in relation to Community-funded expenditure which is carried out over a period of years. It applies for instance clearance-of-accounts procedures in agriculture, financial correction mechanisms in structural measures, and recoveries in internal policies and external actions. Errors which are detected during the course of a multiannual project and the associated undue payments may be recovered in a later year than the one under examination, such as through reducing the final payment to take account of the shortcoming found.*

The application of these procedures by Member States and the Commission, and the other control measures effected provide, with the limitations described in the 2007 annual activity reports, reasonable assurance that the resources assigned to the Commission's activities have been used for their intended purpose and in accordance with the principles of sound financial management. The control procedures put in place give the necessary guarantees concerning the legality and regularity of the underlying transactions.

Thus the Commission assumes its final responsibility for the implementation of the budget laid down by Article 274 of the EC Treaty.

The Commission welcomes the Court's increased emphasis on examining measures taken to detect and correct errors, principally through financial corrections, clearance and recoveries. The Commission has made substantial efforts to improve the quality of data on recoveries provided by Member States and is currently carrying out work to verify the completeness and accuracy of these data.

Progress has been made in producing reliable evidence of the operation of the multi-annual corrective mechanisms. The Commission has included in the notes to the annual accounts of the European Communities for the financial year 2007 a new chapter about the recovery of undue payments. The objective of this chapter is to give an overview of the procedure in place for the recovery of undue payments and to present a best estimate of the total amount recovered.

⁽¹⁾ Article 53 of the Financial Regulation.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

1.34. The principal sources described above can be complemented by two other sources:

- (a) an analysis of the Annual Activity Reports and the declarations of the Commission's Directors-General and their synthesis, stating whether the Commission has reasonable assurance that the systems in place ensure the legality/regularity of the underlying transactions;
- (b) an examination of the work of other auditors, defined as those that are independent of the Community's management and control process (e.g. Supreme Audit Institutions in the Member States or third countries) ⁽³⁹⁾.

Definition and treatment of errors

1.35. Errors may relate to a 'condition for payment' or to an 'other compliance issue'. In general, payment conditions are breached when legal requirements of the respective aid scheme or contract are not fulfilled. On the other hand, other compliance issues are specific conditions to be fulfilled, which result from related policy objectives (protection of the environment, good agricultural practices, etc.) or systems requirements (minimum number of controls, prescribed structures and procedures, etc.).

1.36. The Court classifies errors as being either 'quantifiable' or 'non-quantifiable'. The first category refers to errors, which have a direct and measurable financial impact on the amount of underlying transactions financed from the EU budget ⁽⁴⁰⁾.

1.37. Only quantifiable errors are taken into consideration when estimating the financial impact of errors for the population as a whole. Frequency of errors refers in this report to quantifiable and non-quantifiable errors ⁽⁴¹⁾.

⁽³⁹⁾ More detailed information can be found on the Court's Internet site www.eca.europa.eu.

⁽⁴⁰⁾ This includes, for example, serious cases of non-respect of public procurement procedures affecting the conditions for payment (see for instance paragraph 6.17).

⁽⁴¹⁾ Quantifiable and non-quantifiable errors are classified as being either limited or serious based on nature, context, financial importance and/or proportion of transaction affected. Serious quantifiable errors refer to errors above 2 %.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

General overview of audit results 2007

1.38. In the area of Revenue, Economic and financial affairs and Administrative and other expenditure, where the supervisory and control systems, taken as a whole, are properly and correctly applied (see paragraphs 4.40 to 4.41, 10.32 to 10.33 and 11.25), the Court estimates that the errors have a financial impact of less than 2 % of the total amounts (see **Table 1.3**). In addition, the Court's assessment of the declarations by Directors-General and authorising officers by delegation confirmed that no, or only minor reservations had to be presented (see paragraphs 2.6, 2.7 and 2.9 and **Table 2.1**).

1.38. *The conclusions of the synthesis report 2007 state that the internal control systems in place, subject to the limitations described in the 2007 annual activity reports, provide reasonable assurance that the resources assigned to the Commission's activities have been used for their intended purpose and in accordance with the principles of sound financial management.*

However, it acknowledges that further efforts are needed to resolve a number of weaknesses, in particular those highlighted in the reservations of the delegated authorising officers — and those belonging to budget areas that were not considered satisfactory by the Court of Auditors.




Table 1.3 — Summary of 2007 DAS results on the legality and regularity of underlying transactions

Specific assessments of the 2007 DAS Annual Report	Paragraphs in Annual Report	Functioning of supervisory and control systems	Error range
Revenue ⁽¹⁾	4.40-4.41		
Agriculture and natural resources	5.50-5.55	⁽²⁾	⁽³⁾
Cohesion	6.32		
Research, energy and transport	7.40-7.41		
External aid, development and enlargement	8.31-8.32		
Education and citizenship	9.24		
Economic and financial affairs	10.32-10.33		
Administrative and other expenditure	11.25		

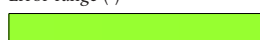
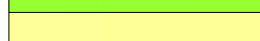

The above table summarises the overall assessment of supervisory and control systems, as outlined in the relevant chapters, and gives the broad results of the Court's substantive testing. The table highlights the key elements but cannot present all of the relevant detail (in particular concerning weaknesses of supervisory and control systems and types of error) for which it is necessary to refer to the body of the report, within the context of the methodology underlying the Court's audit approach (see paragraphs 1.33 to 1.37).

Legend:

Functioning of supervisory and control systems

	Effective
	Partially effective ⁽⁴⁾
	Not effective

Error range ⁽⁵⁾

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

⁽¹⁾ See scope limitations in paragraphs 4.4 and 4.9.

⁽²⁾ The Court concludes that IACS continues to be effective in limiting the risk of irregular expenditure where properly implemented and if accurate and reliable data is introduced as regards SPS payments based upon allocated entitlements (see paragraph 5.52).

⁽³⁾ Rural development accounts for a disproportionately large part of the overall error rate: for EAGF expenditure the Court estimates the value of the error rate to be slightly below 2 % (see paragraph 5.13)

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

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

THE COURT'S OBSERVATIONS

1.39. In the area of Agriculture and Natural Resources, Cohesion, Research, Energy and Transport, External Aid, Development and Enlargement and Education and Citizenship, where supervisory and control systems are at best only partially effective, (see paragraphs 5.50 to 5.55, 6.32, 7.40 to 7.41, 8.31 to 8.32 and 9.25), the Court estimates that for these areas the errors have a financial impact of more than 2 % of the total expenditure ⁽⁴²⁾ (see **Table 1.3**). In addition, the Court's assessment of the declarations by Directors-General and authorising officers by delegation confirmed that major reservations were either presented or, in the Court's view, should have been presented for the areas in question (see paragraphs 2.6 to 2.11 and **Table 2.1**).

THE COMMISSION'S REPLIES

1.39. *The Commission aims to ensure that supervisory and control systems are effective in detecting and correcting errors, with due regard to the costs and benefits of the checks which have to be made on the spot. Its action plan towards an integrated internal control framework has been largely implemented and improvements are gradually being seen. Its full impact is longer term.*

As regards agriculture and rural development, the Commission underlines the Court's finding that the most likely overall error rate is not significantly different from last year's, as reported in its 2006 statement of assurance. Control statistics received from Member States indicate as well that the error rate found at the level of final beneficiaries under the EAGF, which accounts for about 85 % of total agriculture and rural development expenditure, is below the materiality threshold. This confirms for 2007 the positive results from 2006 acknowledged by the Court in the Annual report 2006 ⁽²⁾. The annual activity report for 2007 of the Directorate-General for Agriculture and Rural Development provides further details.

The Integrated Administrative Control System (IACS) covering most of agricultural expenditure is effective in limiting the risk of irregular expenditure, where accurate and reliable data is introduced and the system is properly implemented.

The 2007 agriculture and rural development expenditure likely to be excluded from Community financing by future conformity decisions, amounting to an estimated sum of EUR 439 million, together with the EUR 152 million of recoveries from final beneficiaries ⁽³⁾.

In the cohesion area, the Commission is implementing an Action Plan (COM(2008) 97 final) to strengthen its supervision of Member States' systems so as to reduce errors.

The control strategy of the Research, energy and transport area aims to detect and correct errors. When fully implemented over a period of four years, this should ensure that the residual error rate (errors that remain uncorrected) is below the materiality threshold, as described in detail in the Annual Activity Reports of the Research Directorates-General.

⁽⁴²⁾ For Agriculture and Natural Resources the overall error rate is not significantly different from the value obtained last year but does not take account of certain serious errors which could not be quantified (see paragraph 5.13).

⁽²⁾ OJ C 273, 15.11.2007.

⁽³⁾ In 2007, 607 million euro was recovered by financial correction and 247 million euro recovered from final beneficiaries by Member States (chapter 6 of the notes to the annual accounts 2007).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

The errors in External aid, development and enlargement mostly concern expenditure made by the organisations implementing the projects on advance payments made by the Commission. Mandatory financial audits foreseen under the Commission's control system before the final payments should allow the Commission to detect and correct such errors.

The errors concerning the Directorate-General for Education and Culture (DG EAC) are related to final payments of actions under the former legal framework. The design of the new programmes for the 2007-2013 period has taken into account the Court of Auditors' recommendations of previous years to simplify the rules and to make extensive use of lump sum financing. This should reduce the error rate in the future.

Furthermore, the results of the ex-post controls carried out by DG EAC, as presented in its annual activity report 2007, do not identify a material level of error.

See also replies to paragraphs 2.8, 2.11, 5.50 to 5.55, 6.32, 7.41-7.42, 8.31 to 8.33 and 9.25.

1.40. Compared to previous years the following changes have been noted: a reduction in the sample estimate of the level of error has been identified for the policy areas formerly covered under Internal policies⁽⁴³⁾ and External actions⁽⁴⁴⁾ (see **Table 1.3**). The value of agricultural expenditure covered by IACS has significantly increased through the inclusion of some higher risk spending areas, including olive oil. The Court concludes, however, that IACS continues to be effective in limiting the risk of irregular expenditure where properly implemented and if accurate and reliable data is introduced as regards SPS payments based upon allocated entitlements. The recent introduction in SPS of support schemes, such as those related to olive oil, is a positive development although in the short term might lead to a higher frequency of errors (see paragraph 5.52).

1.40. *The Commission would also point out that for the cohesion area, there was an increase in the proportion of projects in which no errors were found, and the Court's overall assessment of the supervisory and control systems improved from 'not effective' to 'partially effective'.*

As regards IACS, the Commission considers that the introduction in SPS of support schemes that in the past had a higher level of risk, such as the olive oil sector, has reduced the risk of incorrect spending by cancelling the old production aid system.

⁽⁴³⁾ The former 'Internal policies' are now covered under the policy groups 'Research, Energy and Transport', 'Education and Citizenship' and 'Economic and Financial Affairs' (see **Table 2.1**).

⁽⁴⁴⁾ The former 'External actions' are now a part of the policy group 'External Aid, Development and Enlargement' (see **Table 2.1**).

THE COURT'S OBSERVATIONS

1.41. The Court emphasises that its audits in the areas of 'Agriculture and Natural Resources', 'Cohesion', 'Research, Energy and Transport' as well as 'Education and Citizenship' show that complicated or unclear eligibility criteria or complex legal requirements have a considerable impact on the legality and/or regularity of underlying transactions ⁽⁴⁵⁾.

Assessment of progress made towards an effective Community internal control framework

Introduction

1.42. Paragraph 1.39 and **Table 1.3** show that the majority of spending by value has only partially or wholly ineffective supervision and control, and underlying transactions continue to contain a material level of error. However, the 2007 and previous annual reports identify that:

- (a) Commission internal control arrangements continue to improve (i.e., annual activity reports — see paragraphs 2.8, 2.10 to 2.12 and 2.37) or remain at a high level (i.e. compliance with internal control standards — see paragraphs 2.25 and 2.39);
- (b) the Commission has made progress in implementing its action plan for an integrated internal control framework (see paragraphs 2.29 to 2.36 and 2.39);
- (c) the Commission's management of the budget has improved over the last few years (see paragraphs 3.4, 3.6, 3.11, 3.15 and 3.30 to 3.32).

These seemingly contradictory observations are analysed in the following paragraphs.

THE COMMISSION'S REPLIES

1.41. Simplification is a major element of the Commission's better regulation programme. The Member States are also required to simplify the eligibility criteria in their national programmes. However, a certain level of complexity is unavoidable and should be taken into account in future discussions on a tolerable level of risk.

1.42. The Court's assessment concerns the effectiveness of the supervision and control in preventing errors. The Community internal control framework includes those controls necessary to detect and correct errors, as well as those designed to prevent errors from occurring. The Commission will assess the impact of this framework on the effectiveness of the systems as a whole.

For example, the control strategy of the research, energy and transport area, as described in detail in the Annual Activity Reports of the Research Directorates-General, aims to detect and correct errors so that, when fully implemented over a period of four years, it should ensure that the residual error rate is below the materiality threshold.

The level of residual risk (errors that remain uncorrected) which can be accepted will be examined towards the end of 2008 in a Communication from the Commission.

⁽⁴⁵⁾ For example, because of the often complex eligibility conditions, errors were significantly more frequent among transactions underlying the European Agricultural Fund for Rural Development (EAFRD) examined by the Court than among transactions financed by the European Agricultural Guarantee Fund (EAGF) and examined by the Court. For EAGF expenditure the Court estimates the value of the error rate to be slightly below 2 % whereas for EAFRD expenditure it is estimated to be significantly above (see paragraph 5.13 of the present Annual Report and paragraph 1.42 of the Annual Report concerning the financial year 2006).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Framework for supervision and control ⁽⁴⁶⁾

1.43. The EU budget involves payments made to millions of individual final beneficiaries. Payments are made based on the compliance of the final beneficiaries with legal or regulatory conditions (such as beneficiary or costs meeting sometimes complicated eligibility rules), as well as the accuracy and existence of the underlying activities and/or costs. Some of these funding conditions are determined by Community rules, including rules of general application such as the public procurement directives, while others are decided by the Member States. Final beneficiaries are either paid directly (such as in the case of direct management) or through the reimbursement of claims of eligible spending from Member State authorities (notably in the case of shared management).

1.44. Payments are legal and regular when these conditions are met, and the right beneficiaries receive the right amounts at the right time. This requires adequate supervision and control. Ensuring that the budget is properly spent — expenditure is legal and regular as well as providing value for money — is the responsibility of the Commission. For around 80 % of spending — cohesion and agriculture — the task of implementation is shared with Member States, which in practice means they have specific obligations to select projects for funding, make payments and operate control systems, which manage the risks effectively and to report on the outcome.

1.45. Factors affecting whether or not errors occur, or are not prevented or detected and corrected by control systems, are multiple. They include: the complexity of the eligibility rules and obligations with which beneficiaries must comply, and their familiarity with them; the way that claims are made and processed; the number and extent of checks made; the extent of sanctions imposed on over-claiming beneficiaries when errors are detected; and the visibility — and associated deterrent effect — of the control procedures. Therefore, well designed rules and regulations which are clear to interpret and simple to apply, decrease the risk of errors.

⁽⁴⁶⁾ Court's opinion No 2/2004 on the 'single audit' model (and a proposal for a Community internal control framework).

THE COURT'S OBSERVATIONS

1.46. Whatever management approach is involved, supervision and control arrangements correspond to a framework comprising three broad functional levels:

- (a) *primary level* controls, which check compliance of final beneficiaries with their regulatory obligations;
- (b) *secondary level* controls, which check the effectiveness of the primary controls; and
- (c) *overall supervision* by the Commission, to ensure that Member States and/or Commission Directorates-General meet their obligations and responsibilities in respect of their management of the budget ⁽⁴⁷⁾.

How the different levels of control operate

1.47. The nature of EU spending means that the main risk of error resides at the level of the final beneficiary, who deliberately, negligently or inadvertently makes claims for reimbursement of expenditure that is ineligible because it does not meet the regulatory conditions, or is not properly documented or incorrectly calculated. This is borne out by the Court's previous audit findings, as well as those in this annual report (see paragraphs 5.12 to 5.16, 6.22 to 6.27, 7.14 to 7.22, 8.9, 9.8 to 9.11 and 10.16 to 10.19). Not only does the main risk reside at this level, but also errors can often only be detected reliably on the spot, making desk-based checks only partially effective. This — together with the fact that many millions of payments are made each year — means that primary level of controls are expensive to undertake, with overall cost being a direct function of the coverage.

1.48. On-the-spot checks made at this level often represent only a small proportion (usually 5 to 10 % per year, depending on the area) of individual claims. The Court finds weaknesses concerning the checks in agriculture (see paragraphs 5.27, 5.28, 5.30 to 5.32 and 5.34 to 5.36) and Cohesion policies (see paragraph 6.29), corresponding to weaknesses within Member State authorities. Cases of poor quality primary controls were also identified for direct management, including Commission level checks on reimbursements to research beneficiaries failing to operate satisfactorily (paragraphs 7.29 and 7.30) and poor quality audits carried out by independent auditors on individual claims (see paragraphs 7.32 to 7.33 and 10.29 to 10.30).

THE COMMISSION'S REPLIES

1.47. *The Commission agrees that desk-based checks on claims can only be partially effective in preventing errors. Therefore the Commission's internal control framework increases assurance on the legality and regularity of the expenditure on a multiannual basis through a higher number of on-the-spot audits.*

See also replies to paragraphs 5.12 to 5.16, 6.23 to 6.27, 7.15 to 7.22, 8.9, 9.8 to 9.10 and 10.16.

1.48. *Whilst it is true that on-the-spot checks are rarely conducted for all beneficiaries of the scheme, the regulatory administrative checks are always carried out in respect of all individual claims. This is because on-the-spot checks are too costly.*

The recommended frequency of on-the-spot primary controls in structural actions expenditure is much higher than the Court suggests as indicated in the guidance note on good practice for management verifications for the 2000-2006 period.

The Court's comments principally concern errors which can only be detected by checks on-the-spot, which are too costly to be undertaken before paying every claim. Beneficiaries can be required to submit with their final claim a certificate established by an independent auditor.

⁽⁴⁷⁾ Overall supervision by the Commission may also draw on primary and secondary level controls.

THE COURT'S OBSERVATIONS

1.49. The nature of primary level controls means that poor performance at this level cannot be compensated for directly by secondary level controls. The effectiveness of the latter is therefore determined by their ability to promote adequate control arrangements at the primary level, rather than the ability to detect and correct individual errors. The Court's audit work on the 2007 financial year again found that secondary checks by Member States and supervisory checks by the Commission ⁽⁴⁸⁾, are not achieving the desired level of effectiveness. For example, the Court found weaknesses in:

- (a) the Commission's conformity clearance in agriculture (see paragraphs 5.47 and 5.48);

THE COMMISSION'S REPLIES

In the research, energy and transport area, the control systems have been significantly strengthened with the introduction of audit certificates as from the sixth Framework Programme.

The Commission agrees that the reliability of the Sixth Framework Programme (FP6) audit certification is not fully satisfactory, considering the remaining level of errors noted in audits. Nevertheless, the overall level of errors in FP6 is lower than the errors noted in uncertified cost claims related to the Fifth Framework Programme (FP5). This indicates that audit certificates do contribute to improving the accuracy of cost claims.

For the Seventh Framework Programme (FP7), the Commission has further improved the reliability of audit certificates by using 'agreed upon procedures', setting out in detail the audit work to be performed by the certifying auditors and encouraging optional certification of the cost methodology.

1.49. *The Commission's supervision is aimed at improving management and control systems so that they prevent or detect and correct errors, as the Court recommends, and also at ensuring that required corrective measures are taken. It is not itself aimed at individual error detection.*

- (a) *The Court's findings referred to in paragraphs 5.47 and 5.48 are inherent in the conformity clearance mechanism in agriculture and, thus, cannot be considered as weaknesses of that mechanism. The Commission considers that the mechanism is functioning well and fully achieves the objective for which it has been designed, which is to exclude expenditure from Community financing which has not been effected in conformity with Community rules.*

Moreover, where undue payments to beneficiaries can be identified as a result of the conformity clearance, Member States are required to follow them up by recovery actions against these beneficiaries. However, even where recoveries from beneficiaries are not needed because the financial correction only relates to deficiencies in the Member States' management and control system and not to undue payments, these corrections are an important means to improve the Member States' systems and thus to prevent or detect and recover irregular payments to beneficiaries.

See also replies to paragraphs 5.47 and 5.48.

⁽⁴⁸⁾ This does not refer to the Commission's Internal Audit Service and Internal Audit Capabilities.

THE COURT'S OBSERVATIONS

- (b) audits in Cohesion spending (see paragraphs 6.30 and 6.31);
- (c) *ex-post* financial audits in research, energy and transport (see paragraph 7.34); and
- (d) *ex-ante* declaration of assurance in respect of the quality of management and related monitoring visits (see paragraphs 9.16, 9.17 and 9.20).

1.50. Weak primary and secondary controls cannot be compensated by the Commission's supervision. The purpose of this supervision is to ensure that adequate primary and secondary level control arrangements are in place, and are being operated effectively. Weaknesses at the lower levels should be identified (for example in the Directorate-Generals' annual activity reports), and measures taken to remedy the situation (see paragraph 2.40). Supervision occurs at different levels within the Commission, both at Directorates-General involved in shared management expenditure, and at the highest level of the Commission in respect of individual Directorates-General.

1.51. This process is hampered by factors directly linked to the number of beneficiaries, the complexity of the rules, the difficulty in checking compliance and the dissuasive effect of financial corrections and sanctions.

THE COMMISSION'S REPLIES

- (b) *The Commission considers that in most cases the audits examined by the Court in the Cohesion Policy area led to effective corrective measures and operationally useful results. Furthermore, the Annual Activity Reports of the competent Directorates-General set out in detail the results of the audit activity, in particular remedial actions, suspensions and financial corrections.*

See also replies to paragraphs 6.30 and 6.31.

- (c) *The Research Directorates-General have significantly increased their audit efforts in 2007 and have met their annual targets.*

Attention is now turned towards the correction of the detected errors. The Research Directorates-General are actively striving to improve the monitoring tools and are issuing more precise administrative and financial guidelines. These are expected to improve the efficiency and completeness of the recovery process (including extrapolation and follow-up of the Court's findings).

- (d) *The Directorate-General for Justice, Liberty and Security (DG JLS) has improved its guidance and has set up an action plan for finalising its monitoring visits. See replies to paragraphs 9.16, 9.17 and 9.20.*

1.50. *In agriculture, weaknesses in Member States' management and control systems are detected through conformity clearance procedures and may lead to financial corrections being imposed on Member States. These corrections are an important means to improve the Member States' systems and thus to prevent or detect and recover irregular payments to beneficiaries.*

In the cohesion sector, the Commission is acting in accordance with the Court's recommendations. It is targeting its audit work at improving the effectiveness of primary controls and at the same time is investing in preventive activities such as guidance on good practices and training of national authorities. It also takes actions to mitigate the risk of deficient systems through the application of financial corrections. The Commission identifies systems with significant deficiencies, and presents the corrective actions being undertaken to remedy these, in the Annual Activity Reports of the Directorates General concerned.

See also reply to paragraph 2.40.

1.51. *These are inherent risks of certain policy areas which have to be taken into account in determining the control strategy, in particular in the context of multiannual programmes.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Cost and benefits of controls should be balanced and approved

1.52. The Court's Opinion No 2/2004 recommends that control systems governing Community expenditure should strike an appropriate balance between the cost of controls, and the benefits they bring in terms of reducing the risk of error in transactions to a reasonable level (residual risk). This requires recognition by all participants in the budget process:

- (a) not all final beneficiaries can be checked on the spot, and therefore some residual risk of error will always be present. The key issue is to set that risk at an appropriate (tolerable) level, taking into account the nature of the different types of spending, the complexity of existing rules and the dissuasive effect of sanctions available;
- (b) costs of control are an important issue, both for the EU budget and Member or beneficiary states; and
- (c) the balance between cost and residual risk for individual spending areas is of such importance that it should be approved by the political level (i.e. by the budget/discharge authorities) in the name of the citizens of the Union;
- (d) if a scheme cannot be satisfactorily implemented at an acceptable level of cost and with tolerable risk it should be reconsidered.

1.53. Establishing an internal control framework based around these rational principles would allow control systems to be defined in terms of what they should achieve ⁽⁴⁹⁾ (output targets), as well as agreed criteria against which to judge and audit their performance.

1.54. The Court encourages the Commission to conclude its analysis on the cost of controls and on the different levels of risk inherent in the spending areas ⁽⁵⁰⁾. A realistic, transparent, rational and cost-effective approach to risk management would, in the Court's view, be to the benefit of contributors and beneficiaries alike.

⁽⁴⁹⁾ Also in terms of residual risk output targets, rather than inputs (i.e. percentage of claims to be checked) as presently (see paragraph 2.42(b)).

⁽⁵⁰⁾ A Communication on this issue is to be published by the Commission in October 2008.

1.52. *The Commission agrees with the recommendations in the Court's Opinion No 2/2004, and is implementing them within its Action Plan towards an Integrated Internal Control Framework, as presented in its progress report (COM(2008) 110 final). It is continuing its work on the costs and benefits of controls under point 10 of this Action Plan and will re-launch the debate on tolerable risk towards the end of 2008.*

(b) *It is particularly the cost of on-the-spot checks which is high.*

1.53. *The Commission will examine this idea. The current guidance in the Cohesion policy area already encourages a results-oriented approach to controls based on the recording of error rates and their variation over time, and a requirement to monitor and report error rates is mandatory in the legislation for the 2007-2013 period. In agriculture, the results of the checks required under IACS are closely monitored.*

CHAPTER 2

Commission internal control system

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THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

INTRODUCTION

2.1. This chapter reports on the Commission's progress in 2007 in improving the effectiveness of its supervisory and control systems in its Directorates-General in order to ensure the legality and regularity of transactions financed by the EU budget. In particular, it analyses the extent to which:

- (a) the management representations contained in the annual activity reports and the declarations of the Directors-General and in the Commission's Synthesis report are confirmed by the Court's audit findings (paragraphs 2.2 to 2.14);
- (b) the Commission has succeeded in increasing assurance on legality and regularity by the use of indicators, relevant materiality criteria and annual summaries (paragraphs 2.15 to 2.23);
- (c) the Commission has made progress on the implementation of internal control standards and on the integrated internal control framework, and the extent to which it has been able to demonstrate their impact on 2007 expenditure (paragraphs 2.24 to 2.36).

2.1.

- (c) *The internal control systems in place, with the limitations described in the 2007 annual activity reports, provide reasonable assurance that the resources assigned to the Commission's activities have been used for their intended purpose and in accordance with the principles of sound financial management. The control procedures put in place and the follow-up of the Court's audit findings give the necessary guarantees concerning the legality and regularity of the underlying transactions.*

The Commission is taking action to further improve its internal control system in the light of its own experience and to address issues raised by auditors. Actions taken in 2007 included the revision of the internal control standards for effective management, the continued implementation of the Action Plan towards an Integrated Internal Control Framework and revised guidelines for the annual activity reports.

The Commission is tackling issues, such as those highlighted in the reservations of the delegated authorising officers. It will explain more clearly the reasons where there are differences of opinion between the Court's annual view, required by the EC Treaty, and the managers' multiannual view, which takes into account the measures taken to detect and correct errors which occur during the year.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

AUDIT FINDINGS CONCERNING COMMISSION'S
MANAGEMENT REPRESENTATIONS**Synthesis report of the Commission**

2.2. By adopting the Synthesis Report the Commission assumes its political responsibility for the operational implementation of the budget through its Directors-General ⁽¹⁾. The Commission considers that the 'control procedures put in place give the necessary guarantees concerning the legality and regularity of the underlying transactions for which the Commission takes overall responsibility pursuant to Article 274 of the EC Treaty.'

2.3. The Commission acknowledges nevertheless that further efforts are needed to resolve a number of weaknesses, in particular those highlighted in the reservations of the delegated authorising officers and those belonging to the budget areas that were not considered satisfactory by the Court of Auditors. In this respect the Court considers that the scope of some reservations should be greater than presented by the Commission's Directors-General (paragraph 2.12 and **Table 2.1**)

2.3. *The Commission welcomes the improved assessment of the Court in table 2.1 concerning the evidence given by the Directors-General in their 2007 annual activity reports for the Court's DAS conclusions.*

The Commission considers that the scope of potential reservations was in line with the criteria it established (see reply to paragraph 2.12).

The synthesis report takes account of reservations made by the Directors-General in their 2007 annual activity reports and observations made by the Court of Auditors in the 2006 annual report. The Commission is then able to conclude that the internal control systems in place, with the limitations described in the 2007 annual activity reports, provide reasonable assurance that the resources assigned to the Commission's activities have been used for their intended purpose and in accordance with the principles of sound financial management.

⁽¹⁾ Communication from the Commission to the European Parliament, the Council and the Court of Auditors — Synthesis of the Commission's management achievements in 2007, COM(2008) 338 final, 4.6.2008.

Table 2.1 — Evolution of the evidence given by Commission Directorates-General's annual activity reports for the Court's Statement of Assurance

Policy Group ⁽¹⁾	Most important reservations of Directors-General (included in the declarations)	2005	2006	2007	Impact of these most important reservations on the Director-General's assurance in the Court's view ⁽²⁾			Other significant weaknesses revealed by the Court's audit and/or the Commission (not included in the declarations)	2005	2006	2007	Evidence given by the annual activity report for the Court's audit conclusions ⁽³⁾				
					2005	2006	2007					2005	2006	2007		
Agriculture and natural resources	— Insufficient implementation of IACS in Greece	x	x	x	}	B	B	B	}	— Management and control systems in the Member States concerning rural development	x	}	B ⁽⁵⁾ C ⁽⁶⁾	B ⁽⁵⁾ C ⁽⁶⁾	B	
	— Expenditure under Rural Development			x												
Cohesion	— ESF: management and control systems (2000/2006)	x United Kingdom	x Spain, Scotland (United Kingdom), Sweden, Slovakia, Slovenia, Latvia, Calabria and Lazio (Italy)	x Spain, United Kingdom, France, Italy, Slovakia, Portugal, Belgium and Luxembourg	}	B	B	B	}	— Risks connected with the closure of the 1994-1999 programming period and/or significant weaknesses in the implementation of Regulation (EC) No 2064/97	x	}	C	C	B	
	— ERDF: management and control systems (2000/2006)	x United Kingdom and Spain	x England and Scotland (United Kingdom)	x Czech Republic, Finland, Germany, Greece, Ireland, Italy, Luxembourg, Poland, Slovakia and Spain						— Management and control systems in the Member States (2000/2006) ⁽⁴⁾	x					x
	— Interreg: management and control systems (2000/2006)		x All programmes (except IIB North West Europe and Azores, Canaries and Madeira)	x On a total of 51 programmes												
	— Cohesion Funds: management and control systems (2000/2006)	x Greece	x Spain	x Bulgaria, Czech Republic, Slovakia, Hungary and Poland												
Research, energy and transport	— Insufficient assurance/weaknesses on management through National Agencies	x	x		}	B	B	B	}	— Error frequency for 6th Framework Programme of research ⁽⁴⁾	x	}	B	B	B	
	— Lack of evidence to determine the residual level of error with the regard to the accuracy of cost claims	x	x 6th Framework Programme	x 6th Framework Programme												
	— Error frequency (eligibility) in the cost claims for research contracts	x 5th Framework Programme	x 5th Framework Programme													

Policy Group ⁽¹⁾	Most important reservations of Directors-General (included in the declarations)	2005	2006	2007		Impact of these most important reservations on the Director-General's assurance in the Court's view ⁽²⁾			Other significant weaknesses revealed by the Court's audit and/or the Commission (not included in the declarations)	2005	2006	2007		Evidence given by the annual activity report for the Court's audit conclusions ⁽³⁾		
						2005	2006	2007						2005	2006	2007
External aid, development and enlargement	<ul style="list-style-type: none"> — Legal status and liability of contractual partner in the framework of the implementation of EU contribution to UNMIK Pillar IV in Kosovo — Phare: Potential irregularities in the management of Phare funds by certain Implementing Agencies in Bulgaria 	×		×	}	A	A	A	<ul style="list-style-type: none"> — Supervisory and control systems for the legality and regularity of underlying transactions at the level of implementing organisations need to be further improved to be fully operational 		×	×	}	B	B	B
Education and citizenship	<ul style="list-style-type: none"> — Absence of a structured <i>ex-post</i> control system and of on-the-spot controls in the DG as well as controls carried out in the representations for the major part of the year — 10 out of 12 months — Weaknesses in the management and control system of the European Refugee Fund in Italy for the programming period 2000-2004 and 2005-2007 — Limited assurance as to the underlying operations' legality and regularity implemented by 14 Member States in the framework of the European Refugee Fund II (2005-2007) — Weaknesses in the European Fund for Refugee's management and control systems 	NA ⁽¹⁾		×	}	NA	B		<ul style="list-style-type: none"> — Weaknesses in the assessment by the Commission of the <i>ex-ante</i> declarations submitted by Member States for the Lifelong Learning Programme 	NA		×	}	NA	B	
Economic and financial affairs	<ul style="list-style-type: none"> — Possibility that additionality requirements are not sufficiently met for one financial activity implemented by an external body — The rate of residual errors with regard to the accuracy of cost claims in Sixth Research Framework Programme — FP6 — Unsatisfactory functioning of the financing of European standardisation 	NA ⁽¹⁾		×	}	NA	B			NA		}	NA	A		
Administrative expenditure	<ul style="list-style-type: none"> — Implementation of internal control standards in the EU's delegations 	×	×		}	A	A	A	<ul style="list-style-type: none"> — Weaknesses in the supervisory and control systems in the EU's delegations ⁽⁴⁾ 		×		}	A	A	A

Key:

⁽¹⁾ The Court has decided to regroup the specific assessments for DAS purposes around policy groups. These correspond to the different chapters in this current Annual Report, but may not always allow a direct comparison with the data in the equivalent table in the Court's Annual Report 2006.

⁽²⁾ Impact of these most important reservations on the Director-General's declaration in the Court's view:

A: reasonable assurance that the internal control systems ensure the legality and regularity of the underlying transactions with no or insignificant qualifications.

B: reasonable assurance but with qualifications concerning identified weaknesses in the internal control system.

C: no assurance.

⁽³⁾ Evidence given by the annual activity report for the Court's audit conclusions:

A: sufficient evidence for the Court's DAS conclusions (clear and unambiguous).

B: supporting evidence for the Court's DAS conclusions after corrections.

C: no supporting evidence for the Court's DAS conclusions.

⁽⁴⁾ Although included in the annual activity reports.

⁽⁵⁾ For CAP expenditure, where IACS is properly applied.

⁽⁶⁾ For CAP expenditure, which is not subject to IACS or where IACS is not properly applied.

Source: Court of Auditors.

THE COURT'S OBSERVATIONS

2.4. For the Structural Funds, the Commission indicates that it provided aggregate figures for financial corrections made at national level through withdrawals and recoveries by Member States ⁽²⁾. However, the Commission should put more emphasis in its Synthesis Report on 'gaps and inconsistencies' in the data from the Member States. The measures intended to improve the quality of the information should therefore not be limited solely to the Commission, as stated in the Synthesis Report, but also extended to Member States (see also paragraphs 1.42, 2.31 to 2.33 and 3.26 to 3.28).

2.5. For some of the Commission's multiannual objectives its assessment is different to that made by the Court. The Commission rates, for example, its objectives of achieving an effective internal control system and of promoting accountability through Annual Activity Reports as completed. However the Court notes that although the internal control standards have been implemented, the effectiveness of a number of supervisory and control systems in preventing or detecting and correcting errors cannot yet be demonstrated (see also paragraph 2.26) and that the scope and scale of some of the reservations in the Annual Activity reports should be broader in order to fully reflect their potential impact (see paragraph 2.12).

THE COMMISSION'S REPLIES

2.4. *The annex to the 2006 annual report on the Structural Funds, to which the Synthesis Report (COM(2008) 338 final) refers, and the 2007 annual accounts acknowledge that there are gaps and inconsistencies in the data received from Member States.*

The 2007 Synthesis Report repeats the Commission's commitment (see section 3.1) to provide the European Parliament with quarterly reports on the progress in implementing its action plan to strengthen the Commission's supervisory role under shared management of structural actions (COM(2008) 97 final). These quarterly reports include information on corrections and recoveries imposed by the Commission in the area of shared management, and the second quarterly report contains information on withdrawals and recoveries by Member States reported in 2008 in relation to the previous year. The Commission's action plan includes measures aimed at improving the quality of the information provided by Member States.

See also replies to paragraphs 2.32, 2.33 and 3.26, and 3.27 to 3.28.

2.5. *The Commission's synthesis report (COM(2008) 338 final, annex 3) rated some of the initiatives to meet the objectives as being completed. This does not imply that the Commission considers that no further actions will be taken to improve the internal control systems or the annual activity reports in future. The Commission is committed to continuously improving its internal control system.*

For example in 2007 the Commission closed two specific initiatives under the objective promoting accountability through annual activity reports and a new action has been introduced which consists in promoting consistency in the treatment of reputational risks and in addressing more clearly the link between error rates, materiality and reservations.

The action concerning the annual activity reports and Synthesis has been taken. Directors-General now give a fuller explanation on their environment, on the risks faced and on the overall impact on assurance. For example, in the areas of cohesion and agriculture, the reservations made by the Directors-General in their 2007 annual activity reports were in the Commission's view in line with the materiality criteria established and covered all systems where there were material deficiencies and that the potential impact of reservations was adequately assessed.

Before signing their declarations, the Directors-General consider the effectiveness of the control framework as a whole, not just its effectiveness in preventing errors.

See also the replies to paragraphs 2.12, 2.25 and 2.26.

⁽²⁾ By referring to the annex to the report on the Structural Funds SEC(2007) 1456.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Annual Activity Reports and Declarations by Directors-General

2.6. In its examination of annual activity reports and the declarations of the Directors-General, the Court has assessed the extent to which they present a fair picture (i.e. with no significant distortions) of the effectiveness of the procedures in place. In particular, whether supervisory and control systems generate the necessary assurance in so far as the legality and regularity of the underlying operations are concerned.

2.7. A review was carried out on all annual activity reports, complemented by an in-depth analysis on those of 15 Directorates-General.

Process of preparation

2.8. The guidance⁽³⁾ for the 2007 annual activity reports emphasised the need expressed by the central services of the Commission to clarify the link between the effectiveness of internal control systems and the basis on which the declarations are built. In practice, most Directors-General explained in detail the 'building blocks' or key elements on which they have based their assurance.

Declarations by the Directors-General

2.9. All the Directors-General stated that they had obtained reasonable assurance that the resources allocated to them had been used for the specified purposes and that the internal controls which they had introduced ensured the legality and regularity of the underlying transactions, in a number of cases subject to reservations. The Court assessed the basis for these statements by comparing their coverage and impact with the results of the Court's own audit.

⁽³⁾ Note from the Commission's central services (SEC GEN, DG BUDG and DG ADMIN) to Directors-General and Heads of Service — Standing instructions for the preparation of the annual activity reports for the year 2007, SEC(2007) 1645 of 12.12.2007.

THE COURT'S OBSERVATIONS

2.10. Out of the 40 declarations for 2007, 13 ⁽⁴⁾ contain one or more reservations, the majority of which refer to weaknesses concerning the legality and regularity of the underlying transactions. The total number of reservations fell from 20 (2006) to 17 (2007), although their combined financial impact increased.

2.11. For Directorates-General for Regional policy and for Employment, Social Affairs and Equal Opportunities the total estimated financial quantification of the impact of their reservations increased from approximately 140 million euro in 2006 to nearly 725 million euro in 2007 ⁽⁵⁾. For the Directorate-General for Agriculture and Rural Development the new reservation for 2007 on Rural Development expenditure is based on information from Member States which shows an error rate in excess of 3 %. However, this information had not been validated by the certification bodies or accepted by the Directorate-General. The most significant reservations in the context of the legality and regularity of underlying transactions are shown in **Table 2.1**.

2.12. The table shows that the annual activity reports provide clear and unambiguous evidence for the Court's DAS conclusions for administrative expenditure and for economic and financial affairs only. For most policy areas the annual activity reports are closer to the conclusions of the relevant DAS specific assessment than in previous years, particularly in the case of agriculture and cohesion policies. The Court notes, however, that the scope and scale of these reservations should be broader in order to fully reflect their potential impact and, for a number of policy areas the Directors-General still arrive at a more positive conclusion on the legality and regularity of EU spending than the Court's own audit findings.

⁽⁴⁾ Directorates-General AGRI, REGIO, EMPL, RTD, INFSO, ENTR, TREN, ENV, JLS, ECFIN, ELARG, COMM and DIGIT.

⁽⁵⁾ The overall amount of payments relating to the systems at risk is 10 200 million euro (approximately 28 % of cohesion expenditure). The Directorates-General quantified the impact of these reservations at 726 million euro (2006-140 million euro) on the basis of an estimated 5 or 10 % flat-rate correction.

THE COMMISSION'S REPLIES

2.11. *The annual activity reports of the Directorates-General for Regional Policy, and for Employment, Social Affairs and Equal Opportunities set out both the amounts at risk, namely the payments relating to the systems affected by deficiencies, and the quantification of the financial impact. The latter is made by reference to scales of flat rate corrections for deficiencies in the management and control systems. The Commission considers that this approach gives a fair assessment of the potential financial impact of deficiencies detected.*

The reservation for 2007 on Rural Development expenditure was based on information made available by the Member States by 31 March 2008 as well as audit results of the Court.

For the 2008 budget, the Commission is expecting to have validated information from Member States before the end of March 2009.

2.12. *While the Court expresses an annual audit opinion on the legality and regularity of the underlying transactions (as required by the EC Treaty), the opinion of the Directors-General focuses on whether funds have been used for their intended purpose, taking account of the multi-annual nature of controls, and their effectiveness in detecting and correcting errors. Directors-General express a management opinion based on information which includes the Commission's own audit work, reports and observations of the Court of Auditors and, where relevant, the results of Member States' controls.*

As already mentioned under the replies to paragraphs 2.3 and 2.5, the Commission considers that the reservations made by the Directors-General in their 2007 annual activity reports or the absence of reservations were in line with the materiality criteria established and covered all systems where there were material deficiencies, and that the potential impact of reservations was adequately assessed.

Before signing their declarations the Directors-General consider the effectiveness of the control framework as a whole, not just its effectiveness in preventing errors.

THE COURT'S OBSERVATIONS

2.13. As regards the policy area Education and Citizenship, the assurance provided by the Directors-General is not compatible in some significant respects with the Court's findings. The Court found significant weaknesses in the *ex-ante* declaration procedures under the responsibility of Directorate-General for Education and Culture (see paragraphs 9.17 and 9.25), however these weaknesses are not shown as a reservation of the Director-General. For the Directorate-General for Communication there is a reservation on the lack of structured *ex-post* controls, but the Court also finds that there are significant weaknesses in *ex-ante* controls (see paragraphs 9.23 and 9.25).

2.14. In the policy area External Aid, Development and Enlargement the Court finds that underlying transactions are affected by a material level of error of legality and/or regularity mostly within transactions managed by implementing organisations (see paragraph 8.31) and that the supervisory and control systems are partially effective (see paragraph 8.32). These findings are not adequately reflected by the Directors-General in their reservations.

THE COMMISSION'S REPLIES

2.13. *The Directorate-General for Education and Culture (DG EAC) has based its assurance on a comprehensive set of controls and not only on the procedure of assessing the ex-ante declaration.*

The management and control system provided for in the legal basis of the Lifelong Learning Programme 2007-2013 improves the 2000-2006 system taking account of the Court's recommendation. The Commission controls in earlier years contributed, together with those undertaken in 2007, to DG EAC's conclusion that control systems provide reasonable assurance, though significant improvements are needed in the application of the control system at the level of checks by the national authorities.

Furthermore, the results of the ex-post controls carried out by DG EAC, as presented in its annual activity report 2007, do not identify a material level of error.

In relation to the system as a whole, the Directorate-General for Communication had already entered a reservation in its annual activity report because of the lack of supervision, and had adopted the necessary measures to improve matters, starting with the establishment on 1 November 2007 of a monitoring unit which now incorporates the second level ex-ante control.

See also replies to paragraphs 9.17, 9.20, 9.23 and 9.24.

2.14. *The Court concludes on materiality against a sample of transactions which cuts across several Directorates-General. Yet each Director-General can conclude and report on materiality only for his own area.*

Having examined the errors detected by the Court and taking into account future possible corrections, notably as a result of mandatory audits, the Commission considers that the residual risk of error is not material.

The errors detected by the Court mostly concern expenditure made by the organisations implementing the projects on advance payments made by the Commission. Mandatory financial audits foreseen under the Commission's control system before the final payments should allow the Commission to detect and correct such errors. The Commission considers the residual risk of error to be sufficiently mitigated.

The Commission is however committed to further improving its systems and additional measures to further reinforce controls at the level of implementing organisations were taken in 2007, including revised terms of reference for audits of projects.

See also the reply to paragraph 8.31.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Legality and regularity indicators

2.15. The Commission has placed particular emphasis on providing regularity indicators in the 2007 Annual Activity Reports ⁽⁶⁾. Most Directors-General have used the indicative internal control templates to show how relevant legal, regulatory and contractual provisions have been complied with and how these could be connected with reasonable assurance ⁽⁷⁾. For one Directorate-General, however, the basic data used is not reliable and/or the link with legality and regularity is not clearly established ⁽⁸⁾. Almost all Directors-General have not included comparable indicators for previous years nor set legality or regularity targets ⁽⁹⁾.

2.15. *The Commission developed several internal control templates aimed at presenting the control strategies in a harmonised way, but adapted to different management issues or modes. Legality and regularity indicators, aimed at facilitating the monitoring and reporting on legality and regularity of transactions, became mandatory for the 2007 annual activity reports. The Commission considers that this constitutes an important first step but recognises that some improvement will have to be made in terms of reliability and clarity of the indicators. They need to be fully and easily used for follow-up and monitoring purposes.*

Assurance drawn from Annual Summaries

2.16. Article 53b(3) of the revised financial regulation ⁽¹⁰⁾ provides that: 'Member States shall produce an annual summary at the appropriate national level of the available audits and declaration' ⁽¹¹⁾. According to the instructions of the Commission's Central services, the Directors-General should present a preliminary assessment of the assurance gained from the annual summaries in the 2007 annual activity reports ⁽¹²⁾.

⁽⁶⁾ See the Annual Report concerning the financial year 2006, paragraph 2.37(a).

⁽⁷⁾ SEC(2007) 1645 of 12.12.2007. The use of such templates is obligatory although may be adapted to the specific situation of the DG/Service establishing the AAR.

⁽⁸⁾ For example, in DG TRADE, indicators on commitment rates for operational and administrative appropriations are given without a clear interpretation of their relevance.

⁽⁹⁾ Nor do they always indicate in their Annual Management Plans legality and regularity targets to be met in the future and demonstrated by indicators in the Annual Activity Reports for 2008.

⁽¹⁰⁾ Council Regulation (EC, Euratom) No 1995/2006 of 13 December 2006, amending Regulation (EC, Euratom) No 1605/2002 on the Financial Regulation applicable to the General Budget of the European Communities (OJ L 390, 30.12.2006).

⁽¹¹⁾ Applicable for the first time in 2008 and covering certified expenditure and audit activity for 2007.

⁽¹²⁾ SEC(2007) 1645 of 12.12.2007, p. 12.

THE COURT'S OBSERVATIONS

2.17. The Court has previously recognised that annual summaries are an additional element of internal control and has encouraged the Commission to add value to the process by identifying common problems, possible solutions and best practices and using this information in its supervisory role ⁽¹³⁾.

2.18. The Court's audit showed that as at 31 March 2008, 25 of the 27 Member States had submitted an annual summary. Of this 25, a total of eight Member States did not comply with the minimum requirements of the Financial Regulation and the Implementing Rules ⁽¹⁴⁾ and a further 12 Member States only partially. In addition, only 15 of these 25 Member States provided a statement on the completeness and accuracy of the information provided of which two related to the 2007-2013 programming period for which only advances had been paid with little attendant risk.

2.19. The disparity of presentation and the frequent absence of a statement on the completeness and accuracy of the underlying data have meant that the annual summaries do not yet provide a reliable assessment of the functioning and effectiveness of the supervisory and control systems.

2.20. The Court considers that, for this first year of annual summaries, the Commission has adequately supervised the process both by issuing clear guidelines and by pursuing the reasons for non-compliance with deadlines and criteria for scope or quality.

THE COMMISSION'S REPLIES

2.18. *The Commission welcomes the Court's conclusion that the Commission adequately supervised the annual summary process by issuing clear guidelines and pursuing non-compliance promptly.*

The Commission has taken appropriate steps to follow up all cases of non-compliance with the minimum requirements and issues concerning the quality of the submissions.

An infringement procedure has been launched against the Member State which failed to submit an annual declaration in line with the requirements of the regulation.

2.19. *Overall the outcome of the first round of annual summaries has been positive in that almost all Member States finally complied with the requirements and the Commission considers this provides a good basis for improving the quality of the summaries for the next round. The Commission will present a revised guidance note to Member States with recommendations aimed at obtaining a higher quality of their annual summaries for 2008.*

⁽¹³⁾ Opinion of the Court No 6/2007 on the annual summaries of Member States; 'national declarations' of Member States; and audit work on EU funds of national audit bodies (OJ C 216, 14.9.2007, p. 3).

⁽¹⁴⁾ In terms of scope or appropriateness of administrative level.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Materiality criteria and criteria for defining reservations

2.21. Most Directorates-General have established materiality criteria ⁽¹⁵⁾ in line with Commission guidelines and have adapted them to their particular management modes, their internal control environment and control systems in Member States ⁽¹⁶⁾.

2.22. Following a recommendation of the Court in its Annual Report 2006 ⁽¹⁷⁾ the four main Directorates-General responsible for the implementation of the EU budget under shared management arrangements ⁽¹⁸⁾ have reviewed the method for assessing the functioning of the management and control systems for structural actions in Member States. The Directors-General now consider all programmes or systems for which an adverse audit opinion has been issued by an appropriate body as containing, 'significant deficiencies', unless there is reliable audit evidence, from a different source, to the contrary ⁽¹⁹⁾.

2.23. One Directorate-General applied materiality thresholds which are not compatible with the other information and assurance given elsewhere in its Annual Activity Report ⁽²⁰⁾.

2.23. *The central services of the Commission have committed themselves in the Synthesis Report to providing further guidance to the Directorates-General to address more clearly the link between the error rates, materiality and reservations.*

However, for the case evoked in footnote 20, the expenditure concerned was particularly immaterial to the Commission's operations as a whole, and the approach taken is consistent with the principle that Directorates-General must find a balance between costs and benefits when setting up their control systems. This is compatible with other statements as to the high level of assurance.

⁽¹⁵⁾ Defines the circumstances the non-respect of which means that a weakness or series of weaknesses is considered significant enough to warrant a reservation.

⁽¹⁶⁾ 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 21.1.2003) et seq.

⁽¹⁷⁾ See paragraphs 2.35 and 2.37(a).

⁽¹⁸⁾ DGs AGRI (for EAGGF Guidance expenditure), EMPL, REGIO and MARE.

⁽¹⁹⁾ In the area of agriculture (EAGF and EAFRD) the materiality criteria used was the level of errors detected at the level of final beneficiaries and as a complementary criterion, the estimated financial risk of significant deficiencies in management and control systems.

⁽²⁰⁾ DG DGT set a materiality level of 5 %. This is in spite of a budget for 2007 of non-differentiated appropriations of around 17 million euro spent entirely by direct central management and the Director General's opinion that the internal control system in place provides reasonable assurance regarding the legality and regularity of transactions and is moreover, 'sufficiently robust and effective in preventing/detecting/correcting errors.' (Annual activity report 2007, DG DGT, p. 25).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

COMMISSION'S INTERNAL CONTROL STANDARDS

2.24. The Court examined the application of selected internal control standards (ICS) by a number of the Commission's services. The examination aimed to assess not only the degree of implementation of the minimum requirements (baselines), but also to evaluate the effectiveness of the systems ensuring the legality and regularity of underlying transactions. The latter is particularly important for 2007 as it enables conclusions to be drawn about the success of the Commission's efforts in this field before the general revision of the standards effective as from 2008.

2.24. The Commission is aiming to show that the implementation of the standards is effectively contributing to management assurance. This principle underlies the 2007 revision of the internal control standards (effective from 2008).

Compliance with baseline requirements

2.25. The Court's assessment of the implementation of the internal control standards for the 2007 financial year shows that the Directorates-General comply on average with 96 % (2006, 95 %) of the baseline requirements (see **Table 2.2**). The Commission has thus implemented ICSs to a consistently high degree since 2004.

2.25. The Commission adopted its internal control standards in the year 2000 as part of the reform launched that year. The standards and their associated minimum requirements were intended to enable the maturity of the Commission's internal control systems to be measured. The success of this approach is demonstrated by the consistently high level of compliance reported both by the services and by the Court in recent years.

Effectiveness at the end of 2007

2.26. Despite this achievement the Commission has been unable to comprehensively demonstrate for 2007 that supervisory and control systems are sufficiently effective in mitigating the risk of error in certain policy areas such as Agriculture and Natural Resources (paragraph 5.51), Cohesion (paragraph 6.32) ⁽²¹⁾, Research, Energy and Transport (paragraph 7.41), External Aid, Development and Enlargement (paragraph 8.32) and Education and Citizenship (paragraph 9.25).

2.26. The Commission acknowledges that measures have to be taken in order to increase the effectiveness of the internal control and supervisory systems for certain policy areas. This is a continuing process and involves the further improvement of control systems including all control levels.

See also replies to paragraphs 5.51, 6.33, 7.42, 8.31 and 9.25.

⁽²¹⁾ A finding echoed by the Commission's Internal Audit Service report on 'Preventing and Detection of fraud in the Structural Funds', 19 December 2007. The Court also notes, however, the potential mitigating effect of the actions outlined in the Communication from the Commission to the European Parliament, the Council and the Court of Auditors, 'An action plan to strengthen the Commission's supervisory role under shared management of structural actions', COM(2008) 97 final of 19.2.2008.

Table 2.2 — The Court's analysis of the implementation of internal control standards (with a direct link to the legality and regularity of underlying transactions) for selected Directorates-General (Situation as at 31.12.2007)

Directorate-General or Service	Standard 11 'Risk analysis and management'		Standard 12 'Adequate management information'		Standard 14 'Reporting improprieties'		Standard 17 'Supervision'		Standard 18 'Recording exceptions'		Standard 20 'Recording and correction of internal control weaknesses'		Standard 21 'Audit Reports'		Standard 22 'Internal audit capability'	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
General Services																
Publications Office	A	A	A	A	A	A	B	A	A	A	A	A	A	A	A	A
Policies																
Agriculture and Rural Development	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Economic and Financial Affairs	B	A	B	A	A	A	A	A	A	A	A	A	A	A	A	A
Employment, Social Affairs and Equal Opportunities	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Energy and Transport	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Maritime Affairs and Fisheries	B	A	A	A	A	A	A	A	A	A	A	A	A	A	A	B
Information Society and Media	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Regional Policy	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Research	B	A	B	B	A	A	B	A	A	A	A	A	A	A	A	A
External Relations																
Enlargement	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
EuropeAid	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
External Relations	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Humanitarian Aid	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Internal Relations																
Budget	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Office for Administration and Payment of Individual Entitlements	B	B	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Office for Infrastructures and Logistics in Brussels	A	A	A	A	A	A	A	B	A	A	A	A	A	A	A	A
Office for Infrastructures and Logistics in Luxembourg	B	B	A	A	A	A	B	B	A	A	A	A	A	A	A	A

Partial compliance was also noted for 2007 for the following: ICS 11 for Europe Aid, DGs EAC, DEV and ENTR, ICS 12 for DG TAXUD and BEPA and ICS 18 DGs ENV and SANCO.

Assessment:

Compliance

A: Compliance with baseline requirements.

B: Partial compliance with baseline requirements.

Source: Court of Auditors.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Effectiveness and the transition to the revised standards

2.27. In 2007 the Commission decided to replace the current ICS structure by basic principles and by more detailed related requirements corresponding essentially to the former ICS and baseline requirements ⁽²²⁾. An analysis of the eight ICS relevant for the Court's assessment in 2007 reveals no material changes in their new format.

2.28. One of the components of the revised ICSs is the Internal Control Effectiveness Assessment whereby Commission services are required to judge and demonstrate the effectiveness of their internal control systems in practice. This will be based on a prioritisation of certain standards and an annual risk assessment by management. However, as the ICSs are interdependent and together form a control framework, the Commission must also be in a position to demonstrate each year the effectiveness of the internal control system as a whole.

ACTION PLAN

General assessment

2.29. December 2007 marked the end of the two year period set by the Commission for the implementation of its Action Plan towards an Integrated Internal Control Framework ⁽²³⁾. The Commission's summary report for 2007 ⁽²⁴⁾ provides a confident assessment of progress made in the implementation of the actions at this date, whilst indicating that the evidence of the effectiveness of the actions in terms of reducing the level of error in the underlying transactions may still be some way off.

⁽²²⁾ Communication to the Commission, 'Revision of the Internal Control Standards and Underlying Framework — Strengthening Control Effectiveness', SEC (2007) 1341 of 16.10.2007.

⁽²³⁾ COM(2007) 86 final, p. 11.

⁽²⁴⁾ Communication from the Commission to the European Parliament, the Council and the European Court of Auditors. Report on the Commission Action Plan towards an Integrated Internal Control Framework, COM(2008) 110 final, {SEC(2008) 259}, of 27.2.2008.

2.27. *The aim of the revision of the standards was to clarify and simplify their implementation: the new standards cover the same areas but use a language more accessible to all staff. The new framework also removed overlaps between the previous standards and emphasises the effectiveness of the control systems.*

See also reply to paragraph 2.28.

2.28. *The requirement to report on effectiveness operates at two levels:*

- *showing that the standards themselves (covering financial and non-financial issues) are effectively implemented within Commission services; and*
- *showing that the systems in place within the Commission are effectively managing the risk of error in the underlying transactions, which is subject of this observation.*

The implementation of selected priority standards within each service will be reported in the 2008 annual activity reports, as the requirement goes beyond pure compliance. The effectiveness of the internal control system as a whole to guarantee the legality and regularity of underlying transactions is the subject of the Delegated Authorising Officers' declarations, introduced with the annual activity reports in the year 2001.

2.29. *The Action Plan aims to addressing specific gaps in the internal control framework. The 16 actions were intended to be implemented over a two year period to 31 December 2007. This objective was largely achieved (the remaining actions are planned to be completed by the end of 2008).*

The implementation of the actions should be distinguished from the impact these will have (see Commission Communication of 27 February 2008 ⁽¹⁾: '...Reduction of errors and increase in assurance will only build over time as the actions taken begin to have an impact on underlying control systems'). The Commission has committed itself to publishing an annual impact report covering the different actions.

⁽¹⁾ COM(2008) 110 final: Report on the Commission Action Plan towards an Integrated Internal Control Framework.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Assessment by action***Implementation of actions has progressed ...***

2.30. On the basis of the Court's analysis (see **Table 2.3**), the Commission has made progress in the implementation of its Action Plan in 2007. Overall, at the end of 2007 a total of 21 (2006-2007) sub-actions have been implemented and 14 (2006-2019) remain in various stages of progress.

2.30. *The Court's analysis largely confirms the Commission's own analysis in its progress report of 27 February 2008 (COM(2008) 110 final). The implementation of the actions is a continuing process and is being pursued vigorously. The impact of the actions is necessarily posterior to their implementation over the years 2006 and 2007. A first impact report will be made in early 2009.*

Action 1 must necessarily be treated as completed, as the 2007-2013 rules are now largely adopted. Some simplification was achieved, notably in the areas of structural fund programming and in the acceptance of lump-sum reimbursements in several policy areas.

On action 7c (Extend criteria for certification audits, focusing on the use of 'agreed-upon procedures', to other management modes), the Commission underlines that this is in progress. Agreed upon procedures are used in external aid and their use is being considered for education and culture.

For action 8N (contact with the Supreme Audit Institutions (SAIs) to determine how their work can be used to provide assurance and the launch of a case study on the key issues faced by SAIs in examining Community expenditure) the work planned under the action plan is almost completed as reported by the Commission. Contact with several SAIs has been pursued, including with those Member States providing a national declaration. A case study with the Slovenian SAI has led to considerable improvements in the financial reports provided by the Commission to all national SAIs.

On Action 12 (Put in place steps to close gaps in the internal control framework via the annual management plans and annual activity reports) the Commission considers this implemented as Directorates-General are required to analyse their risks as part of the annual management plan process and report on the effectiveness of their internal control systems via the annual activity reports. While such analysis and reporting is an ongoing responsibility of management, the Commission considers that the gaps identified in the action plan are being addressed through the standard reporting processes.

Table 2.3 — Overview of the implementation of the Commission’s action plan towards an integrated internal control framework

Reference	Domain/(sub-)actions/deadline set in the action plan	Assessment of the completion by the Commission as at 31.12.2007	Court’s assessment of the stage of implementation as at 31.12.2007	Commission’s assessment of the impact achieved (February 2008) (1)	Court’s preliminary assessment of the impact achieved as at 31.12.2007 (2)
Simplification and common control principles (Actions 1-4)					
1	Keep under consideration simplification of the rules for the 2007-2013 period concerning in particular the eligibility of expenditure in the structural funds and in the research programmes (31.12.2006).	Completed	Completed	■□□□□	Not measurable
2	Propose internal control as budgetary principle in the revised Financial Regulation on the basis of the results of the interinstitutional consultation (1.6.2006).	Withdrawn	Not implemented	—	—
3a	Establish Internal Control Templates which outline the range of control components which would be expected in a given control environment (31.5.2006).	Completed	Implemented	■■□□□	Not measurable
3b	Demonstrate how Directorates-General will gain assurance on the internal control structures for shared management and internal policies, taking the developed templates and control strategies at Commission-level into account (30.9.2006).	Completed	Implemented		
3c	Organise peer review to enhance coherence and consistency of control strategies per family (31.3.2007).	Completed	Implemented		
3d	Demonstrate how Directorates-General will gain assurance on the internal control structures for external policy, administrative expenditure, pre-accession aid, EDF and own resources, taking the developed templates and control strategies at Commission-level into account (31.12.2007).	Completed	Implemented		
3e	Organise peer review to enhance coherence and consistency of control strategies per family (31.12.2007).	Completed	Implemented		
3N	As from Synthesis Report 2006, the Commission will clearly set out and communicate to the budgetary authority reservations to the global assurance, including where relevant by sector or Member State, together with the corresponding financial corrections or suspensions of payments (31.12.2007).	Completed	Implemented	■□□□□	Not measurable
4	Launch interinstitutional initiative on the basic principles to be considered regarding the risks to be tolerated in the underlying transactions and the definition of common benchmarks for the management of this risk (31.3.2006).	Withdrawn	Not implemented	—	—
Management declarations and audit assurance (Actions 5-8)					
5	Promote the use of management declarations at operational level in the negotiations on the 2007-2013 legislation for indirect centralised management and the establishment of national coordinating bodies able to provide an overview of the assurance available for example by a synthesis of operational declarations per policy area (30.6.2006).	Completed	Implemented	■■□□□	Not measurable
6a	Develop guidelines on making management declarations more effective in research and other internal policies (30.9.2006).	Combined with action 7	—	—	—

Reference	Domain/(sub-)actions/deadline set in the action plan	Assessment of the completion by the Commission as at 31.12.2007	Court's assessment of the stage of implementation as at 31.12.2007	Commission's assessment of the impact achieved (February 2008) ⁽¹⁾	Court's preliminary assessment of the impact achieved as at 31.12.2007 ⁽²⁾
6b	Extend guidelines on making management declarations more effective for external policies (31.12.2007).	Withdrawn	Withdrawn	—	—
7a	Establish criteria for certification audits in research and internal policies, focusing on the use of 'agreed-upon procedures' (31.12.2006).	Completed	Implemented	□□□□□	Not measurable
7b	Examine criteria, where these are not already in place, for certification audits in shared management 2007-2013, considering also the use of 'agreed-upon procedures' (31.3.2007).	Withdrawn	Withdrawn	—	—
7c	Extend criteria for certification audits, focusing on the use of 'agreed-upon procedures', to other management modes, where appropriate (31.12.2007).	In progress	Being implemented	□□□□□	Not measurable
8	Analysis of potential additional assurance from SAIs on existing practice related to EU funds (31.12.2006).	Completed	Implemented		
8N	To build on the momentum created by this action, the Commission will pursue contact with the SAIs with a view to determining how their work can be used to provide assurance on the execution of its programmes in the Member States. It will also launch a case study on the key issues faced by SAIs in examining EU expenditure (31.12.2007).	Almost completed	Being implemented	■□□□□	Not measurable
Single audit approach: sharing of results and prioritising cost-benefit (Actions 9-11)					
9a.1	Assess potential actions necessary for enhancing the sharing of audit and control results and recording of their follow-up in the area of internal policies, including research (31.12.2006).	Completed	Implemented		
9a.1N	To oversee the initial stages of data-sharing in ABAC, the Commission will, for the Sixth Framework Programme, monitor the use of data sharing and management reporting with a view to identifying key factors for success in better integrating the sharing of data in the overall control process (31.12.2007).	Completed	Being implemented		
9a.2	Assess potential actions necessary for enhancing the sharing of audit and control results and recording of their follow-up in the area of structural funds 2007-2013 (31.5.2007).	Almost completed	Being implemented	■□□□□	Not measurable
9a.3	Assess potential actions necessary for enhancing the sharing of audit and control results and recording of their follow-up in the area of other policies (31.12.2007).	See under sub-action 9b	See under sub-action 9b		
9b	For expenditure under direct management, implement a tool linked to ABAC for a Commission-wide exchange of information on control and audit missions on all legal entities (31.12.2007).	Completed	Implemented		
9c	Award tender for a Commission-wide contractual framework to assist Directorates-General on methodological issues, implementation of control work and tracking control performance (30.4.2007).	Completed	Implemented		

Reference	Domain/(sub-)actions/deadline set in the action plan	Assessment of the completion by the Commission as at 31.12.2007	Court's assessment of the stage of implementation as at 31.12.2007	Commission's assessment of the impact achieved (February 2008) (1)	Court's preliminary assessment of the impact achieved as at 31.12.2007 (2)
10a.1	Assess costs of controls in shared management: define a common methodology (31.5.2006).	Completed	Implemented	■□□□□	Not measurable
10a.2	Assess costs of controls in shared management: launch initiative for data to be provided by Member States (30.9.2006).	Completed	Implemented		
10a.3	Assess costs of controls in shared management: provision of data by Member States (28.2.2007).	Almost completed	Being implemented		
10a.4	Assess costs of controls in shared management: analysis of received information (30.9.2007).	Almost completed	Being implemented		
10b	Make a first estimation on the costs of control incurred in direct management expenditure (30.6.2007).	Completed	Implemented		
10N	To further explore the cost-benefit ratio of control, the Commission will examine the effect of programme design and eligibility requirements on costs of control to develop a detailed analysis of tolerable risk on a practical basis (31.12.2007).	Mostly completed	Being implemented		
11	Run a pilot-exercise for evaluating benefits in the context of control of internal policies (30.6.2007).	Almost completed	Being implemented		
11N	To determine whether recovery and offsetting systems are working effectively, by identifying amounts recovered in 2005 and 2006 and their coherence with errors identified during controls the Commission will, in direct management, develop a typology of error and the relationship with recoveries, financial corrections and adjustments to payments and for shared management it will examine the reliability of national monitoring and reporting systems (31.12.2007).	Mostly completed	Being implemented	□□□□□	Not measurable
Sector specific gaps (Actions 12-16)					
12	Put in place steps to close these gaps via the annual management plans, with follow-up reporting on progress in the annual activity reports (15.6.2007).	Completed	In progress of implementation		
12N	To ensure effective delivery of added assurance, the Commission will perform 300 audits for FP6 in 2007, compared with the 45 carried out in 2006. In addition, having developed a systematic approach to analysing and sampling the FP6 beneficiary population as part of action 16b, the Commission will proceed with the identification and correction of errors in beneficiaries receiving the most significant proportion of the budget. This will also provide, by the end of 2007, a representative picture of the level and nature of irregularities in the research budget as a whole (31.12.2007).	Completed	Implemented	■□□□□	Not measurable
13.1	Finalise, as requested by Ecofin, the analysis for structural funds on the present controls at sector and regional level and the value of existing statements and declarations, taking the article 13 annual reports due by June 2006 and the results of Commission audits into account (31.3.2007).	Completed	Implemented	■□□□□	Not measurable
13.2	Update, in the context of the annual activity reports, how Directorates-General gain assurance from the internal control structures for structural funds and agriculture for the 2007-2013 period (31.12.2007).	Completed	Being implemented		

Reference	Domain/(sub-)actions/deadline set in the action plan	Assessment of the completion by the Commission as at 31.12.2007	Court's assessment of the stage of implementation as at 31.12.2007	Commission's assessment of the impact achieved (February 2008) ⁽¹⁾	Court's preliminary assessment of the impact achieved as at 31.12.2007 ⁽²⁾
14a	Disseminate good practices for primary level checks to manage the risk of error in underlying transactions and recommend Member States to step up their information activities directed at beneficiaries, including information on controls and risk of cancellation of funds (30.6.2006).	Completed	Implemented	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	Not measurable
14b	Provide in the context of the structural funds and indirect centralised management 2007-2013 guidelines for beneficiaries and/or intermediate levels on controls and responsibilities in the control chain (31.12.2007).	Almost completed	Being implemented		
15	Conclude for structural funds 'contracts of confidence' with eight Member States, if sufficient volunteers, as a sound basis to prepare for implementation of the new legislation and to improve assurance on expenditure under the existing legislation (31.12.2007).	Almost completed	Being implemented	<input checked="" type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	Not measurable
16a	Establish guidelines, based on existing experience, on accreditation, training and monitoring of external auditors in the domain of research and other internal policies (30.6.2007).	Completed	Implemented		
16b	Develop common approaches to using risk and representative sampling in research and other internal policies, and external policies (31.12.2007).	Completed	Implemented	<input checked="" type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	Not measurable
16c	Coordinate audit standards, error rate reporting, etc. for structural funds (31.12.2007).	Almost completed	Being implemented		

⁽¹⁾ Based on a Commission grading system of 1 to 5 filled boxes.

⁽²⁾ The Commission also states that the impact of the various (sub-)measures on the reduction of errors or the increase in assurance will only build over time as they begin to have an impact on the underlying control systems.

Source: Court of Auditors.

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... with one notable exception

2.31. In March 2007 sub-action 11N was introduced aiming at assessing whether recovery and off-setting systems were working effectively, by identifying amounts recovered in both 2005 and 2006 and their coherence with errors identified during controls.

2.32. Despite considerable efforts, the Commission was not able to present complete and reliable figures for 2005 and 2006. Moreover, the Commission was not able to demonstrate that the figures eventually presented related to the years in question, took into account all recoveries initiated by Member States and could be reconciled transparently to published financial statements.

2.33. The Commission's initiative to record in the central financial and accounting system complete data on recoveries by the Commission as from 2008 is a positive development. The Court notes, however, that this opportunity has been lost for 2007.

First assessment of the impact of the Action Plan

2.34. The Commission has made a first assessment of the impact of the action plan as at February 2008 ⁽²⁵⁾. Overall, it rates the actions as beginning to show an impact with smaller variations noticeable between individual sub-actions (see **Table 2.3**). To increase transparency the Commission should clarify the basis for its impact assessment.

2.32. Chapter 6 of the notes to the annual accounts for 2007 gives the best estimate of recoveries (see also reply to paragraph 3.29). In the area of cohesion policy, the Commission publishes figures for financial corrections which result from its own control activity. Improvements have already been achieved as regards the reliability of this data. It is taking steps to improve the reporting by Member States of the corrections following their control activity to ensure its future completeness.

2.33. The cost of retroactively updating all credit note records and recovery order records for 2007 was considered prohibitive.

2.34. From 2009, the emphasis of reporting will shift from implementation towards impact measurement. The Commission will provide more information on the assessed impact of each action in its first impact report in early 2009 with reference to specific impact indicators for each action. The Commission can however already demonstrate real impact on some actions, for example:

- (for action 3) the internal control templates and the enhanced peer review process, along with clearer guidelines to Directorates-General, has led to a measurable improvement in the annual activity reports, as shown in the Court's Table 2.1;
- (for action 8N) the case study has led to improvements in the reports provided to Supreme Audit Institutions which has in turn led to more SAIs making use of these in their work;
- (for action 12) the audit strategy for Research Framework Programme 6 has been recognised by the Court as 'likely to contribute to more effective operation of this [ex post] control'.

⁽²⁵⁾ COM(2008) 110 final, p. 2.

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2.35. Whilst the Court recognises that a large part of the Action Plan has been implemented it does not find evidence for an improvement which is directly and measurably linked to the actions especially those related to the legality and regularity of transactions. To the extent that the impact can be objectively measurable, the Court considers that this can only be assessed over a longer time frame.

2.36. The Court notes that the Commission intends to present a first annual report in early 2009 on the impact of the Action Plan.

OVERALL CONCLUSIONS AND RECOMMENDATIONS

Conclusions

2.37. For 2007, the Court has identified further progress in the Commission's supervisory and control systems, in particular, the improvement of the process of preparation of the annual activity reports and declarations (paragraph 2.8), the impact of the relevant reservations on the assurance given in the Directors-General declarations (paragraphs 2.10 to 2.11) and a move towards greater consistency with the conclusions of the DAS specific assessments (paragraph 2.12).

2.38. The Court's audits however identified for some annual activity reports and declarations continuing weaknesses in the scope and scale of reservation and in the assessment and functioning of the supervisory and control systems (paragraphs 2.13 to 2.14).

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2.35. Any simplification of the rules, and all improvement to the Commission's controls, will take time to have an effect on the prevention of errors. Furthermore, many measures concern ex-post controls, and the recovery of errors in years after they have occurred. The Commission agrees with the Court's view that impact can only be assessed over a longer time frame as set out in the Commission's February 2008 report on the Action Plan (COM(2008) 110 final); see also response to paragraph 2.29.

Certain of the actions within the action plan will also be taken further as part of the Commission Action Plan to improve its supervision of the Member States with regard to the Structural Funds.

2.37. The Commission welcomes the progress identified by the Court and is committed to continuing its efforts. For example, the internal process of 'peer review' examination before the finalisation of the annual activity reports helped ensure the consistency and robustness of the reports. This process will be further enhanced for the 2008 annual activity reports, as announced in the Synthesis Report.

2.38. The Commission has instructed its services to take vigorous action to address the causes of reservations in the 2007 Annual Activity Reports and will closely monitor progress, with special attention to recurring reservations. During 2008, further guidance will be provided to services to promote consistency in the treatment of reputational risks and the link between error rates, materiality and reservations.

The Directors-General assess the functioning of the control framework as a whole, not just its effectiveness in preventing errors. They take into account the measures aimed at detecting and correcting errors, and pay due regard to the costs and benefits of controls, in particular regarding on-the-spot checks. Several measures were taken by the Commission so

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2.39. The Commission has been able to demonstrate a consistently high degree of implementation of internal control standards since 2004 (see paragraph 2.25) and by the end of 2007, had implemented more than two thirds of the sub-actions in its action plan towards an integrated internal control framework (paragraph 2.30).

2.40. However, the Court notes that the Commission is not able to demonstrate that its actions to improve supervisory and control systems have been effective in mitigating the risk of error in large areas of the budget. The Court does not yet find evidence to support the impact of the action plan claimed by the Commission.

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that the 2007 annual activity reports better demonstrate the link between the effectiveness of internal control systems and the basis of assurance. For example, Directors-General were invited to describe the 'building blocks' on which they based their assurance and to explain the reasons for any differences of opinion between the Court and themselves. These differences will be addressed during 2008 and Directorates-General will then report on these issues in their 2008 annual activity report.

The reservations made by the Directorates-General in their 2007 annual activity reports were in the Commission's view in line with the materiality criteria established and covered all systems where there were material deficiencies and that the potential impact of reservations was adequately assessed.

2.40. *Over recent years, the improvements made in the legislative frameworks for Community funding programmes, the improvement of control conditions, the simplification of financial rules and the addition of the annual summaries in shared and centralised indirect management have been initiatives designed to improve the internal control framework and to mitigate the risk of error in underlying transactions.*

It is difficult to assess the impact of each action taken in 2006 and 2007 on the risk of errors. Any simplification of the rules, and all improvement to the Commission's controls, will take time to have an effect on the prevention of errors. Furthermore, many measures concern ex-post controls, and the recovery of errors in years after they have occurred. The Commission agrees with the Court's view that impact can only be assessed over a longer time frame. The Commission is fully aware of the need to demonstrate the impact of its action plan: the Synthesis Reports concludes that the Commission will make all efforts to demonstrate the effectiveness of its controls. The Synthesis Report also underlines that addressing the causes of error is vital and that its services will issue guidance on this subject.

The action plan was designed to meet specific gaps and the Commission is taking many other measures to further improve its internal control systems. The Court's own assessment indicates that improvements are being made in internal control systems (notably the appreciation of annual activity reports has risen in some cases).

The Commission can demonstrate the impact of some of the actions even at this early stage and will present its first annual impact report in early 2009. See also replies to paragraphs 2.26 and 2.35, and to paragraphs 5.51, 6.33, 7.42, 8.31 and 8.32, and 9.25.

THE COURT'S OBSERVATIONS

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Recommendations

2.41. The Court recommends that the Commission continues its efforts to ensure and demonstrate the effectiveness of the supervisory and control systems of its Directorates-General by focusing on the following areas:

- (a) ensuring that annual activity reports and declarations present a consistent assessment of supervisory and control systems which is compatible with the reservations (paragraphs 2.12 to 2.14);
- (b) collaborating with Member States to improve the information provided in Annual Summaries and demonstrate how this information has been used to gain assurance or add value to the assurance provided in Annual Activity Reports (paragraph 2.19);
- (c) completing an appropriate follow-up of the relevant measures of the action plan towards an integrated internal control framework in view to ensure a real impact on the supervisory and control systems (paragraph 2.35), in particular in relation to sub-action 1 (simplification), sub-actions 10a and 10b (cost-effectiveness) and sub-action 11N (recovery systems) (paragraph 2.31).

2.42. The Court recommends that the legislative authorities and the Commission be prepared to reconsider the design of future expenditure programmes by giving due consideration to the following:

- (a) simplifying the basis of calculation of eligible costs and making greater use of lump sum or flat rate payments instead of reimbursement of 'real costs';

2.41.

- (a) *While the Director-General remains solely responsible for the annual activity report and for any reservation(s) made, the 'peer review' of draft annual activity reports exercise was reinforced for the 2007 exercise. The annual activity reports and declarations do now largely present a consistent assessment of supervisory and control systems, taken as a whole, and not only their effectiveness in preventing errors. This is compatible with the reservations. Furthermore, the Commission is improving the annual activity reports process in certain areas, notably to ensure full consistency between services and it will continue its efforts in this respect.*

See also replies to paragraphs 2.12 to 2.14.

- (b) *The Commission will present a revised guidance note to Member States with recommendations to improve the quality of their annual summaries for 2008.*

See also reply to paragraph 2.19.

- (c) *A report on the impact of the Action Plan as at end-December 2008 will be presented in early 2009. The Commission will also follow-up on the results of actions 4, 10 and 11 in a Communication in November 2008 which aims to re-launch the discussion on tolerable risk.*

For the cohesion policy, the Commission has made substantial efforts to improve the quality of data provided by Member States and is currently carrying out work to verify the completeness and accuracy of this data.

See also reply to paragraphs 2.31 and 2.35.

2.42.

- (a) *The Commission agrees that extra simplification is needed with regard to cost eligibility issues.*

The Commission has already committed under its Action Plan towards an Integrated Internal Control Framework to make proposals for simplified rules in future legislative rounds. It does not however act alone and would also need the Legislative Authority to ensure that simplification measures are included in future legislation.

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- (b) re-defining control systems in terms of their output (the risk objective and the resulting acceptable level of error) rather than input as is currently the case (the number of checks to be undertaken);
- (c) making progress in taking forward the concept of tolerable risk.

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The Commission has undertaken to ensure that future legislative proposals include clear and straightforward rules as concerns extended use of lump sum or flat rate payments.

The current rules for Cohesion Policy already allow flat-rates in some circumstances and the Commission will explore the scope for extending this practice, which is presently applicable to only a limited number of cost categories. For capital projects, they are inappropriate because of tendering rules and value-for-money considerations.

As regards research, the Commission agrees that further simplification is needed with regard to cost eligibility issues, particularly for personnel and indirect costs. It draws attention to the legal limitations of the 7th Framework Programme (FP7) and to the difficulties to define lump sums and flat-rates which are representative.

Furthermore, the ex ante certification of cost calculation methodology introduced in FP7 is a major step towards simplification. The Commission refers to the issues discussed in its reply to paragraphs 7.20-7.21.

- (b)** *The Commission accepts this recommendation, and will examine how to implement it in practice.*
- (c)** *The Commission will make a Communication on this issue in Autumn 2008 aimed at re-launching the interinstitutional discussion on tolerable risk.*

CHAPTER 3

Budgetary Management

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INTRODUCTION

3.1. This chapter analyses issues arising from the implementation of the EU general budget in 2007, the first year of the multiannual financial framework 2007 to 2013. It covers in particular the rate of budgetary implementation and the level of outstanding budgetary commitments with a special focus on the application of the $n + 2$ rule. This chapter also discusses financial corrections and recoveries in respect of system weaknesses or incorrect payments in previous years, which have to be taken into account in the budget process.

3.2. A central task in the Commission's budgetary management is to ensure that the funds that the Council and Parliament have allocated according to the EU's political priorities are spent in accordance with rules and following the principles of sound financial management. The analysis of the implementation of the budget is only one aspect of correct budget implementation. The budget should also adhere to the principles of economy, efficiency and effectiveness, which are more the subject matter of the Special Reports issued by the Court than of this Annual Report.

OBSERVATIONS

Underspending managed by amending budgets

3.3. The budgetary appropriations adopted for 2007 (voted budget and amending budgets) totalled 126,4 billion euro in commitments and 113,8 billion euro in payments, an increase of respectively 5 % and 6 % compared to the final budget 2006. Overall, the total budgetary commitment appropriations of the year were 2,5 billion euro below the financial framework ceiling, while payment appropriations remained below by 10 billion euro (see *Diagrams III* and *IV* in *Annex I*).

3.4. The seven amending budgets voted during the year resulted in an overall 0,167 billion euro decrease in appropriations for commitments and a 1,65 billion euro decrease in appropriations for payments. The latter is mostly a reaction to lower than expected spending in the areas of Competitiveness (0,5 billion euro), Cohesion Policies (0,7 billion euro) and Agriculture and Natural Resources (0,5 billion euro). Reducing appropriations for payments in this way reflects good budgetary management as it demonstrates the ability to react to changes and reduces the budgetary surplus ⁽¹⁾ (allowing own resources to be returned to Member States).

⁽¹⁾ The budgetary surplus (budget outturn) is the result of the implementation of the budget. It is not a reserve and it cannot be accumulated and used in future years to finance expenditure. The unused revenue that the surplus represents is offset against the own resources to be collected for the following year.

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3.5. **Diagrams III** and **IV** in **Annex I** give detailed information on appropriations for commitments and payment appropriations for payments as well as their respective actuals in 2007 per heading in the financial framework as well as by ABB policy area.

3.6. The Commission produces a series of documents (in part overlapping) containing *inter alia* the following information on the implementation of the budget of the European Communities ⁽²⁾:

- the budgetary surplus decreased from 1,9 billion euro in 2006 to 1,5 billion euro in 2007;
- utilisation rates for both commitments and payments, at 96 % and 98 % respectively, remain at a similar high level as in 2006 (99 % and 96 %);
- 1,2 billion euro of unused payment appropriations (excluding assigned revenue) were not cancelled but carried over from 2007 to 2008 or reprogrammed, a similar level to last year;
- for the area of 'Cohesion' (included in the Titles 04, 05, 11 and 13 ⁽³⁾) the 0,745 billion euro reduction in payment appropriations resulted in a final utilisation rate of almost 100 %, (it would have been 97 % had the amending budget not been adopted). Member States' payment forecasts have improved in recent years. The overall over-estimation was reduced from 33 % in 2006 to 18 % in 2007.

3.6. *The documents to which the Court refers are produced for different purposes (see reply to paragraph 3.20).*

- *While Member States continue to improve the accuracy of the forecasts, they remain too inconsistent to be used for budgeting purposes. However, with further improvement, they could become a useful tool to help ensure continued high utilisation rates.*

⁽²⁾ Detailed information on budgetary implementation for 2007 can be obtained from Part II of the Annual Accounts of the European Communities, Financial Year 2007, the EC's (DG Budget) documents 'Report on budgetary and financial management — financial year 2007' as well as from the Report on the 'Analysis of the budgetary implementation of the Structural and Cohesion Funds in 2007', pp. 57-58. It must be noted, however, that figures mentioned in the different documents are not fully consistent and vary slightly.

⁽³⁾ The titles cover policy areas 04-Employment and Social Affairs; 05-Agriculture and Rural Development; 11-Fisheries and Maritime Affairs; 13-Regional Policy.

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Outstanding budgetary commitments 5,2 % higher than in the previous year

3.7. Outstanding budgetary commitments arise as a direct consequence of differentiated expenditure, where expenditure programmes take a number of years to be completed and commitments are made in earlier years before the corresponding payments. One-off increases in commitments (for example, following enlargements) and underspending (failure to use all budgeted payment credits) can lead to an increase in the level of outstanding commitments. As commitments are liquidated by payments, the long-term effect of commitments significantly exceeding payments is a structural build up of outstanding commitments, with the situation being rolled forward each year ⁽⁴⁾.

3.8. Outstanding budgetary commitments (i.e. unused commitments carried forward to meet future spending), mainly on multi-annual programmes, increased by 6,855 billion euro (5,2 %) to 138,6 billion euro. Referring exclusively to policy areas financed through differentiated appropriations, the amount of outstanding commitments totals 136 billion euro, which is 1,9 years worth of commitments or 2,1 years of payments at the 2007 spending rate in the respective policy areas.

3.9. Structural Funds represent the biggest share of the outstanding commitments. In this area, outstanding commitments amounted to 84 billion euro ⁽⁵⁾ (around 66 % of the total amount), representing 1,9 years worth of commitments or 2,3 years worth of payments at the 2007 spending rate. However, 2007 was the first year of the new programming period. Therefore, advance payments represent a share of around 20 % of the overall amount of payments. Due to this, a comparison with the reference values of last year of two possible indicators (the year end outstanding commitments compared to the commitments appropriations or the payments implemented in the year) is not as meaningful as in preceding years.

3.7-3.9. *Commitments are consistently budgeted higher than payments on account of a longer period for payments than commitments. Commitments therefore generally increase year on year.*

The $n + 2/n + 3$ rule in Cohesion Policy ensures that commitments are largely used up within 2-3 years.

⁽⁴⁾ See also paragraphs 3.9 to 3.11 of the Annual Report concerning the financial year 2006.

⁽⁵⁾ For Cohesion see EC's (DG Budget) report 'Analysis of the budgetary implementation of the Structural and Cohesion Funds in 2007', p. 35.

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3.10. 13 % of the unused commitments (18,1 billion euro) concerned the Cohesion Fund, despite the fact that it represents only around 5 % of total authorised commitment appropriations for 2007. This is an increase of 2,7 billion euro or about 15 % compared to 2006. The high level of outstanding budgetary commitments regarding the Cohesion Fund represents 2,5 years worth of commitments or 4,2 years worth of payment at the 2007 spending rate and reflects also the fact that this fund is not subject to the $n + 2$ rule (see paragraphs 3.12 to 3.17). The spending rate for the Cohesion Fund was less than expected, especially for projects in Spain, the Czech Republic and Slovenia. An amending budget reduced the payment appropriations by 0,67 billion euro (14 %).

3.11. Concerning the outstanding commitments for Structural Funds for the old programming period 2000 to 2006, a decrease by 41 % from 78 billion euro (2,4 years worth of payments at the 2007 spending rate) to 46 billion euro (1,5 years worth of payments at the 2007 spending rate ⁽⁶⁾) can be noted ⁽⁷⁾. However, beneficiaries of the funds have only until the end of 2008 to make payments in order to enable the Commission to liquidate the remaining amount. In this context, the Commission has to ensure that the closure of the old programming period 2000 to 2006 will not be delayed and therefore impacts negatively on the implementation of the approved new programmes for 2007 to 2013. The Court notes a considerable improvement for the new programming period as, due to the timely adoption of the programmes, over 98 % of appropriations for 2007 have been committed in this policy area ⁽⁸⁾ as compared to around 50 % in 2000 for the old programming period.

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3.10. *The closing date for many Cohesion Fund projects to incur expenditure is in 2010. For the new programming period, the Cohesion Fund is subject to the $n + 2/n + 3$ rule.*

3.11. *The Commission will make every effort to avoid any delay in the closure of 2000-2006 programmes, which will essentially take place in 2010/2011. To prepare for closure, the Commission issued guidelines in 2006 and has been holding closure seminars with Member States. It is also carrying out audits of Member States' preparations for closure (see action 3.1 of the Commission's Action Plan of 19 February 2008 to strengthen its supervisory role in the shared management of structural actions (COM(2008) 97 final). If the closing date for expenditure is not met, the Commission will decommit the unspent funds when it closes the programmes.*

⁽⁶⁾ See EC's (DG Budget) report 'Analysis of the budgetary implementation of the Structural and Cohesion Funds in 2007', table 5 and 6, p. 13.

⁽⁷⁾ See EC's (DG Budget) report 'Analysis of the budgetary implementation of the Structural and Cohesion Funds in 2007', table 10, p. 37.

⁽⁸⁾ Due to late submissions of Operational Programmes and/or lengthy negotiations with Member States concerned, commitment appropriations amounting to 130 million euro have been carried forward to 2008, relating to one Convergence Operational Programme, nine Territorial Cooperation Programmes and six IPA Cross Border Cooperation Programmes. Some related technical assistance actions were also postponed to 2008 and 2009. See EC's (DG Budget) Report on budgetary and financial management; Financial year 2007 and Analysis of the budgetary implementation of the Structural and Cohesion Funds in 2007 (table 3, p. 12).

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Year n + 2 rule accelerates payments

3.12. For structural actions, typically implemented over a multi-annual period, a system of automatic decommitments was introduced by Article 31 of Council Regulation (EC) No 1260/1999 of 21 June 1999 laying down general provisions on the Structural Funds ⁽⁹⁾ for the period 2000 to 2006 in order to avoid an increasing build-up of potentially abnormal outstanding commitments being rolled forward each year. This mechanism is also known as the year n + 2 rule.

3.13. An analysis of the outstanding commitments ('RAL' ⁽¹⁰⁾) by the year of origin as published in the annual accounts ⁽¹¹⁾ shows the impact in the area of Structural Funds of efforts to settle outstanding commitments by payments prior to the application of the automatic decommitment rule. In the annual accounts the outstanding commitments for the last three years of the 2000 to 2006 period represent about 95 % of their total amount. Conversely, only 5 % of outstanding commitments which are not yet settled in the area of Structural Funds, refer to earlier years.

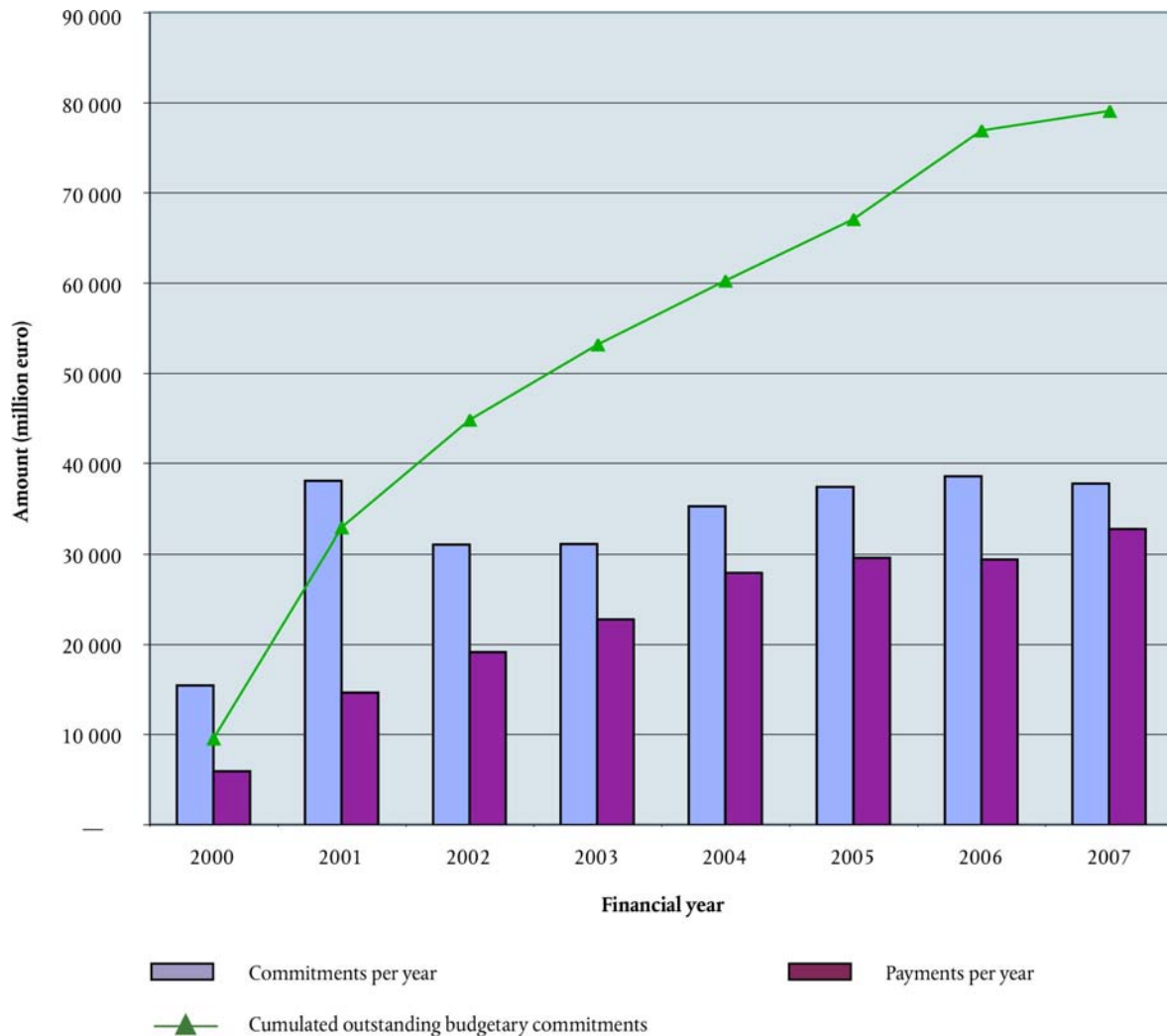
3.14. While an accelerated payment process has been fostered by the n + 2 mechanism (see paragraph 3.15), a steady increase of the cumulative amount of outstanding commitments can be noted in the area of Structural Funds (see **Graph 3.1**) reaching 79 billion euro at the end of 2007 (see also paragraph 3.7).

3.14. As noted in the Commission's replies to the 2006 annual report (paragraphs 3.9-3.10), the build-up of outstanding commitments over the period since 1994 has also been partly due to the changeover in the commitments and payments system in the 2000-2006 period and to enlargement. The effect of the different programming periods is clearly illustrated in Chart 21 on page 38 of the Commission's report 'Analysis of the budgetary implementation of the Structural and Cohesion Funds in 2007', May 2008, which shows the natural decline of the outstanding commitments (RAL) over time.

⁽⁹⁾ OJ L 161, 26.6.1999, p. 1.

⁽¹⁰⁾ For outstanding commitments the French acronym 'RAL' for *reste à liquider* is often used.

⁽¹¹⁾ See Annual Accounts of the European Communities, Financial Year 2007, table 13b.

Graph 3.1 — Development of cumulated outstanding commitments in Structural Funds 2000-2007

Source: Annual Accounts of the European Communities, Part II: Consolidated Reports on the Implementation of the Budget of the European Communities.

3.15. In only a small proportion of cases has the $n + 2$ rule led to automatic decommitments (an average of about 200 million euro during the last three years). In other words, the $n + 2$ system of potentially impending automatic decommitments has had the intended effect of encouraging the timely liquidation of commitments. However, there is the danger of an undesirable side-effect if the accelerated payment process to reduce outstanding commitments were to be achieved by applying less strict internal control procedures, thereby increasing the risk concerning the legality and regularity of underlying transactions ⁽¹²⁾.

3.15. *The Commission takes account of the risk referred to in its audit work and takes appropriate action when it finds that Member States have adopted unacceptable measures to avoid de-commitments under $n + 2$.*

⁽¹²⁾ See also paragraph 2.25 of the Annual Report concerning the financial year 2004.

THE COURT'S OBSERVATIONS

3.16. The loosening of the automatic decommitment mechanism in the new programming period 2007 to 2013, by introducing a year $n + 3$ rule for certain Member States, might partially reverse this trend in coming years ⁽¹³⁾. Commitments related to Member States subject to the $n + 3$ rule under the new Financial Framework account for 61 % of all commitments between 2007 and 2010.

3.17. In other policy areas dealing with multiannual projects where there is no rule analogous to $n + 2$ (for example in Directorates-General for Research, Information Society and Media, Energy and Transport) outstanding commitments do not show the tendency to be settled as quickly as in Structural Funds ⁽¹¹⁾.

Commission report on budgetary and financial management

3.18. As remarked in previous years, the Commission's report on budgetary and financial management provides considerable information on detailed budget implementation, outstanding budgetary commitments and reasons for lower than forecast spending. However, further improvement is possible, especially as regards the analysis of the data referring to outstanding commitments ('RAL').

3.19. Furthermore, information provided should better distinguish between the different programming periods.

3.20. Other documents such as the Annual Accounts contain also relevant information on the implementation of the budget which is missing in the report on budgetary and financial management (e.g. on budget outturn). The consistency of the data as presented in these different documents needs to be given additional attention ⁽¹⁴⁾.

THE COMMISSION'S REPLIES

3.16. *As noted in the Court's report for 2006 (paragraph 3.17), this effect is likely to be mitigated by the application of the $n + 2/n + 3$ rule to Cohesion Fund projects in the 2007-2013 period. For the new rural development fund, the $n + 2$ rule continues to be applied.*

3.17. *In EU funded research actions, each specific commitment has its own 'final date for implementation' (FDI) depending on the project duration. Project duration varies from a few months to several years depending on the nature of the action. According to Article 77 of the Financial Regulation any outstanding amount 6 months after the FDI should be decommitted. Amounts decommitted correspond to project underspending and in very exceptional cases to abnormal termination of projects because of scientific or financial problems.*

3.18. *The Commission agrees that further improvement is possible.*

3.19. *Information is provided in the report on the 'Analysis of the budgetary implementation of the Structural and Cohesion Funds in 2007'.*

3.20. *The Commission does not consider that the budget outturn should also be presented in the report on budgetary and financial management as the definition of appropriations of the year is logically different in this accounting calculation (whose objective is to calculate the amounts to be returned to the Member States) than in traditional implementation analysis. Furthermore, on the revenue side, the report is limited to own resources.*

⁽¹³⁾ Article 93(2) of Council Regulation (EC) No 1083/2006 (OJ L 210, 31.7.2006, p. 25).

⁽¹⁴⁾ For instance, the amounts regarding the implementation of the budget differ between the Annual Accounts and the 'Report on budgetary and financial management'.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

The Commission endeavours to ensure a high degree of consistency of the data published in different Commission documents. However, these documents are produced for different purposes. A meaningful analysis of implementation and budgetary adjustments as part of the budgetary management has to be based on the financial framework, with the priority to the voted and the carryover appropriations. This structure is followed neither by the annual accounts (focus on implementation reporting on use, cancellation, and carryover of all authorised appropriations) nor the budget (nomenclature by policy areas which include both administrative and operational expenditure). This means that implementation data has to be structured in different ways in Commission documents and some figures, which may seem to cover the same area, are in reality based on (slightly) different definitions.

Financial corrections/recoveries as part of the budget process: better information on and management of financial corrections required

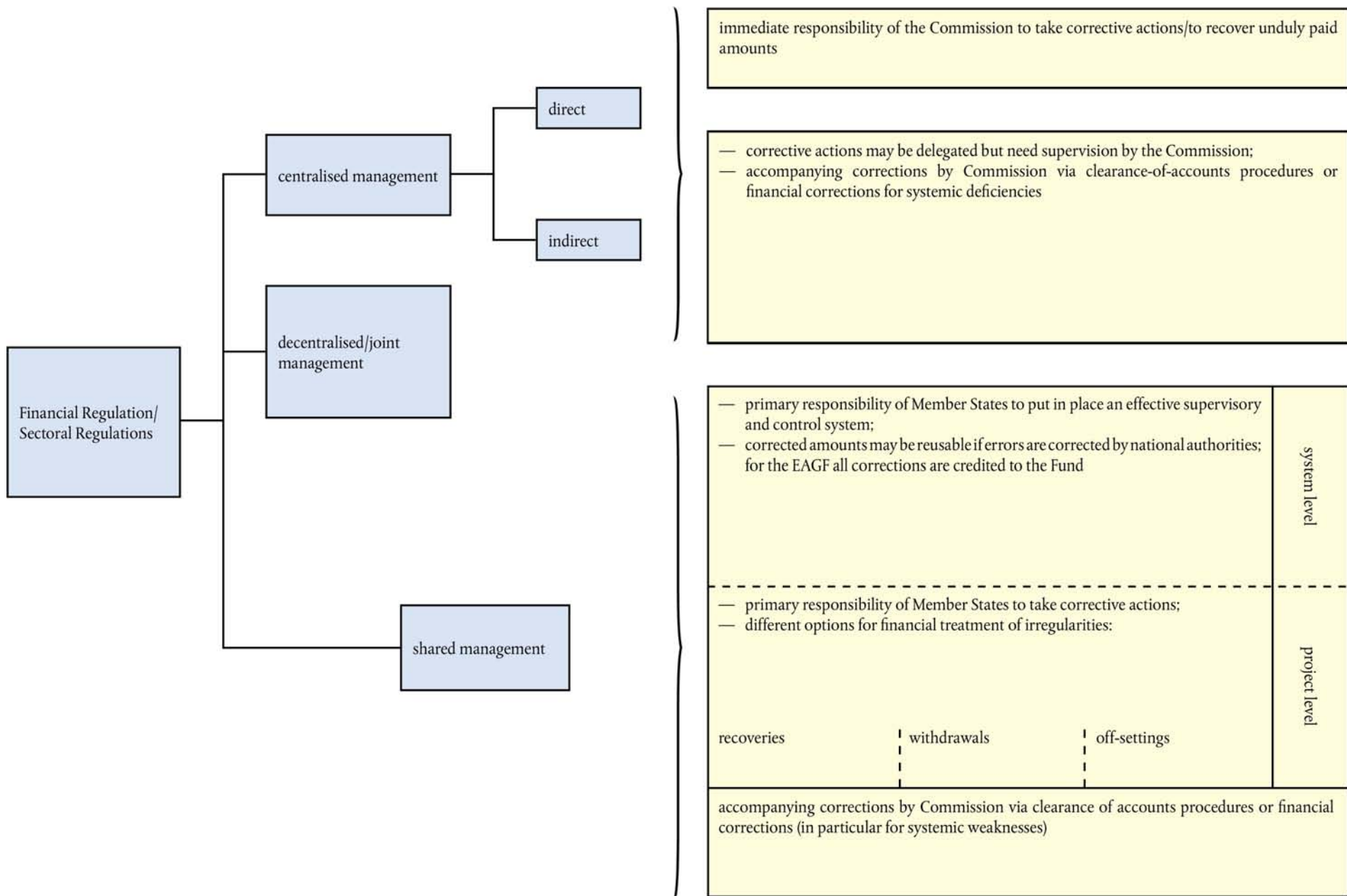
Legal and organisational framework

3.21. First subparagraph of Article 274 of the EC Treaty stipulates that 'the Commission shall implement the budget, [...] on its own responsibility ... [and] ... Member States shall cooperate with the Commission to ensure that the appropriations are used in accordance with the principles of sound financial management.' Thus, the Commission bears the ultimate responsibility for the correct implementation of the budget.

3.22. The Financial Regulation distinguishes different management modes for implementing the budget, each requiring appropriate supervisory and control systems to prevent or detect and correct errors in payments.

3.23. Because of the way the legal requirements of the Treaty, Financial Regulation and sectoral regulations as regards financial management and control interlink, the resulting structure of responsibilities and different instruments for financial corrections is extremely complex. **Diagram 3.2** provides a simplified overview of the different legal components and how they interact.

Diagram 3.2 — Legal framework and resulting mechanisms to carry out financial corrections



THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

3.24. For direct centralised management (budget execution by Commission departments, e.g. administrative expenditure and parts of research, energy and transport) and indirect centralised management (budget execution by delegated entities, e.g. executive agencies) the Commission has sole responsibility for implementation, including the application of appropriate corrective measures. For expenditure under shared management — in particular agriculture and cohesion — the responsibility for the correct implementation of the budget, including recovery of incorrect payments, lies in the first instance with the Member States ⁽¹⁵⁾. However, where Member States fail to correct irregular expenditure or to put in place effective supervisory and control systems to prevent the reimbursement of such expenditure or make corrections, the Commission applies financial corrections through clearance-of-accounts or similar procedures ⁽¹⁶⁾.

Lack of complete and reliable information from Member States

3.25. As in previous years, the Court's audit has found evidence of material error in substantial areas of EU spending under shared management and that most errors occur at the level of final beneficiaries. The recovery mechanisms, and level of recoveries made, should reflect the type and extent of the risks involved. While the complex and diverse nature of EU aid schemes make it difficult to make an overall assessment of the effective functioning of the correction mechanisms at Member State level, the Court found insufficient evidence that multiannual correction mechanisms of certain EU actions (e.g. employment and social affairs, regional policy) are commensurate with the risk involved.

3.25. *A recovery can only be effected after the audit findings have been confirmed in a contradictory procedure with the auditee, which in some cases leads to the finding being dropped or modified. Therefore, it is inevitable that recoveries will be less than the risks identified by audits.*

The Commission has made substantial efforts to improve the quality of data on recoveries provided by Member States and is currently carrying out work to verify the completeness and accuracy of this data. There has therefore been progress in producing reliable evidence of the operation of the multiannual corrective mechanisms.

⁽¹⁵⁾ For the EAGF all corrections are credited to the Fund. In the Structural Funds, Member States withdraw irregular expenditure found in their control and audit work from the expenditure declared for the programme or project concerned. They do so either immediately the irregular expenditure is detected or after the undue payment has been recovered from the beneficiary. The resources from the Structural Funds released in this way may be reused.

⁽¹⁶⁾ Analogous rules as for shared management are applicable in cases of decentralised or joint management where the Commission implements the budget together with international organisations or other independent bodies.

THE COURT'S OBSERVATIONS

3.26. At present, the information provided on correction mechanisms applied at Member State level is incomplete and unreliable as regards cohesion policies. Concerning agriculture the Court has doubts on the reliability of the information provided (see paragraph 5.44). The Commission does not yet have complete and/or fully reliable information on the consequences for recipients of EU spending, the EU budget and national budgets.

3.27. Correction mechanisms do not necessarily involve recovery of overpaid amounts from individual beneficiaries. For example, if the overpaid amounts are of low value it may not be cost effective to recover them, or individual overclaiming beneficiaries may not have been identified by the control procedures (such as when extrapolated error rates from sample-based approaches are used as a basis for correction). Furthermore, when financial corrections are imposed on Member States for weaknesses in their supervisory and control systems, amounts are, in general, not recovered from beneficiaries.

3.28. In the cases mentioned in paragraph 3.27 corrections end up being financed by national taxpayers, rather than by the overclaiming beneficiaries. The direct deterrent effect of the control and sanction systems is thus reduced so that errors may reoccur. However, the effectiveness of the recovery procedures should also be judged by their impact on stimulating improvements in supervisory and control systems (and thereby reducing the risk of error in the future).

THE COMMISSION'S REPLIES

3.26. *The Commission has included in the notes to the annual accounts of the European Communities for the financial year 2007 a new chapter about the recovery of undue payments. The objective of this chapter is to give an overview of the procedure in place for the recovery of undue payments and to present a best estimate of the total amount recovered.*

Financial corrections at Member State level in the Cohesion Policy area are reported to the Commission annually and the data are published in the Annual Report on the Structural Funds. As noted in the reply to paragraph 3.25, the Commission is taking action to improve the reliability and completeness of this information. Information on the recoveries made from beneficiaries in individual cases is provided by the obligatory reporting procedures under Regulation (EC) No 1681/94, as well as being available in the Member States' monitoring systems. The Commission focuses on having complete and reliable information to demonstrate that the EU budget has been safeguarded by the exclusion of funding which is irregular.

As regards agriculture expenditure, the Commission considers the information which it has received from Member States to be complete and sufficiently reliable since no discrepancy with a material impact has been found. However, the Commission recognises that there is scope for improvement and has revised the relevant Guidelines for the financial year 2008 accordingly. It will also continue to closely monitor the situation (see reply to paragraph 5.44).

3.27-3.28. *Member States are required to recover overpaid amounts from beneficiaries wherever this is appropriate, and there is evidence that generally they do so. Where errors are attributable to deficiencies in management and control systems, it may not be appropriate to recover from the beneficiary who was not at fault. Where flat rate or extrapolated corrections are applied, the national authorities will only be able to take recovery action against individual beneficiaries for whom there is evidence of irregularity. The main purpose of the correction mechanism is to exclude expenditure from Community financing which has not been effected in compliance with Community rules, thus shielding the Community budget from expenditure that should not be charged to it. When the Member State's administration bears the cost, flat rate or extrapolated corrections protect the Community budget, and encourage the authorities to prevent a recurrence of such deficiencies. Flat rate or extrapolated corrections are therefore an important means to improve the Member States' management and control systems and thus to prevent irregular payments to final beneficiaries or ensure the detection and correction of such payments.*

THE COURT'S OBSERVATIONS

3.29. Based on its review of the systems and procedures for obtaining and reporting on recoveries, the Court concludes that the Commission should ⁽¹⁷⁾:

- list and describe all the procedures used to recover amounts by both Member States and Commission in order to increase transparency concerning existing correction mechanisms;
- make a clear link between errors detected by controls and the resulting recovery or adjustment (off-setting) to amounts claimed by beneficiaries, and to ensure adequate monitoring and reporting of the process;
- link recoveries and adjustments to claimed amounts with the year in which the errors or irregularities occurred, thus providing a basis to assess the effectiveness of the multiannual correction mechanisms;
- quantify the amounts recovered from overclaiming final recipients and financial corrections paid by the national budget, i.e. the tax payers;
- ensure that Member States deliver timely, complete and reliable information on withdrawals, recoveries and pending recoveries particularly in respect of Structural Funds;
- assess the extent to which financial corrections are effective in stimulating improved supervisory and control systems in Member States; and

THE COMMISSION'S REPLIES

3.29. *The Commission confirms its commitment to continue improving the information available on recoveries and financial corrections made either by itself or by Member States.*

- *Information in the Commission accounts:*

The notes to the Annual Accounts for the financial year 2007 includes a chapter on recovery of undue payments, which provides an overview of the procedures in place for the recovery of undue payments.

The chapter also presents a best estimate of the total amount for recoveries, based on the information currently available. This information does not yet include all recoveries made by deduction from a subsequent payment managed directly by the Commission. It includes only provisional data on recoveries by Member States in the Cohesion Policy area.

In order to further improve the information on errors corrected at Commission level, the Commission has in 2008 introduced modifications in the financial accounting system 'ABAC' so that a clear link between errors or irregularities detected by controls and the resulting recovery or adjustment to amounts claimed by beneficiaries can be made. The modification will also make it possible to link recoveries and adjustments to claimed amounts with the year in which errors or irregularities were committed, thus permitting the Commission to monitor the effectiveness of the multiannual recovery systems as recommended by the Court.

- *Information obtained from the Member States:*

In agriculture, the amounts recovered from final recipients are declared to the Commission, and included in the 2007 accounts as well as in the notes to the 2007 accounts together with the financial corrections charged to Member States. All decisions concerning financial corrections are published in the Official Journal of the European Union and the Annual Activity Report of the DG Agriculture and Rural Development contains complete information as regards financial relations between the Commission and the Member States and the Member States' recovery of undue payments from the final beneficiaries.

For Structural Actions expenditure too, financial corrections decided by the Commission are reported in the accounts. For corrections made at national level, Member States are required to submit annual reports to the Commission on the corrections they have made through withdrawals and recoveries of grants and on the recoveries that are pending at the end of the year. The Commission presented the information it obtained from the Member States for 2006 in an annex to the 2006 Annual Report on the Structural

⁽¹⁷⁾ Some of these points were mentioned in the reply from Vice-President Kallas to written question No 21 from the European Parliament (Cocobu) within the discharge procedure for the financial year 2006.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Funds (SEC(2007) 1456) and will publish the data for 2007 in the 2007 report. Specific actions in the Action Plan to strengthen the supervisory role of the Commission in structural actions (COM(2008) 97 final) address the need to further improve this reporting. These include on-the-spot checks to assess the reliability and completeness of the information submitted.

The Commission continuously assesses the effectiveness of supervisory and control systems in Member States and reports its conclusions, in particular, in the Annual Activity Reports of the Directorates General concerned. When serious deficiencies are found, the Commission will, as in the past, suspend payments and impose financial corrections if the Member State does not take the agreed action to improve the systems.

For agricultural expenditure, the Court has acknowledged in the past that Member States' supervisory and control systems have improved (see e.g. the Court's Annual Report for 2006). The Commission considers these improvements to be, at least partially, a consequence of its recommendations being implemented by Member States and of the financial corrections imposed on Member States.

- assess the appropriateness of the type of correction mechanisms to be used by the Commission and the Member State respectively, and the intensity of their application, in the light of cost effectiveness ⁽¹⁸⁾.

- *Costs of control:*

The Commission is completing its assessment of the costs of control in agriculture, ERDF and direct centralised management. The results will form the basis of a Communication by the Commission towards the end of 2008 aimed at relaunching the inter-institutional discussion on tolerable risk.

CONCLUSIONS AND RECOMMENDATIONS

3.30. In comparison to the beginning of the preceding programming period a considerable improvement can be stated for 2007 as regards the implementation of commitment appropriations for the first year of the new programming period. The spending rates in 2007 remained at a high level. In the case of the cohesion policy area initial payments appropriations were reduced by 0,745 billion euro by amending budgets.

⁽¹⁸⁾ See Opinion No 2/2004 of the Court of Auditors of the European Communities on the 'single audit model' (and a proposal for a Community internal control framework) (OJ C 107, 30.4.2004, p. 1).

THE COURT'S OBSERVATIONS

3.31. Member States improved their expenditure forecast in the area of Structural Funds reducing the over-estimation rate from 33 % in 2006 to 18 % in 2007 ⁽¹⁹⁾.

3.32. Outstanding budgetary commitments on differentiated expenditure remain at a very high level exceeding the total budgetary commitment appropriations for 2007. The system of automatic decommitments has led to a relative improvement in this respect in the area of structural actions. However, there is a risk that accelerated payments may lead to less strict internal control procedures concerning the legality and regularity of the underlying transactions. The Commission needs to keep this aspect in mind whilst reflecting on an introduction of similar rules in other areas with multiannual activities, such as research, energy and transport, information society and media.

3.33. The information on the management of corrective actions and their impact needs to be significantly improved in order to allow the assessment of the effectiveness of multiannual correction mechanisms for EU spending.

THE COMMISSION'S REPLIES

3.31. *While Member States continue to improve the accuracy of the forecasts, they remain too inconsistent to be used for budgeting purposes. However, with further improvement, they could become a useful tool to help ensure continued high utilisation rates.*

3.32. *The Commission takes account of the risk referred to in its audit work and takes appropriate action when it finds that Member States have adopted unacceptable measures to avoid de-commitments under n + 2.*

3.33. *The Commission has improved and is further improving the information available (see paragraph 6.5 of the 2007 accounts).*

For the Structural Funds, complete information on corrections applied by the Commission is provided in the 2007 accounts. Extensive information was also presented in the annex to the 2006 Annual Report on the Structural Funds. This will be further improved in the 2007 report, in particular concerning corrections effected by Member States.

In agriculture, all the relevant information is already published and can be scrutinised and verified. This includes the corrections charged by the Commission to the Member States and the Member States' recovery of undue payments from the final beneficiaries.

⁽¹⁹⁾ Whereas for the Cohesion Fund the over-estimation rate increased from 32 % in 2006 to 54 % in 2007.

CHAPTER 4

Revenue

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INTRODUCTION

Specific characteristics of Revenue

4.1. The revenue in the budget of the European Union consists of own resources and other revenue. The principal difference compared to 2006 is that in 2007 corrections and recoveries in the context of the European Agricultural Guarantee Fund and the European Agricultural Fund for Rural Development as well as the Temporary Restructuring Amount are recorded as assigned revenue rather than being netted off against expenditure (2 448 million euro or 2,1 % of revenue) ⁽¹⁾.

4.2. As shown in **Table 4.1**, **Graph 4.1** and **Graph 4.2** own resources are by far the main source of financing of budgetary expenditure (93,5 %).

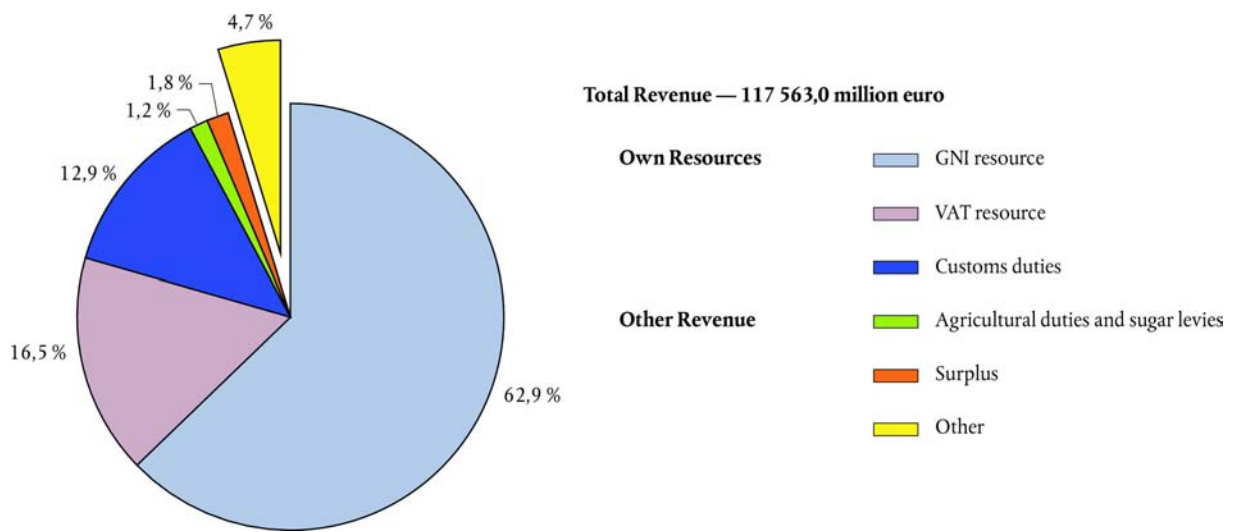
Table 4.1 — Revenue for the financial years 2006 and 2007

Type of revenue and corresponding budget heading	Actual revenue in 2006	Development of the 2007 budget		Actual revenue in 2007	% change (2006 to 2007)
		Initial budget	Final budget		
		(a)	(b)		
1 <i>Traditional own resources (net of 25 % collection costs)</i>	15 028,3	17 307,7	16 532,9	16 573,0	10,3
— Agricultural duties (Chapter 1 0)	1 291,8	1 486,7	1 486,8	1 404,0	8,7
— Sugar and isoglucose levies (Chapter 1 1)	151,6	533,1	– 37,7	– 31,0	– 120,4
— Customs duties (Chapter 1 2)	13 584,9	15 287,9	15 083,8	15 200,0	11,9
2 <i>VAT resource</i>	17 206,2	17 827,4	19 478,5	19 441,0	13,0
— VAT resource from the current financial year (Chapter 1 3)	17 219,8	17 827,4	18 517,2	18 468,0	7,2
— Balances from previous years (Chapter 3 1)	– 13,6	0,0	961,3	973,0	7 254,4
3 <i>GNI resource</i>	70 132,1	79 152,8	74 022,0	73 914,0	5,4
— GNI resource from the current financial year (Chapter 1 4)	68 602,1	79 152,8	71 153,1	71 057,0	3,6
— Balances from previous years (Chapter 3 2)	1 530,0	0,0	2 868,9	2 857,0	86,7
4 <i>Balances and adjustments</i>	– 15,3	0,0	0,0	59,0	485,6
— UK correction (Chapter 1 5)	– 6,0	0,0	0,0	61,0	1 116,7
— Final calculation of UK correction (Chapter 3 5)	– 4,0	0,0	0,0	– 2,0	50,0
— Intermediate calculation of UK correction (Chapter 3 6)	– 5,3	0,0	0,0	0,0	100,0
5 <i>Other revenue</i>	6 071,7	1 209,3	3 812,3	7 576,0	24,8
— Surpluses, balances and adjustments (Chapter 3 0)	2 502,8	0,0	2 108,5	2 109,0	– 15,7
— Miscellaneous revenues (Titles 4 to 9)	3 568,9	1 209,3	1 703,8	5 467,0	53,2
Grand Total	108 423,0	115 497,2	113 845,7	117 563,0	8,4

Source: Budgets and amending budgets for 2007; Annual Accounts of the European Communities, 2007.

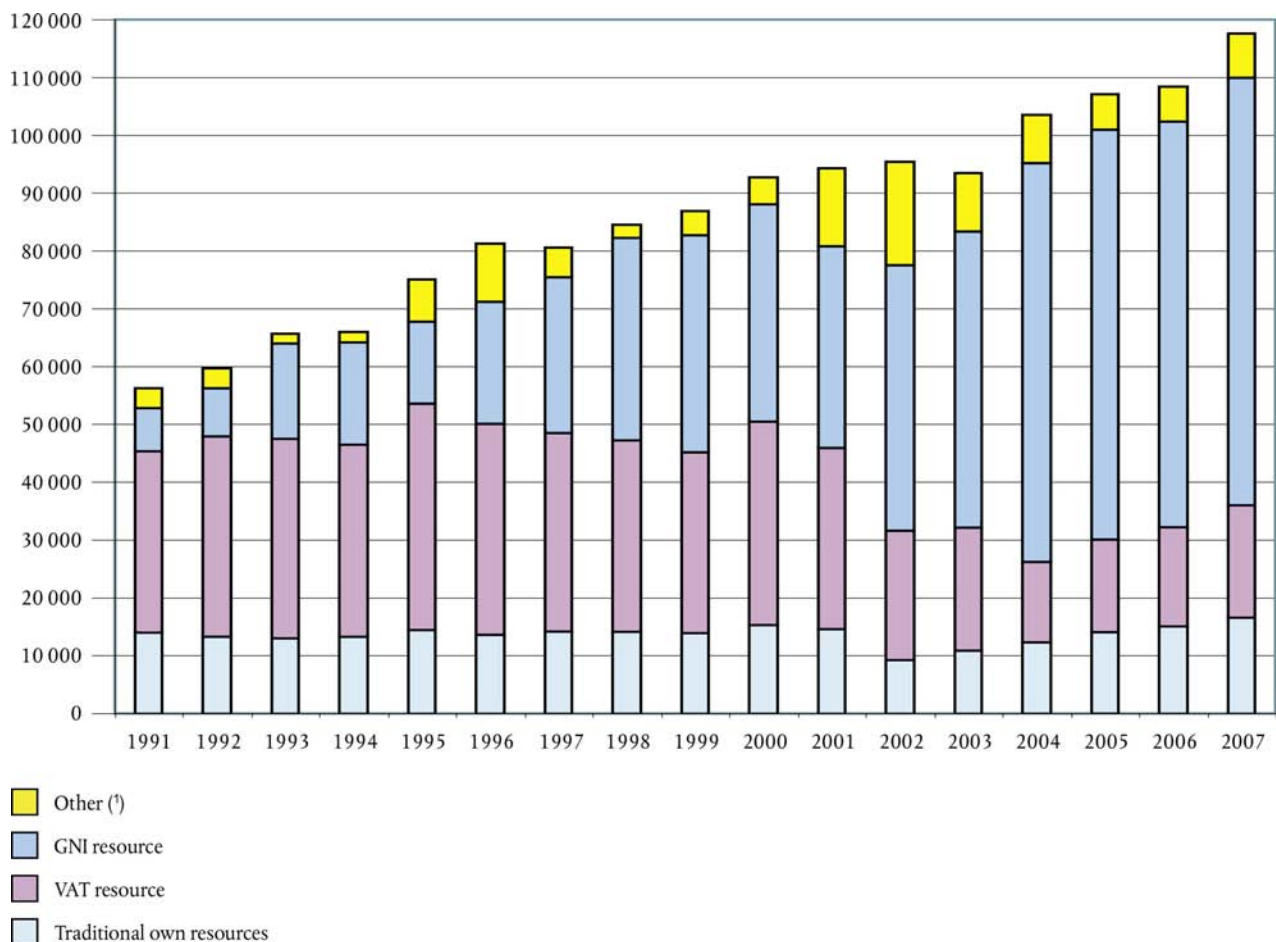
⁽¹⁾ Article 34 of Council Regulation (EC) No 1290/2005 of 21 June 2005 on the financing of the common agricultural policy (OJ L 209, 11.8.2005, p. 1).

Graph 4.1 — Breakdown of actual revenue in 2007



Source: Annual Accounts of the European Communities, 2007.

Graph 4.2 — Evolution of sources of actual revenue 1991 to 2007



(*) Contains surplus from previous financial year and miscellaneous revenue.
 Source: Annual Accounts of the European Communities, 2007.

THE COURT'S OBSERVATIONS

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4.3. There are three categories of own resources: traditional own resources ⁽²⁾ (customs duties, agricultural duties and sugar levies, 14,1 %), own resources calculated on the basis of value added tax (VAT) collected by Member States (16,5 %) and own resources based on the Member States' gross national income (GNI, 62,9 %) ⁽³⁾.

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Audit scope***Traditional own resources***

4.4. The main risks to the receipt of traditional own resources are evasion of duty by taxpayers, miscalculation or failure to establish duty because of undetected errors and errors in Member States' accounting for the duty established which reduce or delay the amounts made available to the Commission. The Court's audit of the transactions underlying the accounts cannot cover undeclared imports or those that have escaped customs surveillance.

4.5. The Court audited a random sample of 30 import declarations in each of six Member States ⁽⁴⁾. It also carried out an assessment of supervisory and control systems in those Member States as well as at the Commission.

4.6. This audit work included a review of the organisation of customs supervision and of the national accounting systems for traditional own resources as well as an evaluation of the supervisory role of the ACOR ⁽⁵⁾. The audit also included an examination of the Commission's accounts for traditional own resources and an analysis of the flow of duties in order to gain reasonable assurance that the amounts recorded were complete and correct.

⁽²⁾ Traditional own resources are collected by Member States on behalf of the European Union, retaining 25 % to cover collection costs.

⁽³⁾ The VAT and GNI own resources are contributions resulting from the application of uniform rates to Member States' harmonised VAT assessment bases or to the Member States' GNI, calculated in accordance with Community rules.

⁽⁴⁾ The Court selects Member States for detailed audit on a cyclical basis, with the largest contributors being examined more frequently. For 2007 the countries audited were Bulgaria, Denmark, Germany, Spain, Romania and Portugal.

⁽⁵⁾ Advisory Committee on Own Resources, referred to in Article 20 of Council Regulation (EC, Euratom) No 1150/2000 (OJ L 130, 31.5.2000, p. 1). The Committee consists of representatives of the Member States and of the Commission, and provides the liaison between the Commission and the Member States on own resources matters. It examines questions concerning the implementation of the own resources system, as well as the estimates of own resources.

THE COURT'S OBSERVATIONS

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4.7. Furthermore, a specific examination on customs warehousing was performed both at the Commission and in seven Member States ⁽⁶⁾.

VAT and GNI own resources

4.8. The main risks for these two resources occur because national accounts are drawn up on the basis of statistical data and estimates, and because of the complexity of the legislative framework.

4.9. VAT and GNI own resources are based on macroeconomic statistics, for which the underlying data cannot be audited directly. For this reason, the VAT/GNI audit took as its starting point the receipt by the Commission of the macroeconomic aggregates prepared by the Member States and then assessed the Commission's systems for processing the data until they are included in the final accounts. The audit thus covered the drawing up of the annual budget and the correctness of the contributions by Member States. The audit also covered the Commission supervisory and control systems which are intended to provide reasonable assurance that these resources are correctly established and collected, as well as the roles of the ACOR ⁽⁷⁾ and GNI ⁽⁸⁾ Committees.

4.10. On 7 June 2007 the Council adopted a new Decision on the system of the European Communities' own resources (2007/436/EC, Euratom) ⁽⁹⁾, which will come, retroactively, into effect from 1 January 2007. This Decision introduced a uniform rate of call for the VAT-based own resource (0,30 %) and brought about additional reductions in the VAT- and GNI-based contributions of certain Member States for the period 2007-2013 ⁽¹⁰⁾. Accordingly, the 2007 Member States' VAT and GNI-based contributions will be recalculated retroactively upon completion of the ratification procedure, which is expected to occur in early 2009.

⁽⁶⁾ Belgium, Czech Republic, France, Italy, Slovakia, Sweden and United Kingdom.

⁽⁷⁾ See footnote 5.

⁽⁸⁾ The GNI Committee is referred to in Article 4 of Council Regulation (EC, Euratom) No 1287/2003: the GNI Regulation (OJ L 181, 19.7.2003, p. 1). The Committee consists of representatives of the Commission and Member States. Each year, the Committee examines the GNI data forwarded by the Member States and issues an opinion on the appropriateness of these data for own resource purposes with respect to reliability, comparability and exhaustiveness.

⁽⁹⁾ OJ L 163, 23.6.2007, p. 17.

⁽¹⁰⁾ Reduced VAT rates of call for Austria, Germany, the Netherlands and Sweden and gross reductions in the GNI-based contributions of the Netherlands and Sweden.

THE COURT'S OBSERVATIONS

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Legality and Regularity of underlying transactions***Traditional own resources***

4.11. Traditional own resources are collected by the Member States who enter them in the accounting system kept by their national Treasury ('the A account') and thereafter make the resources available to the Communities. Where duties or levies remain unpaid and no security has been provided, or they are covered by securities but have been challenged, Member States may suspend making these resources available by entering them in a separate account ('the B account').

4.12. The Court found that the Member States' declarations to the Commission were free from material error of legality and regularity. However weaknesses were noted which, while not sufficiently material to affect the overall conclusion, should be corrected.

4.13. Concerning the A account, in Denmark the data input in the electronic clearance system by the economic operators frequently did not reflect the reality of the import and therefore were not reliable. This has led to a net underpayment to the Commission. In Portugal the duties collected under enforced recovery are accounted for and made available to the Commission with systematic delay.

4.14. As in previous years, the Court's audit detected problems relating to the B accounts, in particular:

- there were cases where goods had been released for free circulation without the customs debt being paid or secured;
- unchallenged customs debts at least partly covered by securities were recorded in the B accounts, even though those parts covered by the security should have been made available;

4.13. *The Commission is following up these findings with the authorities concerned. Action will be taken to recover any own resources not made available and any interest due as a result of delays.*

4.14. *B accounts are often maintained locally by individual customs offices and as such can be subject to a high-risk of one-off errors. Therefore examining the accuracy of B accounts is a regular theme of Commission inspections. Additionally in 2007 the Commission provided Member States with specific guidance on the correct use of the accounts.*

— *The Commission will take up this finding with the Member State concerned.*

— *The Commission was already pursuing this issue with the one Member State where the finding was systematic as a result of an inspection in 2007. The remaining three individual cases to which the Court refers will be addressed with the Member States concerned.*

THE COURT'S OBSERVATIONS

- a comprehensive security provided by a warehouse keeper was not considered as such, leading to post-clearance recovery debts being systematically and erroneously entered in the B account.

VAT and GNI own resources

4.15. The Court's audit found the calculation of Member States' contributions and their payment to be free from material error.

Assessment of supervisory and control systems**Traditional own resources**

4.16. On-the-spot audits by the Court confirmed that overall the audited supervisory and control systems for customs and for traditional own resources accounting were functioning well. The Court also reviewed the inspections carried out by the Commission, which found that the own resources collection systems were generally satisfactory. The management of B accounts continued to be an area where the Commission reported weaknesses.

Customs warehousing

4.17. The customs warehousing suspensive regime permits the storage of non-community goods without them being subject to import duties or commercial policy measures while they are stored in premises or under an inventory system authorised as a customs warehouse ⁽¹¹⁾.

4.18. Based on information received from the Member States, the Court estimates that 20 % of traditional own resources are collected on goods which have previously been stored in a customs warehouse in the Community. The principal risk is that goods may be removed from customs supervision and diverted to the internal market without the duties due being paid or without being subject to other import-related measures. To limit this risk only reliable traders should be authorised to operate a customs warehouse ⁽¹²⁾ and its operation must be supervised by Member States' customs. However Community legal provisions do not define a minimum level of verification to be carried out to ensure compliance with Customs legislation.

⁽¹¹⁾ Articles 84 to 90 and 98 to 113 of the Community Customs Code (Council Regulation (EEC) No 2913/92 (OJ L 302, 19.10.1992, p. 1)) together with Articles 496 to 535 of the Community Customs Code Implementing Provisions (Commission Regulation (EEC) No 2454/93 (OJ L 253, 11.10.1993, p. 1)).

⁽¹²⁾ Article 86 of the Community Customs Code.

THE COMMISSION'S REPLIES

- *The Commission will follow up this point with the Member State concerned but considers it possible that this is a local error. Its own 2005 inspection of Customs warehousing not only did not disclose similar errors but confirmed the national instructions complied with Community legislation on this point.*

4.18. *The risk is further limited because customs authorities may require a guarantee (Article 88 of the Community Customs Code). If a Member State does not choose to do so and subsequently proves unable to recover a customs debt then the Commission will hold the Member State liable for the own resources.*

Furthermore, it is for Member States to arrange the methods and frequency of customs controls. Community legal provisions only define minimum levels of verification in a small number of cases where particular risks are considered to apply.

THE COURT'S OBSERVATIONS

4.19. The Court examined the systems in place to authorise and supervise customs warehouses. Overall the Court found that these systems were working well. The following weaknesses were however detected:

- in a third of the authorisation files checked there was no evidence that the stock record systems met the Community requirements ⁽¹³⁾. The Court found stock record deficiencies and discrepancies between stock records and the actual stock in customs warehouses;
- in four of the seven Member States visited the audit found that the selection of goods to be examined by customs was not risk-based ⁽¹⁴⁾ by incorporating risk profiles into the computerised customs declaration system;
- the following failures in the internal control systems were found, with a risk of unauthorised release onto the internal market and a loss of revenue. Two customs warehouses had erroneously used the same warehousing licence number, allowing imported goods to be placed in a customs warehouse other than the one declared to customs. In another case a warehouse keeper, who should have presented the goods for each exit to the customs, was using unauthorised simplified exit procedures, thereby circumventing checks;
- the Court found that the frequency of post-clearance audits in customs warehouses was so low as to increase the risk of loss of revenue due to time-barring ⁽¹⁵⁾. Moreover there was little evidence of risk-based selection of warehouses to be subjected to such audits.

VAT own resources**Reservations**

4.20. Reservations are a device to keep doubtful elements in the VAT statements submitted by Member States open for correction after the statutory time limit of four years. Of the 35 reservations lifted in 2007 ⁽¹⁶⁾, nine related to 1997 or earlier.

⁽¹³⁾ Articles 515 to 516 of the Community Customs Code Implementing Provisions as last amended by Commission Regulation (EC) No 1875/2006 (OJ L 360, 19.12.2006, p. 64).

⁽¹⁴⁾ Article 4(f) of the Community Customs Code Implementing Provisions.

⁽¹⁵⁾ In accordance with Article 221(3) of the Community Customs Code, communication to the debtor shall not take place after the expiry of a period of three years from the date on which the customs debt was incurred.

⁽¹⁶⁾ In addition there were six cases, three in Germany and three in Italy, where a reservation was partially lifted.

THE COMMISSION'S REPLIES

4.19.

- *The Commission will take up this finding with the Member States concerned. Where applicable, the relevant Member States will be requested to take remedial action where stock discrepancies are not resolved.*
- *This finding will be addressed with the Member States concerned.*
- *The duplication of the authorisation number has been corrected by the Member State and their audit has traced all the goods, finding that any duties due were all properly accounted for. The Member State is also improving its internal control systems to prevent a recurrence of the error. As regards the use of unauthorised simplified procedures, the relevant Member State has been requested to take remedial measures.*
- *The Commission has already raised this issue with one of the Member States concerned as a result of a 2006 inspection, and follow-up is continuing. It will take up this finding with the remaining three Member States.*

4.20. *Two further reservations pre-dating 1998 are expected to be lifted soon while a special visit will be made in 2008 specifically focused on devising, with the Member State concerned, a strategy which will clear the reservation placed in 1989.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

21 reservations in respect of 1997 or earlier (including two relating to 1989 and 1993) remained open as at 31 December 2007 (see **Table 4.2**).

Table 4.2 — VAT reservations as at 31 December 2007

Member States	Number of reservations outstanding at 31.12.2006	Reservations set in 2007	Reservations lifted in 2007	Number of reservations outstanding at 31.12.2007	Oldest year to which reservations apply
Belgium	8	4	4	8	1989
Denmark	1	0	1	0	
Germany	17	9	8	18	1999
Greece	16	3	9	10	1998
Spain	5	1	0	6	1999
France	3	1	0	4	1993
Ireland	12	0	0	12	1998
Italy	13	3	2	14	1995
Luxembourg	1	0	0	1	1997
Netherlands	1	1	0	2	2002
Austria	8	1	1	8	1995
Portugal	10	2	5	7	1996
Finland	6	1	0	7	1995
Sweden	11	1	3	9	1995
United Kingdom	4	3	2	5	1998
Cyprus	0	3	0	3	2004
Czech Republic	0	1	0	1	2004
Estonia	0	0	0	0	
Latvia	0	1	0	1	2004
Lithuania	0	2	0	2	2004
Hungary	0	5	0	5	2004
Malta	0	6	0	6	2004
Poland	0	3	0	3	2004
Slovakia	3	2	0	5	2004
Slovenia	0	0	0	0	
Bulgaria	0	0	0	0	
Romania	0	0	0	0	
Total	119	53	35	137	

Source: European Commission.

4.21. There is no effective instrument for ensuring that Member States provide adequate information within clearly defined deadlines, so enabling the Commission to decide on the lifting of outstanding reservations. In its recommendation on the discharge in respect of 2006, the Council repeated its call for the Commission, in co-operation with the Member States, to continue its efforts to ensure that reservations are lifted within reasonable timescales.

4.21. The present legal arrangements represent a balance reflecting the cooperative approach that needs to exist between the Commission and Member States. However, the Commission is overhauling its arrangements for managing reservations, making them more proactive. Reservations will be categorised making it easier to identify those most requiring action. Management visits focusing solely on strategies to deliver progress leading to the lifting of reservations are in the process of introduction. The Commission will also be more proactive in considering whether instituting infringement proceedings would bring benefits in particular cases.

THE COURT'S OBSERVATIONS

4.22. During 2007 the changes to the EU-27 VAT base following the Commission's control work in Member States resulted in an increase in the aggregate VAT resource of about 50 million euro. In addition the upward revisions to the GNI of Greece (see paragraph 4.28), which in turn had an impact on capping ⁽¹⁷⁾, resulted in an increase in that Member State's VAT contribution of around 300 million euro.

4.23. The Court examined the evidence supporting the lifting of the 35 reservations in 2007. The Commission's work on lifting reservations was generally satisfactory. However the following problem was identified: when the Commission accepts the revised data of a Member State and then lifts the associated reservation, it should immediately input this revised data into its financial database and adjust the amount of own resources due. The corrections in respect of four lifted reservations were not input in this database and the VAT-based own resource has thus not been correctly calculated.

Monitoring of the application of the VAT directive

4.24. DG TAXUD is responsible for ensuring the correct application of the VAT Directive. When the Commission considers that a Member State fails to fulfil its obligations under this Directive, the former may bring the matter before the Court of Justice after having gone through a pre-contentious phase (infringement procedure — Article 226 of the Treaty establishing the European Community). In 2007 there were five such cases, three of which had a negative effect on VAT own resources. For the two cases actually submitted to the Court of Justice in 2007, the average time taken from registration until the sending of the letter of referral was 29 months. The three other cases, dating back to 2003-2005, had not been brought before the Court by the end of 2007 despite the decision to do so being taken in June 2007.

THE COMMISSION'S REPLIES

4.23. *The database changes have now been made, the total financial impact is just under EUR 12 million over the five years of the reservations. Additionally new procedures extending inter-service consultation on the contents of control reports have been introduced. These should provide a safeguard against any future occurrence.*

4.24. *The legal context in Member States is often detailed and complex, requiring substantial analysis. The Commission pays particular attention to the preparation of cases on the interpretation of indirect taxation legislation because of the 'own resources' involved and the unanimity requirement to change the legislation. At the same time the Commission succeeds in ensuring a broadly equivalent rate of progress of cases affecting the own resources as for other complex detailed cases of mis-application of Community law. Although this does not influence its case-management, the Commission claims due amounts, plus interest for the time elapsed, in correcting infringements.*

More generally, the Commission has recently changed its procedures, to allow for more frequent decision-taking in order to reduce the delays which occurred when Member State notifications were received shortly before the next procedural step was due to be taken, allowing for cases to progress as soon as the analysis of the new information has been completed. The Commission risks losing a case on procedural grounds if it does not take full account of the input by Member States. In addition, the preparation of the application to be lodged with the Court of Justice may sometimes prove to be difficult owing to the complexity of the facts, of the applicable legislation or of the legal questions raised.

⁽¹⁷⁾ In accordance with Article 2(1)(c) of Decision 2000/597/EC, Euratom (OJ L 253, 7.10.2000, p. 42) the VAT bases to be taken into account for calculating the Member States VAT contributions shall not exceed 50 % of GNI/GNP for each Member State.

THE COURT'S OBSERVATIONS

4.25. During these periods the VAT Directive was not being applied correctly. This may well have reduced the amount of VAT received by Member States and thereby potentially had an impact on VAT-based own resources.

GNI own resources**Annual GNI data**

4.26. Before 22 September each year, Member States shall provide the Commission (Eurostat) with figures for aggregate GNI and its components (the GNI Questionnaire) covering the preceding year and any revisions made to the figures for previous years. Together with these figures, Member States are required to transmit a report on the quality of GNI data (the GNI Quality Report) setting out how the aggregate was reached, describing any significant changes in the procedures and basic statistics used, and explaining the revisions made to earlier GNI data ⁽¹⁸⁾. The annual GNI figures supplied by Member States can give rise to adjustments to the GNI balances established for previous years ⁽¹⁹⁾.

4.27. At its meeting of 25 October 2007, the GNI Committee considered that, taking due account of the existing reservations, the data of EU-15 Member States were adequate for use for own resource purposes. As regards the EU-12 Member States, the GNI Committee was not able to form an opinion on the data because the analysis of the GNI inventories ⁽²⁰⁾ had just started (see paragraph 4.38).

4.28. The data included in the GNP ⁽²¹⁾/GNI Questionnaire 2007 of Greece showed a retroactive increase of between 8,5 % and 9,9 % for the years 1995 to 2005. In the GNP/GNI Questionnaire 2006 Greece had transmitted revised data showing increases of between 13 % and 26 %, representing an exceptionally significant revision. As it considered that it did not have sufficient information on the revised data and the underlying methodological changes reported by Greece, the GNI Committee had taken the view that the existing unrevised GNP/GNI series should be used for own resources purposes, until the Commission had fully verified the new data and reported the results of its verification to the GNI Committee ⁽²²⁾.

⁽¹⁸⁾ Article 2(2) and 2(3) of the GNI Regulation.

⁽¹⁹⁾ Article 10(8) of the Regulation (EC, Euratom) No 1150/2000 states that any changes to the GNP/GNI of previous financial years shall give rise for each Member State concerned to an adjustment to the balance established. It also states that, after 30 September of the fourth year following a given financial year, any changes to GNP/GNI shall no longer be taken into account, except on points notified within this time limit either by the Commission or by the Member State.

⁽²⁰⁾ Article 3 of the GNI Regulation: 'Member States shall provide the Commission (Eurostat) [...] with an inventory of the procedures and basis statistics used to calculate GNI and its components according to ESA 95. [...]'

⁽²¹⁾ Gross national product.

⁽²²⁾ See paragraphs 4.24 to 4.26 of the Court's Annual Report concerning the financial year 2006.

THE COMMISSION'S REPLIES

4.25. *Any possible effect on the VAT-based resource will be taken into account retroactively when the Court of Justice rules on the cases.*

THE COURT'S OBSERVATIONS

4.29. In 2007 Greece transmitted only a summarised GNP/GNI Questionnaire with no GNP/GNI components and a short explanatory note instead of a Quality Report. Although the GNI Committee considered that, taking due account of the existing reservations, the new Greek GNP/GNI data notified in 2007 were adequate for own resources purposes (see paragraph 4.27), it invited the Greek National Statistical Institute (NSI) and Eurostat to continue their cooperation on outstanding issues, including on some more detailed calculations.

4.30. The Commission had carried out beforehand on-the-spot visits in June and September 2007 to verify the Greek inventory and calculated estimates of revised GDP ⁽²³⁾ figures for the reference year 2000. The total increase was consistent with the revision included in the GNP/GNI Questionnaire 2007.

4.31. The Commission and the Greek NSI set up an action plan for further work to be carried out in order to finalise the calculation of national accounts components. In November 2007 the Commission stressed the importance of checking the reconciliation between total revisions and changes linked to specific reservations as well as the need for the Greek NSI to provide full documentation on them. The action plan also required the Greek NSI to send the official detailed figures in accordance with ESA95's transmission of national accounts data ⁽²⁴⁾ by 10 December 2007.

4.32. In the absence of the complete information on GNP/GNI required by the GNI Regulation (see paragraph 4.29) and as the details on GNP/GNI components and documentation on reservations required by the action plan (see paragraph 4.31) were not available by February 2008, the Court was not able to review the calculation of the GNP/GNI for the years 1995-2006 nor to check whether GNP components revised by Greece are covered by specific reservations set for the period 1995-2001. As a consequence, the Court could not assess the accuracy of the adjustments to the GNI balances for these previous years.

THE COMMISSION'S REPLIES

4.29 to 4.32. *The main corrections to the Greek GDP figures proposed by the Commission derived from its mission in Greece and were presented in full details (in particular in document GNIC/094) and discussed at the GNI Committee meeting of 6 September 2007. The Member States' national accounts experts in the GNI Committee supported the proposed corrections. The GNP/GNI figures for 1995-2006 notified by Greece in October 2007 are in line with these corrections. At their meeting on 25 October 2007, the GNI Committee expressed its support for the process as well as the results of the verification work carried out by Eurostat in cooperation with Member States' GNI experts and in close consultation with the GNI Committee. The Commission is following up the action plan carried out in order to finalise the calculation of the Greek national accounts components. The Greek NSI sent to Eurostat the ESA 95 transmission programme data on 14 December 2007; Eurostat checked the data and made comments, following which the Greek NSI sent revised data, taking account of Eurostat comments and including data for the year 2007, on 4 March 2008. Eurostat will report the results of the outstanding matters in its verifications to the GNI Committee and the Court of Auditors. Further to the request of the GNI Committee, the Commission has continued its cooperation with the National Statistical Service of Greece on some more detailed calculations, and expects that most of the reservations can be lifted soon. The Commission will continue to keep the GNI Committee and the Court of Auditors informed about developments on this issue.*

⁽²³⁾ Gross domestic product.

⁽²⁴⁾ Regulation (EC) No 1392/2007 of the European Parliament and of the Council of 13 November 2007 amending Council Regulation (EC) No 2223/96 with respect to the transmission of national accounts data (OJ L 324, 10.12.2007, p. 1).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Reservations

4.33. At the beginning of 2007, there were 43 open specific GNP/GNI reservations ⁽²⁵⁾ relating to the period 1995 to 2001. During 2007, the Commission lifted 18 reservations leaving a balance of 25 at the year end (see **Table 4.3**). These open reservations relate either to out-of-date sources underlying certain estimates or to methodological and compilation aspects ⁽²⁶⁾. Excluding the case of Greece (see paragraph 4.29), most of the issues underlying reservations have already been addressed by Member States through the transmission of the annual GNI data in 2007 or previous years.

Table 4.3 — GNP/GNI specific reservations as at 31 December 2007

Member States	Number of specific reservations outstanding at 31.12.2006	Specific reservations set in 2007	Specific reservations lifted in 2007	Number of specific reservations outstanding at 31.12.2007
Belgium	0	0	0	0
Denmark	3	0	3	0
Germany	0	0	0	0
Greece	7	0	0	7
Spain	5	0	5	0
France	3	0	3	0
Ireland	4	0	4	0
Italy	4	0	0	4
Luxembourg	8	0	0	8
Netherlands	0	0	0	0
Austria	0	0	0	0
Portugal	0	0	0	0
Finland	3	0	3	0
Sweden	0	0	0	0
United kingdom	6	0	0	6
Total	43	0	18	25

Source: European Commission.

4.34. As regards the period 2002 to 2004, general reservations exist on GNI data of EU-15 Member States pending the analysis of the updated GNI inventories. No general reservations for EU-10 Member States had been set by the end of 2007 as their GNI data in respect of 2004 will remain open for own resource purposes until September 2008.

4.34. In June 2008 the Commission set general reservations on the 10 new EU Member States' GNI data covering reference years 2004-2006.

⁽²⁵⁾ Reservations in respect of the GNI own resource make it possible to adjust GNI data after the 4-year time limit. A general reservation covers all the Member State's data, whereas a specific reservation covers discrete elements of the GNI Inventory.

⁽²⁶⁾ For example, non-compliance with the European System of Accounts (ESA) 95 (for years 2002 onwards) or ESA 79 (for years 1995-2001), issues concerning the transition from ESA 95 to ESA 79 and weak methods for estimating certain components.

THE COURT'S OBSERVATIONS

4.35. The Court examined a sample of 10 specific reservations lifted in 2007, relating to Spain, Denmark and France. It found that the Commission's work to enable the lifting of reservations involved neither desk checks to corroborate the reliability of the information provided by Member States through comparison with external sources, nor on-the-spot control visits to perform direct verification of national accounts' aggregates. For these reasons, the Court considers that these checks were not sufficient to provide reasonable assurance of the accuracy of the underlying data amended.

4.36. The Commission was in many cases slow to request additional information or data from Member States and then to analyse the information received.

4.37. Eurostat's procedure for the management of GNI reservations does not provide specific rules on materiality criteria for setting specific reservations in order to consistently take into account the principle of cost-benefit ⁽²⁷⁾.

Verification of GNI inventories in the Member States

4.38. Some Member States ⁽²⁸⁾ did not provide the Commission with the complete version (including process tables) of updated or new GNI inventories by the end of 2007, even though the deadline was 31 December 2006 ⁽²⁹⁾. This delay had an impact on the planning of the Commission's on-the-spot verification missions foreseen for the period 2007 to 2009. Visits were carried out in three Member States (Greece, Malta and Estonia) in 2007.

⁽²⁷⁾ For example the potential impact of reservations in respect of building caretakers and commissions paid to estate agents was not material. After the Member State's work, the impact was estimated to be around 0,01-0,02 % of GNP. Such cases do not respect the principle of avoiding committing disproportionate resources to calculate insignificant items, as set out in article 5(2)(b) of the GNI Regulation.

⁽²⁸⁾ Luxembourg did not send its inventory and process tables; Austria, Cyprus, France, Malta and United Kingdom did not send the process tables.

⁽²⁹⁾ 31.12.2007 for Sweden (which sent its inventory and process tables at the end of January 2008) and 31.12.2009 for Romania and Bulgaria.

THE COMMISSION'S REPLIES

4.35. *The Commission carried out desk checks that provided sufficient information for lifting the specific reservations mentioned. These desk checks did not demonstrate the necessity of on-the-spot missions, or the need for a comparison with external sources.*

4.36. *The slow progress on lifting specific GNI reservations referred to by the Court was due to resource constraints. Work on reservations has since accelerated and those remaining are expected to be lifted soon.*

4.37. *The Commission sets reservations on specific issues on the basis of its expert assessment which is made taking into account all available qualitative and quantitative information. The Commission considers that this approach is prudent and fully in line with the cost-benefit principle as mentioned in Council Regulation (EC, Euratom) No 1287/2003. In the examples mentioned by the Court in footnote 27, the impact could be quantified only at the end of the Member States' work on the reservations and not before.*

4.38. *The Commission had to adapt its GNI verification plan due to the delayed delivery of the GNI inventory by some Member States. The Commission has constantly urged the Member States, in particular in the GNI Committee, to transmit their GNI inventories and process tables within the agreed deadlines. The fact that the plan of GNI missions had to be adapted had no impact on the quality of GNI nor on their use in the budgetary procedures given the GNI reservations in place.*

THE COURT'S OBSERVATIONS

4.39. In 2007 direct verification on GNI aggregates was only performed in the particular case of Greece. The objective of the visits to Malta and Estonia was principally to obtain clarification on the sources and methods used for the calculation of GNI. The Court has in the past urged the Commission to undertake direct verification in order to obtain assurance that Member States really do use the procedures they describe in their GNI inventories ⁽³⁰⁾.

Overall conclusions and recommendations

4.40. Based on its audit work, and with due consideration to its scope (see paragraphs 4.4 and 4.9), the Court concludes that:

- the Member States' declarations and payments of traditional own resources,
- the Commission's calculation of the Member States' contributions on the basis of the VAT and GNI data received from the Member States, as well as
- other types of revenue

are free from material error.

4.41. Its assessment of the related supervisory and control systems is that they are effective (see **Annex 4.1**). However the Court draws attention to the weaknesses set out in this chapter which, while not being material to the effectiveness of the systems as a whole, merit further attention.

THE COMMISSION'S REPLIES

4.39. *The Commission's chosen method of validation is mainly based on the verification and improvement of the reliability and suitability of the sources and methods used for the compilation of GNI and their conformity with the European system of accounts (ESA95). During 2008 and 2009, the Commission will continue to carry out direct verification in the sense indicated by the Court.*

4.41. *Notwithstanding the Court's evaluation that overall the systems are satisfactory, it has assessed, in Annex 4.1, the management of VAT reservations as only partly effective. Its reasons for this qualification mainly relates to the management of long outstanding reservations. The Commission, in close cooperation with those Member States concerned, is taking measures to address this point. It nevertheless considers the Court's assessment severe.*

Even though the Court assesses the overall GNI systems as effective, the Court considers, in the summary table in Annex 4.1, that more direct verification should be applied during the checks of Member States' GNI. The Commission considers that its action to lift Member States' GNI reservations is based on a thorough verification of the supporting data and information (see reply to paragraph 4.35). However, the Commission started direct verification in 2007 in the sense indicated by the Court, as part of its new three-year cycle of GNI verification, and will continue to also apply this approach during 2008 and 2009.

⁽³⁰⁾ See Annex 4.1 of the Court's Annual Report concerning the financial year 2006.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Traditional own resources

4.42. The Commission should continue its efforts to ensure that the B accounts are utilised appropriately (paragraphs 4.14 and 4.16). The audit of the customs warehousing procedure demonstrated that the underlying controls need to be strengthened (paragraph 4.19).

VAT own resources

4.43. The Commission still has no effective means of ensuring that Member States provide adequate and timely information which would permit it to lift outstanding reservations about the calculation of VAT own resources. The Commission should further examine what steps are open to it to bring pressure to bear on those Member States with very long outstanding reservations (paragraph 4.21).

GNI own resources

4.44. The updated figures for Greece did not include the detail necessary for the Court to verify the accuracy of the adjustments to the GNI balances, in particular for the period 1995-2001 (paragraph 4.32).

4.45. 18 reservations have been lifted in 2007 without either desk checks on the reliability of the information sent by Member States through comparison with external sources or on-the-spot control visits to carry out direct verification (paragraph 4.35). The Commission should apply this control approach in its on-the-spot visits for the verification of inventories in 2008 to obtain a better view of the comparability, reliability and exhaustiveness of GNI data of Member States (paragraph 4.39).

4.42. *The Commission regularly inspects Member States' systems of customs control and their management of the B accounts. It will address the weaknesses found by the Court with the relevant Member States and will, where appropriate, take measures to recover any amounts of own resources or interest due.*

4.43. *The present legal arrangements represent a balance reflecting the cooperative approach that needs to exist between the Commission and Member States. The Commission will be categorising reserves; making management visits focused solely on securing strategies leading to the lifting of reservations; and will be more proactive in considering whether instituting infringement proceedings would bring benefits in particular cases.*

4.44. *The Commission carried out a mission to Greece in June 2007. Experts from other Member States participated. The detailed corrections to the Greek GDP figures were fully explained at the GNI Committee meeting of 6 September 2007. The Member States' national accounts experts in the GNI Committee supported the proposed corrections (see full reply to paragraphs 4.29 to 4.32).*

4.45. *The Commission carried out desk checks which provided sufficient information for lifting the specific reservations mentioned in paragraph 4.35. The results of these desk checks did not show the need for on-the-spot control visits or comparison with external sources.*

The Commission's validation of Member States' GNI data is mainly based on the verification and improvement of the reliability and suitability of the sources and methods used for the compilation of GNI and their conformity with the European system of accounts (ESA 95). During 2008 and 2009 the Commission will continue to carry out direct verification in the sense indicated by the Court.

FOLLOW-UP OF PREVIOUS OBSERVATIONS

4.46. The results of the Court's follow-up of previous observations in recent annual reports can be found in **Annex 4.2**.

ANNEX 4.1

Assessment of supervisory and control systems ⁽¹⁾

Revenue type	Key Internal Control					Overall assessment
	Commission checks in Member States ⁽²⁾	Commission desk checks	Revenue management	Management of Reservations ⁽³⁾	National customs supervision in Member States audited	
TOR				N/A		
VAT					N/A	
GNI					N/A	

⁽¹⁾ See scope limitation referred to in paragraphs 4.4 and 4.9.

⁽²⁾ In respect of the Commission checks on GNI in Member States, the review of sources and methods set out in the inventories is assessed as effective, whereas direct verification is insufficiently used and thus only partially effective.

⁽³⁾ Improvements are required in respect of the management of VAT reservations, notably to be able to lift long-outstanding reservations.

Legend:

	Effective
	Partially effective
	Not effective
N/A	Not applicable

Follow-up of the Court's previous observations

Court observation	Action taken	Court analysis	Commission reply
<i>Traditional Own Resources: Agricultural tariff quotas</i>			
<p>In paragraph 4.13 of the Annual Report concerning the financial year 2006, the Court noted that the securities lodged with a view to imports or exports of agricultural products under the Tariff Quota System managed by an import or export licence and subsequently forfeited become a resource of the Member State concerned. The Court considers that such a security should form part of the Communities' own resources and the amounts involved should be made available to the Commission. The Commission was invited to clarify this issue.</p>	<p>The Commission provided the Court with detailed data concerning securities lodged with a view to imports or exports of agricultural products by an import or export licence subsequently forfeited in the last seven years. Based on this information the Court estimates the annual average to be some 16 million euro of which 3 million euro are under the Tariff Rate Quota (TRQ) System</p>	<p>The Commission, as stated in its reply to paragraph 4.13, should raise the Court's consideration in the appropriate forum in order to clarify the question. This is now planned for 2008.</p>	<p><i>This issue has been placed on the agenda of the July 2008 Advisory Committee on Own Resources in order to further discuss the matter with the Member States.</i></p>
<i>Traditional Own Resources: Potential duties under discussion between the Commission and Germany</i>			
<p>In paragraph 3.23 of Annual Report concerning the financial year 2004, the Court noted that in 2003 Germany removed entries totalling 40,1 million euro from its B account, without providing a full explanation of this reduction.</p> <p>In 2005, the Court indicated that 22,7 million euro of potential duties remain under discussion between the Commission and Germany. This was still the situation in 2006.</p>	<p>The balance of 22,7 million euro was still under discussion in 2007. The Commission has asked Germany to provide the split between guaranteed and non guaranteed debts in the B-account and use this data to evaluate the assurance on the amounts likely to be eventually recovered.</p>	<p>The definitive amount to be recovered should be established in order to finally close this issue.</p>	<p><i>As indicated by the Court, Germany has been requested to supply the ratio between guaranteed and unguaranteed debts in the B account in order to gain assurance that there are no additional amounts due.</i></p>
<i>GNI own resource: revision policy (including the follow-up of the Greek revision)</i>			
<p>In the Annual Report concerning the financial year 2006, the Court made some observations on the Greek revision (paragraphs 4.24-4.26) and recommended in paragraph 4.32 that the Commission:</p> <p>(a) sets rules on communication and is forewarned, together with the GNI Committee, of major revisions;</p> <p>(b) implements a coordinated policy for national accounts data revisions, including the requirement for a regular bench-marking;</p>	<p>(a) (b) On 26 April 2007 the GNI Committee expressed an overall positive opinion on the guidelines proposed by the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB), particularly on coordination and communication on major revisions due to changes in concepts, definitions or classifications in the European Union (including common benchmarking every five years). Nevertheless some Member States wish to retain the right to carry out revisions outside the agreed timetable. On 13 November 2007, Ecofin Council welcomed the guidelines on the communication of major statistical revisions as set by the CMFB and invited Member States to follow these guidelines.</p>	<p>(a) (b) Despite the progress made in the setting of rules on communication of major revisions, a common revision policy in the European Union is not yet implemented. Eurostat should continue to discuss the issue with Member States.</p>	<p>(a) (b) <i>The Commission will monitor the application of the guidelines proposed by the Committee on Monetary, Financial and Balance Payments Statistics (CMFB) on communication of major revisions by Member States. The Commission is continuing discussions with Member States on a common revision policy. Eurostat submitted another document to the meeting of the National Accounts Working Group (NAWG) in May 2008. The NAWG welcomed the principles presented in the document, which will also be presented at the CMFB meeting of June 2008.</i></p>

Court observation	Action taken	Court analysis	Commission reply
(c) ensures that the conclusions from control of the Greek inventory are available early enough, so as to allow the inclusion of corrected data in accounts for the financial year 2007.	(c) See paragraphs 4.28-4.32 in the text above.	(c) Even though the new Greek GNP/GNI data notified in 2007 were considered adequate for use for own resources purposes by the GNI Committee, the figures are not yet final (there are specific reservations for the period 1995-2001, general reservations for the years 2002-2004 and 4-year rule applies for the following years). Eurostat's work should be continued, in cooperation with Greece, in 2008 in order to complete the verification of the Greek GNI inventory and data as well as to lift the specific reservations.	(c) <i>Further to the request of the GNI Committee of October 2007, Eurostat has continued its cooperation with the National Statistical Service of Greece and expects that most of the reservations can be lifted in 2008. The Commission will continue to keep the GNI Committee and the Court of Auditors informed about developments on this issue.</i>

CHAPTER 5

Agriculture and Natural Resources

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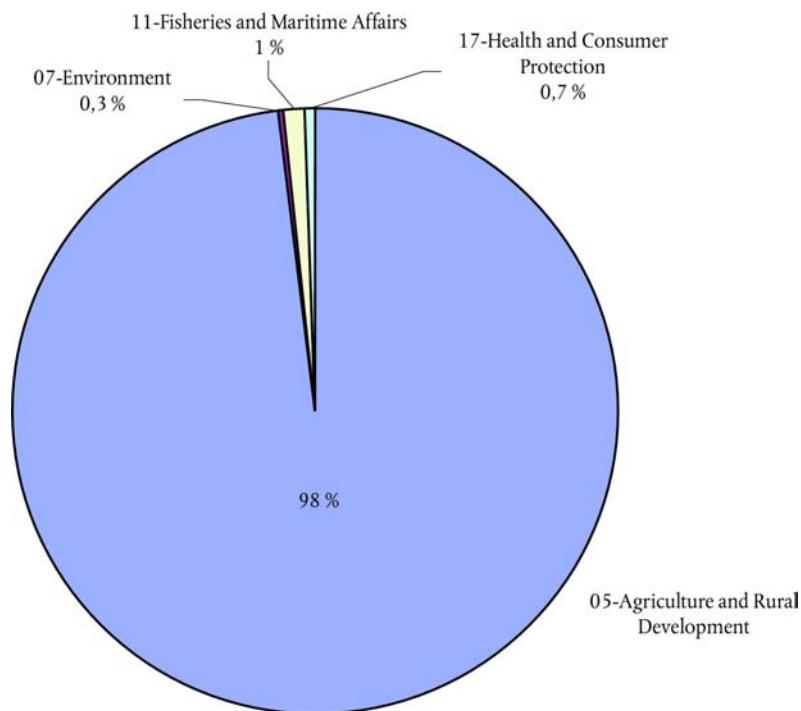
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INTRODUCTION

5.1. This chapter covers the Court's findings on policy group Agriculture and Natural Resources, which comprises the following policy areas: 05-Agriculture and Rural Development; 07-Environment; 11-Fisheries and Maritime Affairs; and 17-Health and Consumer Protection. In 2007 commitments totalled 53 253 million euro and payments totalled 51 044 million euro ⁽¹⁾. The distribution of payments by policy area is given in **Graph 5.1**. More detailed information on spending for the year is provided in **Annex I** of this report. This expenditure falls mainly under the heading Preservation and Management of Natural Resources ⁽²⁾ of the financial framework. The audit results of EAGGF-Guidance expenditure incurred during the year 2007 in respect of the 2000-2006 programming period (3 449 million euro), are reported under chapter 6 — Cohesion Policy.

**Graph 5.1 — Agriculture and Natural Resources (excluding Administrative Expenditure)
— breakdown of payments by policy area**



Total payments in 2007: 51 044 million euro

Source: Annual accounts of the European Communities financial year 2007, Volume II, Annex B.

⁽¹⁾ Source: Annual accounts of the European Communities financial year 2007, volume II, Annex B.

⁽²⁾ Policy area Health and Consumer Protection also includes expenditure under heading 2 and 3b of the financial framework.

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5.2. Under the Treaty, the Commission has overall responsibility for implementing the EU budget. Virtually all agricultural and rural development expenditure is carried out under shared management. For the other areas, budgetary appropriations are spent under direct or indirect centralised management with the exception of the European Fisheries Fund which is under shared management on the basis of multi-annual programmes.

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5.2. Community legislation provides for a comprehensive system for the management and control of agricultural expenditure which relies on four complementary levels:

- (a) a compulsory administrative structure at the level of Member States, centred around the establishment of accredited paying agencies;
- (b) detailed systems for controls and dissuasive sanctions;
- (c) ex-post controls by independent audit bodies on the paying agencies' annual accounts and the functioning of their internal control procedures and by special departments on aid measures other than direct payments covered by the Integrated Administration and Control System (IACS);
- (d) clearance of accounts through the Commission (both annual financial clearance and multi-annual conformity clearance).

Taken together, these four levels are the basis for the Commission to gain reasonable assurance as to the effective management of the risk of error in the legality and regularity of the underlying transactions in agriculture.

Specific characteristics of policy group Agriculture and Natural Resources

5.3. The *Single Payment Scheme (SPS)* financed by EAGF: the SPS was introduced in order to break the link between agricultural production and the payments made to farmers ('decoupling'). In order to qualify under the SPS farmers must first obtain 'entitlements'. The number and value of each farmer's entitlements was calculated by the national authorities according to one of the models provided for under EU legislation⁽³⁾. Every entitlement, together with one hectare of eligible land declared by the farmer and kept in good agricultural and environmental condition (GAEC), gives rise to an SPS payment at least until 2013. SPS has been growing in importance and now constitutes 55 % of expenditure (28 199 million euro) compared to 12 %

⁽³⁾ Under the *historical model* each farmer is granted entitlements based on the average amount of aid received and area farmed during the reference period 2000 to 2002. Under the *regional model* all entitlements of a region have the same flat-rate value and the farmer is allocated an entitlement for every eligible hectare declared in the first year of application. The *hybrid model* combines the historical element with a flat rate amount and, if it is *dynamic*, the historical component decreases each year until it becomes a predominantly flat rate-system.

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(6 260 million euro) paid for direct coupled payments and 10 % (4 869 million euro) for intervention measures in agricultural markets. It is applied in 17 Member States with the remaining 10⁽⁴⁾ scheduled to apply the scheme from 2010 onwards.

5.4. The *Direct Coupled Payments* financed by EAGF: with the introduction of the SPS most farmers are paid independently of the volume of actual production. Nevertheless some aid schemes remain⁽⁵⁾ or may be⁽⁶⁾ coupled to output in order to avoid abandonment of production. The amounts involved are declining as the SPS is extended to additional products and Member States.

5.5. *Intervention measures in agricultural markets* financed by EAGF: the principal measures are intervention storage and export refunds. Expenditure has declined sharply in recent years due to policy choices made in the context of the recent CAP reforms and also because demand and market prices for agricultural products have increased.

5.6. *Rural Development* expenditure is funded under EAFRD and covers a large number of measures such as agri-environmental schemes, compensatory amounts for farming in less-favoured areas, investments in farms, and infrastructure in rural areas.

5.7. *Environment, Fisheries and Maritime Affairs as well as Health and Consumer Protection* are managed by the Commission under specific control systems. They cover protection measures for the environment and consumers, animal welfare measures, as well as international fishery agreements and the European Fisheries Fund.

⁽⁴⁾ The Member States which joined the EU in 2004 and 2007 except for Slovenia and Malta, currently apply a simplified version of SPS called the Single Area Payments Scheme (SAPS) as the farmers did not receive EU subsidies during the reference period.

⁽⁵⁾ The specific quality premium for durum wheat, protein crop premium, crop specific payment for rice, area payment for nuts and aid for energy crops remain coupled. Aid for cotton and for starch potato remain partially coupled.

⁽⁶⁾ The schemes concerned are in particular arable crops, sheep and goats, beef and veal, hops and seed aid. Aid for tobacco can remain partially coupled and a specific aid for the maintenance of olive groves can be granted if the Member State decides so.

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SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Audit scope

5.8. In order to obtain assurance as to the legality and regularity of the transactions underlying the EU accounts, the Court tested a single representative statistical sample of 196 transactions covering the whole of the expenditure dealt with in this chapter (see paragraph 5.1).

5.9. As regards its assessment of supervisory and control systems, the Court has conducted an extensive audit of the establishment of SPS entitlements and the related payments in all Member States applying SPS, with the exception of Slovenia and Malta. During 2007 it examined the reliability of the supervisory and control systems applicable to Single Payment Scheme claims in selected paying agencies in Finland, France, Greece, the Netherlands, Italy, Portugal, Sweden, Spain (Andalucia) and the United Kingdom (England) ⁽⁷⁾.

5.10. The Court has also tested the supervisory and control systems for direct coupled payments in six Member States ⁽⁸⁾. The audit covered an assessment of the functioning of the administrative controls of all claims and the selection and execution by the paying agencies of on-farm inspections for a sample of a minimum of 5 % of the claims, depending on the scheme. In addition, the Court's auditors conducted a number of re-performances of controls on the spot.

5.11. The Court also reviewed the certifying bodies' certificates and reports as well as the paying agency directors' statements of assurance and the related certifying bodies' opinions for 34 paying agencies. For another five paying agencies, with qualified certificates, the grounds for the qualification were examined. Four certifying bodies were visited in order to evaluate the scope and quality of their work. The Court further audited the three conformity clearance decisions taken in 2007 ⁽⁹⁾.

⁽⁷⁾ The 10 Member States which first applied SPS were audited in 2006. See the Annual Report concerning the financial year 2006, paragraphs 5.15 to 5.38.

⁽⁸⁾ Germany (Bayern), Italy (AGEA) and Portugal which have introduced SPS in 2005; France, Greece and Spain (Castilla y Leon) which have introduced SPS in 2006.

⁽⁹⁾ Commission Decision 2007/243/EC (OJ L 106, 24.4.2007, p. 55), Commission Decision 2007/647/EC (OJ L 261, 6.10.2007, p. 28) and Commission Decision 2008/68/EC (OJ L 18, 23.1.2008, p. 12).

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Legality and regularity of underlying transactions

5.12. Based on the results of its audit work, the Court concludes that the transactions underlying the policy group taken as a whole, are affected by a material level of error of legality and/or regularity. The Court's audit found that the intensity and the impact of errors in payments was not distributed evenly across all the policy areas. The Court reiterates that Rural Development expenditure is particularly prone to errors and notes that, in recognition of this, the Annual Activity Report of the Director General for Agriculture contains a global reservation in respect of that expenditure.

5.13. Out of 196 transactions examined, 61 were affected by error. Some two-thirds of the errors (40) were classified as 'serious'. There was a material incidence of error affecting eligibility, accuracy or occurrence, such that the estimated value of the overall error rate falls into the range from 2 % to 5 %. This estimate is not significantly different from the value obtained last year but does not take account of certain serious errors which could not be quantified. Errors were significantly more frequent among rural development transactions examined by the Court than among transactions financed by the EAGF and examined by the Court. Rural development accounts for a disproportionately large part of the overall error rate: for EAGF expenditure the Court estimates the value of the error rate to be slightly below 2 %. The examples below illustrate the nature of the main errors found.

5.12-5.13. *The Commission aims to ensure that supervisory and control systems are effective in detecting and correcting errors, with due regard to the costs and benefits of the checks which have to be made on the spot.*

As regards agriculture and rural development, the Commission underlines the Court's finding that the most likely overall error rate is not significantly different from last year's, as reported in its 2006 statement of assurance. Control statistics received from Member States, indicate as well that the error rate found at the level of final beneficiaries under the EAGF, which accounts for about 85 % of total agriculture and rural development expenditure, is below the materiality threshold.

The Commission shares the Court's view that rural development expenditure, in particular because of agri-environmental measures, is prone to a higher incidence of errors compared to EAGF expenditure. While the Member States have, at the explicit request of the Commission, provided detailed control statistics for the first time, these data are incomplete and have not yet been verified and validated by the certification bodies. The Director General of DG AGRI made a reservation for rural development in its Annual Activity Report 2007 (AAR 2007) for this reason and awaits future discussions on the level of the tolerable error with different institutions.

The 2007 agriculture and rural development expenditure likely to be excluded from Community financing by future conformity decisions, amounts to an estimated sum of 439 million euro, together with the 152 million euro of recoveries from final beneficiaries ⁽¹⁾.

As described in its AAR 2007 the Directorate-General for Health and Consumers (DG SANCO) is confident that its transactions are not affected by a material level of error of legality and regularity given that the residual error rate is 1,6 % and thus below the materiality threshold of 2 %.

As described in its AAR 2007 of the Directorate-General for Environment (DG ENV), the control systems and the shortcomings identification mechanisms have continuously matured and are complemented where appropriate. These alert mechanisms have not revealed any shortcomings, error or risk that could be qualified as significant and lead to reservations, according to the materiality criteria guidelines provided in the AAR circular, except in the area of the ex-post audits where the level of recovery orders recommended by the ex-post auditors and its regular increase over the last years lead to the expression of a reservation concerning the expenditures declared by the beneficiaries of action grants as the materiality level was exceeded by 0,6 %.

⁽¹⁾ In 2007, 607 million euro was recovered by financial correction and 247 million euro recovered from final beneficiaries by Member States (see chapter 6 of the notes to the annual accounts 2007).

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5.14. In the EAGF, the following errors were identified by the Court's sample:

(a) SPS: farmers overclaimed and/or the entitlements were wrongly calculated, resulting in incorrect payments.

(b) SPS: overpayments to certain olive oil claimants as a result of being allocated extra entitlements from the national reserve when they were not eligible to receive them (Spain); the beneficiary audited was paid an amount considerably in excess of the average payment over the reference period (1999-2002) but did not meet the investment criteria of the programme under which the extra entitlements were awarded.

(c) SPS: in its Annual Report concerning the financial year 2006 ⁽¹⁰⁾, the Court pointed out that in Greece, Spain and Italy the olive cultivation GIS data, was neither complete nor reliable, and could have an impact on the integration of the olive oil production aid scheme into the system. These weaknesses persist in Italy and Greece where four out of five transactions audited contained errors, some of which led to significant overpayments.

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5.14. *While the transactions audited are designed to be representative of the policy group as a whole, the errors found do not necessarily permit conclusions to be drawn on the functioning of the individual aid. The errors observed by the Court listed below are only partly agreed by the Commission and the Member States concerned.*

(a) *The audits carried out by the Commission services showed that in general the calculation of entitlements was performed in accordance with the applicable legislation and that administrative and on-the-spot checks are generally operating well. Problems are followed up in the conformity clearance.*

On payments coming from erroneous attributions of entitlements, the applicable regulation provides that the farmer shall not repay the amount in question if an error in the attribution of entitlements stemmed from the national administration and if it could not reasonably have been detected by the farmer. The Commission considers that the conformity clearance is a good instrument to cover the risk for the Fund while respecting the farmers' legitimate expectations.

(b) *The Court's findings in this respect were known to the Commission on the basis of its own audit missions and are already the subject of a conformity clearance.*

(c) *On the basis of its own audit findings, the Commission has already started a conformity clearance in respect of the systemic deficiencies of the Greek control system, including the calculation of entitlements ⁽²⁾.*

The olive cultivation geographic information system (GIS) data are only used as a consistency check before payment of olive oil production. As the entitlements delivered are based on the olive oil production payments, there is no direct link between GIS and the value of the entitlements allocated. Entitlements are regular and legal if they have been calculated on the basis of the amount paid during the reference period ⁽³⁾. The Court's system audit on the establishment of entitlements in Greece concluded that those coming from the olive oil sector were systematically underestimated.

⁽¹⁰⁾ Paragraphs 5.82 to 5.84.

⁽²⁾ Letters of June 2006 and April 2007.

⁽³⁾ Council Regulation (EC) No 1782/2003.

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- (d) Direct Coupled Payments: significant overpayments were found as a result of area discrepancies for nuts and dried grapes (Spain and Greece) and, in one case, large unexplained differences were noted between the number of sheep recorded in the farmer's register, upon which EU aid was paid, and the actual number identified (Spain).
- (e) Other schemes (non-IACS): errors relate to illegal deductions from payments to farmers ⁽¹¹⁾ and failure to charge interest on debts (various Member States), weaknesses in export refund controls (Portugal) and missing quantities of rice from public storage (Greece).

5.15. With regard to rural development operations, the Court found the following types of error:

- (a) agri-environmental schemes: in nine out of 13 cases audited the farmers had not met all the eligibility conditions (France and Ireland);
- (b) interest rate subsidies: the procedures in place do not ensure an adequate audit trail with the result that the regularity of the payment of the EU subsidies to the final beneficiaries cannot be verified (France); additionally, irregularities detected through Member State inspections were not taken into account in the computation of the payment claims to the Commission resulting in the declaration of unjustified expenditure which was charged to the EU accounts.

5.16. As regards environment, fisheries, and health and consumer protection, the payments audited revealed the following errors:

- (a) projects financed through the LIFE instrument included ineligible expenditure;
- (b) inadequate documentation was presented to demonstrate that the invoiced work had actually been performed (Spain);

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- (d)** *The implementation of the dried grapes aid scheme in Greece is subject to repeated and continuing conformity clearance procedures.*

- (e)** *The Commission and the Member State concerned do not share the Court's view that the deductions from payments to farmers were illegal.*

As regards the export refund case, the Commission notes that the transaction was not affected by a quantifiable error.

5.15.

- (a)** *Many of those errors having an important financial impact concern the keeping of records about nitrate reduction at farm level instead of at plot level and the non-presence of permanent fences to protect water courses. On the latter issue of fences, the Commission considers that the objective of the measure to prevent animal movements can also be achieved by movable fences.*

- (b)** *The Commission is aware of the issue referred to by the Court and recognises the importance of sound financial management of interest rate subsidy schemes and the existence of an adequate audit trail. It is following this issue up with the French authorities, including, if appropriate, in the framework of clearance of accounts procedure.*

5.16.

- (a)** *Such ineligible expenditure can only be detected at the time of the final payment or by an ex-post audit.*

- (b)** *Such errors can only be detected by ex-post audits.*

⁽¹¹⁾ Article 23 of Commission Regulation (EC) No 1227/2000 (OJ L 143, 16.6.2000, p. 1), according to which the payments due shall be made in full to the beneficiaries.

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- (c) a disease eradication programme payment was made without adequate supporting documentation; in addition, there was a non-respect of ceilings per test for eligible costs and failure to undertake recommended technical checks (Germany).

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- (c) A Commission decision ⁽⁴⁾ has recently been adopted which strengthens the financial reporting requirements ⁽⁵⁾. The Commission considers that the ceiling referred to is a ceiling applied to Elisa ⁽⁶⁾ testing, implemented at a Member State level. The Commission does not share the Courts interpretation that this should be applied per individual test. Although the Member State involved was entitled to 50 % funding for the programme in question, the actual amount of funding was capped by Commission Decision at a level substantially below the estimated claim. The recommended check (to avoid double payment of test costs between eradication and emergency programmes) was carried out and immediately revealed that such costs were ineligible under the emergency programme. Consequently, more in-depth checks were not necessary.

Assessment of supervisory and control systems

Policy area Agriculture and Rural Development

5.17. The agriculture and rural development expenditure is carried out under shared management and is subject to the following main control systems:

- (a) checks on claims and payments under the Integrated Administration and Control System (IACS) ⁽¹²⁾;
- (b) sector-specific controls, e.g. for rural development;
- (c) physical checks of agricultural products exported under an EU subsidised exports scheme ⁽¹³⁾;
- (d) post-payment scrutiny of commercial documents on the premises of traders and processors of agricultural goods ⁽¹⁴⁾;
- (e) the clearance of accounts procedure, carried out *ex-post* under the responsibility of the Commission (see paragraph 5.39).

5.17. See reply to paragraph 5.2.

⁽¹²⁾ Council Regulations (EEC) No 3508/92 (OJ L 355, 5.12.1992, p. 1) and (EC) No 1782/2003 (OJ L 270, 21.10.2003, p. 1) covering animal premiums and area aid.

⁽¹³⁾ Council Regulation (EEC) No 386/90 (OJ L 42, 16.2.1990, p. 6).

⁽¹⁴⁾ Council Regulation (EEC) No 4045/89 (OJ L 388, 30.12.1989, p. 18) covering payments above a specified threshold of export refunds, processing and transformation subsidies, cotton, olive oil, tobacco and some rural development measures.

⁽⁴⁾ *Sanco 1182/2008 rev.3.*

⁽⁵⁾ Currently set out in Commission Decision 2002/677/EC.

⁽⁶⁾ Enzyme Linked Immuno Sorbent Assay testing (ELISA testing) enables to diagnose classical swine fever.

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5.18. IACS covers the two main schemes audited at Member State level — SPS and Direct Coupled Payments. Certain elements are specific to each scheme while others are common to both. The specific provisions applying to areas such as Rural Development (some elements of which are also controlled by IACS), export refunds and *ex-post* scrutiny of payments are also the responsibility of the Member States. The clearance of accounts procedures are the responsibility of the Commission in order to establish the amounts to be definitively charged to the EU accounts. The Court's assessment of each of these control systems is outlined in paragraphs 5.19 to 5.49.

The Integrated Administration and Control System (IACS)

5.19. IACS consists, in each Member State, of a database of holdings and applications, systems for identifying agricultural parcels and registering animals in case of coupled premium as well as a register of entitlements in those Member States implementing the SPS which constitutes a new component of IACS. The system provides for several eligibility controls: an administrative check of all claims, cross-checks with databases to prevent the same land/animals from being claimed twice and a minimum rate of 5 % for on-farm inspections to be carried out by the paying agencies.

5.20. IACS is effective in limiting the risk of irregular expenditure, where accurate and reliable data is introduced and the system is properly implemented. The IACS is thus the key management and control tool for:

- the Single Payment Scheme (SPS) (see paragraphs 5.21 to 5.26),
- direct coupled payments (see paragraphs 5.27 and 5.28),
- common elements (see paragraphs 5.29 and 5.30).

It now covers almost 85 % of the EAGF as a result of the inclusion in SPS of new aid schemes. This extension of IACS is intended to improve the financial management of high risk areas. In the case of EAFRD, and especially for agri-environment and less-favoured areas, certain basic elements such as surface, number of animals are covered by IACS and others by specifically designed controls.

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The Single Payment Scheme (SPS)

5.21. Correct calculation and allocation of entitlements by national authorities is a prerequisite for correct SPS payments to individual beneficiaries in the first year and all subsequent years. Member States are also required to respect their overall national ceilings. The Court again found ⁽¹⁵⁾ that various Member States have failed to correctly apply certain key elements of the system related to the establishment and management of the entitlements which are incorporated into IACS. Hence the Court considers that the systems for calculating the entitlements were only partially effective and that they do not yet provide reasonable assurance that the annual SPS payments based upon the allocated entitlements are correct.

5.22. As an illustration, the following significant shortcomings, whose financial impact is difficult to estimate, were identified in the calculation of the entitlements:

- (a) in the United Kingdom (England) the four entitlements audited were erroneously calculated mainly due to failure to take account of changes in land parcels; while these errors did not have a significant impact on the 2007 payments, since England applies the 'dynamic' model ⁽¹⁶⁾, these initial entitlements, unless corrected, will result in significant over/underpayments in future years;
- (b) the Netherlands initially allocated entitlements in excess of the national ceiling of 4,9 million euro and have carried out individual payments on this basis. Although the total payments made were less than the national ceiling, individual farmers were overpaid. At the time of the Court's visit (January 2008) no formal recovery action had been taken;

5.21. *Where wrong calculations of entitlements have led to a risk for the Fund, the Commission will follow this up in the conformity clearance. Due to the existence of legitimate expectations at operators' level, it might not always be possible to correct wrongful attributions of entitlements. Furthermore, the trade in entitlements and further reforms require legal certainty as to the entitlements attributed. This issue is therefore addressed in the Health Check.*

5.22.

- (a) *The problem was already known to the Commission on the basis of its own audit missions and is already the subject of a conformity clearance started in 2006.*

The remedial action of the UK authorities to minimise or avoid the consequences indicated by the Court is part of this procedure.

- (b) *According to the information available to the Commission, the total amount of payments made to farmers was 294 million euro, thus not exceeding the national ceiling of 312 million euro. As regards individual overpayments, the Dutch authorities have committed themselves to recover the undue amounts from the beneficiaries.*

⁽¹⁵⁾ Annual Report concerning the financial year 2006, paragraph 5.66.

⁽¹⁶⁾ Under this model the payment for each entitlement consists of two elements: (i) an amount based on an historic reference period for each farmer, and (ii) a flat rate amount which is the same for all farmers. In 2005 the ratio was 90:10 but each year the flat rate increases and will reach 100 % in 2012. If too many entitlements have been given to the farmer he will receive more and more money under the flat rate component which outweighs the loss on the individual component.

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- (c) when calculating the farmer's reference amounts, the Dutch and Greek authorities included bovine animals which were not eligible for premium in the reference period; furthermore the Greek authorities allocated reference amounts to farmers of arable land without taking into account the reductions that had been made during the reference period;
- (d) when calculating the number of entitlements, the Greek and Spanish authorities systematically disregarded forage area requirements for farmers that benefited during the reference period exclusively from premia that did not require any land and allocated *special entitlements* ⁽¹⁷⁾ to them instead of *the entitlements based on areas* ⁽¹⁸⁾, thereby generating much higher payments per hectare, and a consequent reduction in areas required to be subject to GAEC;
- (e) unjustified withdrawal of entitlements, thereby depriving potential beneficiaries of aid (Greece).

5.23. Member States are required to establish a *national reserve* ⁽¹⁹⁾, from which they allocate entitlements to new farmers, those in special situations or those affected by restructuring or development programmes.

5.24. The audit found several weaknesses in the use of the national reserve:

- (a) various instances of misuse of the national reserve (France): two ineligible programmes (totalling 42,4 million euro), failure to respect the statutory deadline for four other programmes, acceptance of investments based on short-term rented equipment, failure to systematically apply mandatory provisions to new farmers who commenced farming during the reference period leading to an overallocation of 20,8 million euro;

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- (c) *As to the Single Payment Scheme in Greece and The Netherlands, the conformity clearance has been launched in April 2007 and May 2008 respectively.*
- (d) *The Court's findings in this respect were known to the Commission on the basis of its own audit missions and are already the subject of a conformity clearance which commenced, as far as Greece is concerned, in April 2007 and for Spain in July 2007.*
- (e) *The problem is already the subject of a conformity clearance procedure which commenced in April 2007.*

5.24.

- (a) *The Commission, on the basis of its own audit findings, already started, by means of a letter of April 2008, a conformity clearance in respect of the same findings.*

⁽¹⁷⁾ Payment entitlements subject to special conditions are set by Articles 47 and 48 of Regulation (EC) No 1782/2003 mainly for cases when the farmer was granted livestock premiums but had no hectares or the entitlement per hectare results in an amount higher than 5 000 euro.

⁽¹⁸⁾ Regulation (EC) No 1782/2003, Chapter 3, section 1.

⁽¹⁹⁾ Article 42 of Regulation (EC) No 1782/2003.

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- (b) irregular allocations of entitlements for new olive oil trees planted after the stipulated deadline and not covered by a specific programme (Italy).

5.25. When allocating entitlements to olive producers, the Italian authorities accepted 1 53 000 hardship cases on the sole recognition by the region or province that the territory concerned had been affected. The available information does not permit an estimation of the total value of irregular payments.

5.26. As regards the *management and monitoring of SPS entitlements*, the following weaknesses were noted:

- (a) incorrect application of late claim penalties (Netherlands, Portugal and the United Kingdom (England));
- (b) in the United Kingdom (England) the same parcel can be claimed by two 'farmers' under different area related EU aid schemes. In nine out of 12 on-the-spot visits to 'new beneficiaries' of EU direct aid that the Court had highlighted in its Annual Report concerning the financial year 2006 ⁽²⁰⁾, the area declared for SPS was not eligible in whole or in part either because it was not in good agricultural condition, its main use was not agricultural or the beneficiary was not eligible because he did not carry out any agricultural activity on the land;
- (c) Portugal has allocated entitlements and paid SPS aid to farmers who declared areas on 'baldio' land. This land is usually public land of very poor pasture and mostly covered by bushes and trees. There are no limits as regards the number of trees allowed on such land and there is no obligation for farmers to respect GAEC on this land. In 2007 Portugal paid 3,5 million euro for 'Baldio' land. In Italy it was found that the areas accepted as permanent pasture for SPS payments were bigger than the eligible part actually covered by grass or herbaceous forage;

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- (b) *The Commission will follow up this matter in the conformity clearance procedure.*

5.25. *The Commission, on the basis of its own audit findings, already started, by means of a letter of August 2006, a conformity clearance procedure in respect of the same findings.*

5.26.

- (a) *For Portugal, the penalties applied were too severe: this is not a risk for the Fund.*
- (b) *The Commission, on the basis of its own audit findings, already started, by means of letters of July 2007 and April 2008, a conformity clearance in respect of the same findings.*

As regards the issue of 'new beneficiaries', following the Court's Annual Report 2006, the Commission has launched special enquiries with regard to those Member States that have chosen regional models and that may therefore be affected by the issue raised by the Court. These audits are still ongoing and risks to the Fund will be covered by financial corrections. Moreover, the issue of excluding certain beneficiaries from direct payments is also addressed in the Commission's proposals for the Health Check.

- (c) *As regards Portugal, the Commission follows up this issue in the conformity clearance procedure. Regarding Italy the Commission, on the basis of its own audit findings, already started a conformity clearance in respect of the same findings.*

⁽²⁰⁾ Paragraphs 5.25 to 5.27.

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- (d) payments were made to 275 farmers in France and 33 farmers in Spain (Andalucia) who did not hold payment entitlements; no recovery action has been taken.

The direct coupled payments

5.27. The direct coupled payments managed under IACS totalled some 5 500 million euro in 2007. For the animal-based schemes the systems are generally functioning satisfactorily, reflecting the reliability of the IACS for this purpose. However, the Court found a number of systems weaknesses in administrative and on-the-spot controls of the area aids (see **Annex 5.1.1**):

- (a) administrative controls weaknesses, leading to errors such as: wrong input of application data (Greece), payment for multiple incompatible aid schemes on the same parcel (Italy), and a failure to correctly apply penalties and sanctions, which lead to overpayments (Greece, Italy, Spain and Portugal);
- (b) lack of documentation of the reasons why certain criteria of the risk analysis have been selected, and absence of yearly reassessment of the risk parameters by the paying agencies, for the selection of the 5 % on-farm inspections (Portugal, Spain).

5.28. The re-performances of controls carried out by the Court found a number of specific weaknesses in the quality of the on-the-spot controls and identified ineligible areas or parcels that should have been excluded by the national inspectors. (Greece, Italy, Spain, Portugal). In Italy, a farmer had received aid for a parcel of pistachio nut trees. While the parcel had been subject to an on-the-spot control by the Italian authorities in 2005, the Court's audit found the parcel to be long established general forest land and, thus, not eligible for aid.

THE COMMISSION'S REPLIES

- (d) According to information available to the Commission, the differences found by the Court in relation to France are due to differences in parameters of extraction of the two files compared by the Court and no payment has been made to farmers not holding entitlements. For Spain, no payment was made to farmers without entitlements. For almost all the cases, these farmers had previously made a request for rectification which was still pending at the date of the payment. In case of withdrawal of entitlements, the paying agency asked for reimbursement.

5.27. As concerns table 5, the Commission disagrees with the Court's evaluation of the systems in Italy.

As the Court has acknowledged, most of the system weaknesses identified were also identified by the Commission's clearance of accounts and appropriate follow-up action has been taken.

- (a) In respect of the incorrect application of sanctions in Italy, Spain and Portugal, the Commission, on the basis of its own audit findings, already started a conformity clearance.
- (b) The need for an annual evaluation has been laid down in Regulation (EC) No 796/2004. As part of its audits, the Commission reviews the improvement of the risk analysis both over the years and its effectiveness for the year concerned. Where it is found that there is a continued dysfunctional risk analysis posing a risk to the Fund, the Member State is asked to take remedial action and the conformity clearance is applied.

In addition, the Commission simplified the Regulation and risk factors are no longer determined in the Commission Regulation as from 2008.

5.28. The Commission audits the control systems of the Member States and deficiencies that create a risk for the Fund are followed up under the conformity clearance. This is the case for the Member States referred to by the Court.

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Supervisory and Control Systems in IACS

5.29. As indicated at paragraph 5.19, the effectiveness of the supervisory and control systems incorporated in IACS forms a key element of the overall effectiveness of the system. This applies to each of the main aid schemes covered by IACS. A general assessment of the reliability of the system in the Member States visited for (the two main schemes SPS and direct coupled payments respectively) is shown in **Annex 5.1.2.** and in **Annex 5.1.1.**

5.30. *Administrative controls to establish eligibility of surfaces:* the effectiveness of the administrative controls depends on the quality of the information recorded in the Land Parcel Identification System (LPIS ⁽²¹⁾), the use of computerised geographical information techniques for the graphical layer of the LPIS which is the Geographic Information System (GIS) and the use of up-to-date aerial or spatial orthoimagery:

- (a) the administrative controls in the United Kingdom (England) do not provide assurance that EU aid is paid out correctly. The United Kingdom (England) do not avail of the option to use aerial or spatial orthoimagery in support of the GIS. The English LPIS does not always contain information on eligible area of the reference parcel;
- (b) in Greece the administrative controls are also deficient; the LPIS is incomplete and contains important errors in the referencing of parcels;
- (c) in France and the Netherlands the paying agencies do not sufficiently deduct ineligible features visible on orthoimages from the eligible area recorded in the LPIS and do not update their LPIS with the results of on-the-spot inspections. In Portugal the update is carried out with significant delays. France and Sweden use orthophotos some of which are more than 5 years old;
- (d) in France, Portugal and Sweden the eligibility of land declared for activation of set aside entitlements ⁽²²⁾ is not reliably verified.

5.29. *The Commission does not share the overall evaluation regarding the effectiveness of IACS referred to in Table 5 as regards France, The Netherlands and the United Kingdom.*

5.30. *The quality of the Land Parcel Identification System (LPIS) is indeed crucial. The Commission is constantly working with the Joint Research Center (JRC) to use the best technical resources to update the LPIS system in the Member States and consequently to optimise the effectiveness of administrative checks.*

- (a) *The use of ortho-imagery is not legally required. As to the other deficiencies in the LPIS-GIS in England referred to by the Court, the Commission, on the basis of its own audit findings, already started a conformity clearance.*
- (b) *The deficiencies of the LPIS in Greece are the regular subject of conformity decisions. At the request of the Commission, the Greek authorities have adopted an action plan that foresees, inter alia, the implementation of a new LPIS-GIS by 31 December 2008.*
- (c) *The findings referred to by the Court have also been identified by the Commission audits. Member States are asked to take remedial action and conformity clearance are started to cover the financial risk resulting from these deficiencies.*
- (d) *The Commission will provide for an adequate follow-up in the context of the conformity clearance once the Court has transmitted to it all the relevant information.*

⁽²¹⁾ LPIS is a database in which all the agricultural area of the Member State is recorded with a unique identification number.

⁽²²⁾ Determination of set aside entitlements is set by Article 53 of Regulation (EC) No 1782/2003.

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Member State controls under IACS and inspection results

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

Rural Development

5.32. The imprecise definitions in national legislation of some eligibility conditions and the often complex rules, particularly those related to agri-environmental measures, adversely affect the quality of the controls carried out to verify the farmers' compliance with the relevant requirements. These controls have once again, been found deficient. The principal weaknesses detected were:

- (a) insufficient checks on the validity of the bids submitted in the context of private procurement. The checks carried out do not provide reasonable assurance as to the legality of the required tendering procedure which may consequently affect the eligibility of the project as a whole (Romania);

5.31. From financial year 2007 onwards, the certification bodies are required by Commission's guidelines to analyse the effectiveness of the paying agencies internal control systems including on-the-spot checks more systematically and to verify and validate these statistics. The Commission thus implemented the Court's recommendation made in its Annual Report concerning the financial year 2005 (paragraph 5.46) that the certification bodies were to do more work to verify and validate the statistics.

As regards the extension of the work to the final beneficiaries, the certification bodies review a sample of field inspection reports and check that any claim adjustments required (as a result of the check) are made to the final beneficiary's data in the IACS.

In roughly 90 % of the cases, the certification bodies made an assessment and concluded positively for approximately 85 % of them which must be considered as an acceptable result for the first year of application of this new control obligation. The Commission recognises that there is scope for improvement in this area, and has revised its Guidelines accordingly for financial year 2008.

The Commission systematically analyses the IACS statistics for consistency and compliance with regulatory requirements. The data's reliability is verified by the Commission's conformity audits.

5.32. As regards the definition of eligibility conditions in national legislation and their complexity, the Commission shares the view of the Court that they should be as simple as possible to reduce the risk of errors and to limit control costs. However in particular agri-environmental measures are complex by nature and there is very limited scope for simplification without jeopardising the purpose of these measures.

As regards the control system, measures have been taken to reinforce and strengthen the control rules in this area and all eligibility criteria must now be controllable according to a set of verifiable indicators to be established by the Member States (7). Moreover, guidelines have been produced by the Commission on the verifiability of the agri-environmental measures.

- (a) *The findings referred to by the Court in its observation will be followed-up by the Commission in the context of the conformity clearance.*

(7) Article 5 of Regulation (EC) No 1975/2006.

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- (b) lack of cross-checks with the specific animal databases (rare breeds) to validate the number of animals declared by the farmer which is the basis for the agri-environment payments (France);
- (c) inadequate verification of the eligible area under agri-environment measures in cases where this area did not correspond to the data in the IACS database. As a consequence, not all the conditions for granting the support could be checked (Ireland);
- (d) lack of systematic verifications as to whether detailed agri-environment commitments tailored to the farm fulfil the overall requirements of the measure (e.g. the maximum permitted level of chemicals);
- (e) inconclusive and poorly documented administrative and on-the-spot controls with an over reliance on beneficiaries' declarations before approving final payments (Ireland);
- (f) inadequate consideration of the risk factors stipulated in EU legislation for the selection of a sample of farmers to be controlled on the spot (France and Ireland);
- (g) inadequate verification of the existence of private co-financing. Projects were often approved without the required certificate from a financial institution, increasing the risk that EU funds are paid to beneficiaries who are unable to pay their share of the investment (Romania);
- (h) the inadequate audit trail for projects receiving interest rate subsidies made it impossible to trace the final beneficiaries who benefited from EU funding. Consequently, the auditors could not verify whether the amounts declared were correct or if beneficiaries respected all eligibility requirements (see also paragraph 5.15(b) — France).

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- (c) *The findings referred to by the Court in (c), (d) and (e) will be followed up in the conformity procedure.*
- (f) *As to the risk parameters, the Commission simplified legislation and risk factors are no longer determined as from 2008.*
- (g) *The risk is mitigated by the fact that for each project which foresees self-financing, a bank statement not older than 5 working days before the submission of the payment claim is annexed to the claim.*
- (h) *The Commission is aware of the issue referred to by the Court and recognises the importance of sound financial management of interest rate subsidy schemes and the existence of an adequate audit trail. It is following this issue up with the French authorities, including, if appropriate, in the framework of clearance of accounts procedure.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Ex-post scrutiny of payments to traders and processors

5.33. Member States are required to carry out annual programmes of post-payment checks of commercial documentation for export refunds, processing and transformation subsidies and some rural development expenditure. Member States must satisfy themselves that transactions have taken place and been executed correctly, and take steps to recover sums lost as a result of irregularity or negligence. These checks are carried out under Regulation (EEC) No 4045/1989. The Commission plays a supervisory and coordination role.

5.34. The timely execution of the scrutiny programme has improved in 2007. However, there is a limited number of scrutinies not completed from each of the preceding scrutiny periods dating back as far as 2000/2001 ⁽²³⁾. These bear the risk of not being properly executed given that beneficiaries only have a legal obligation to keep the relevant documentation for a limited period and that the payments examined during a scrutiny period normally relate to payments from 2 years earlier. That is to say, the outstanding scrutinies from period 2000/2001 relate to payments made as far back as 1998/1999. Furthermore, the results of the scrutinies carried out on payments made in the year 2006/2007 will not be available to the Commission until the 31 December 2009.

5.35. The Court noted a limited coverage of rural development measures *both at Commission and Member States level*, despite Rural Development representing, for the scrutiny period 2006/2007, 11 % of the expenditure covered by the Regulation and 57 % of all the potential irregularities reported.

5.36. The Court's analysis of the certifying bodies' reports has also shown a need for improvements in the verification and reporting by the paying agencies on the follow up of the potential irregularities reported.

5.34. *At Community level (based on the 2006/2007 scrutiny reports) the required minimum number of scrutinies had been reached for each of the preceding scrutiny periods, with the exception of 2002/2003 and 2004/2005. This was mainly due to a backlog in Italy.*

According to information received from the Italian authorities on 29 May 2008 the minimum number of scrutinies at Community level has been reached for each of the preceding scrutiny periods. However, the Member States' obligation to eliminate the backlog remains.

5.35. *In 2007, the rural development unit mainly carried out audits of measures not covered by Regulation (EEC) No 4045/89, such as agri-environment. However, the unit with horizontal responsibility for Regulation (EC) No 4045/89 carried out two missions in early 2008 covering rural development together with the rural development unit in the framework of the 2007 work programme.*

More importantly, at Member State level about 18 % of the total number of scrutinies in scrutiny year 2006/2007 concerned rural development measures, and this is considered to be an appropriate level of coverage.

5.36. *For the paying agencies concerned the certification bodies made an assessment in 90 % of the cases and in 80 % of them the statement on the follow-up given by the paying agencies is a positive one.*

The revised Guidelines presented to the Member States for the financial year 2008 address the Court's observation.

⁽²³⁾ A total of 916 of the almost 20 000 planned scrutinies were, as at the end of 2007, incomplete.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Export refunds

5.37. Export refunds are paid to exporters of EU agricultural products to cover the difference between EU internal and world market prices. In 2007, 1 445 million euro was paid, 42 % less than the previous year due to policy choices made in the context of the recent CAP reforms and also to increases in world market prices. Regulation (EEC) No 386/90 requires Member States to physically check 5 % of exports to ensure that they are correctly described and qualify for export refunds. They are also required to carry out substitution checks at the point of exit from the EU where this is different from the place at which they were presented for a physical check. The Commission is required to monitor the quality and the number of those checks.

5.38. In its Special Report No 4/2007 ⁽²⁴⁾, the Court pointed out shortcomings in respect of the system of physical and substitution checks on export refund consignments. The Council and Commission acted promptly on the recommendations made by amending the relevant legislation ⁽²⁵⁾. However, the particular weakness concerning the reintroduction of exported goods into EU territory following transportation on a non regular shipping line, has not yet been addressed.

The Commission's clearance of accounts procedures

5.39. As the management of expenditure on agriculture is, in the main, shared between Member States and the Commission, aid is paid by the Member States, who are then reimbursed by the Commission. These reimbursements are considered as advances, although they are reported as payments in the financial statements submitted by the Commission. The final recognition of expenditure is determined through a two-stage procedure called the clearance of accounts. The two stages consist of an annual financial decision and multi-annual conformity decisions taken by the Commission.

5.37. The quality and number of both physical and substitution checks are verified by means of on-the-spot audit enquiries and analysis of the detailed annual returns furnished by all Member States.

5.38. The Commission takes the view that, when it is established that the refund products have left the Customs territory within 60 days, the rest of the journey to the third country of destination continues over international or third country territory which may include transshipment under Articles 9 or 10 of Regulation (EC) No 800/1999 with the related transit through parts of the Community customs territory under customs supervision, which by the EU enlargements since 2004 is more likely to happen. It is legally not possible that the goods or products in question remain on customs territory under a different customs regime although having received refunds.

5.39. The reimbursements by the Commission to Member States are, according to the legal rules, defined as monthly payments and not as advances ⁽⁸⁾.

⁽²⁴⁾ Adopted on 21 June 2007 by the Court (OJ C 252, 26.10.2007, p. 1).

⁽²⁵⁾ Council Regulation (EC) No 14/2008 (OJ L 8, 11.1.2008, p. 1) and Commission Regulation (EC) No 159/2008 (OJ L 48, 22.2.2008, p. 19).

⁽⁸⁾ The first subparagraph of article 5(1) of Council Regulation (EC) No 1258/1999 stated that 'The financial resources required to cover the expenditure... shall be made available to the Member States by the Commission by means of advances ...'. However Council Regulation (EC) No 1290/2005 of 21 June 2005 on the financing of the common agricultural policy has repealed Regulation (EC) No 1258/1999 and article 14(1), replacing Article 5(1), first subparagraph, stipulates that 'The appropriations necessary to finance the expenditure... shall be made available to Member States by the Commission in the form of monthly reimbursements, hereinafter referred to as "monthly payments", on the basis of the expenditure effected by the accredited paying agencies during a reference period.'

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THE COMMISSION'S REPLIES

Financial clearance

5.40. On 30 April 2008 the Commission took three financial clearance decisions for the expenditure made under EAGF, EAFRD and TRDI and cleared all paying agencies accounts, except those shown in **Annex 5.3**. These decisions are based on certificates provided by independent auditors (certifying bodies). The Court's audit did not detect expenditure cleared by the Commission which should have been refused (disjoined) in the financial clearance decisions.

5.41. The financial decisions are however limited to the veracity, completeness and accuracy of the paying agencies' accounts. Legality and regularity of underlying payments ('conformity issues') are outside the scope of the certifying bodies' substantive testing and claims for EU aid are not usually checked on the spot by the certifying bodies. Financial decisions do not therefore mean that the expenditure 'cleared' is free of irregular payments.

5.42. In 2007 the certifying bodies work was extended. In addition to the new verification and validation of IACS statistics (see paragraph 5.31), opinions on the paying agencies Directors Statements of Assurance and on internal control procedures were required. The Court's audit showed that the added value of these new elements has so far been limited. Furthermore, in three cases there was an unresolved contradiction between the paying agency Directors' Statement of Assurance and the qualified audit certificate issued by the certifying body.

5.41. *The audit assurance given is not limited solely to accounting matters. Each certificate also provides an opinion on whether the paying agency's internal control system has functioned satisfactorily for the financial year in question and in this context on-the-spot checks are also assessed.*

In addition, certification bodies provide a separate opinion on the Statement of Assurance (the DAS) provided by each paying agency's director, as well as an analysis of the effectiveness of the on-the-spot controls and the accuracy of the inspection statistics.

5.42. *Together with the other elements referred to by the Court in its observation, the verification and validation work by the certification bodies introduced following recommendations of the Court in its Annual Report concerning the financial years 2005 (paragraph 5.46) and 2006 (paragraph 5.8) are a positive step towards a further improved accountability of paying agencies and lead to greater transparency and ownership of the control results. This is also recognised by the conference of the directors of the paying agencies and by independent certification bodies.*

Each certification body analyses, and reports on, how well each paying agency complies with the accreditation criteria as laid down in Regulation (EC) No 885/2006, and gives an opinion accordingly. The difference of view between the DAS and the certification body's opinion proves the added value of the opinion on the DAS, in that the certification body has appraised the DAS in the light of its own audit work, as foreseen. The 3 paying agencies concerned are now all under probation. For the remaining 79 paying agencies, the two documents were consistent.

THE COURT'S OBSERVATIONS

5.43. Despite the Spanish paying agencies making payments for the first time under the SPS during the year, the Spanish certifying bodies did not include the required verification of entitlements in their work.

5.44. Based on the examination of the certifying bodies work ⁽²⁶⁾ the Court reiterates ⁽²⁷⁾ its doubts as regards accuracy of the debtors accounts: two certifying bodies include qualifications in their certificates and 15 highlight shortcomings in the paying agencies' debt management procedures; 12 certifying bodies failed to provide enough information on the work carried out and two did not adequately test the accounts. Whilst the Commission has initiated the procedure to apply corrective measures ⁽²⁸⁾ for the reported shortcomings, the financial impact of these actions is not yet known. Further the Court notes that the different policies applied to the date of recognition of debts by the paying agencies result in an inconsistent presentation of the global value of debts.

5.45. The Commission in its response to the Court's Annual Report concerning the financial year 2006 ⁽²⁹⁾, has committed itself to follow up the amounts, charged from the debtors' tables to the EU budget under the first financial clearance decision for 2006 taken on 27 April 2007. The three Commission audits carried out in 2007 covered some 7 % of the amounts included in this financial clearance decision.

Conformity clearance

5.46. Conformity decisions are taken following additional verifications by the Commission of the expenditure declared by the Member States. They cover a number of years and have the objective of excluding expenditure from EU financing where the Commission has found that it 'has been incurred in a way that has infringed EU rules ⁽³⁰⁾'.

THE COMMISSION'S REPLIES

5.43. *The certification bodies checked the data provided by the autonomous communities for the calculation of entitlements, but not the calculation carried out at overall national level. The Commission has revised its Guidelines for financial year 2008 to clarify that if the system is managed centrally at national level, but the central paying agency does not manage SPS (as is the case in Spain), the certification body of the central paying agency would still have to cover this part in its report.*

5.44. *The Commission considers that for at least one of these two cases sufficient work was in fact carried out. The Commission also considers that it obtained enough information on debtors for clearance and accounting purposes. In no case was the financial impact found to be material at the overall account level (and thus as regards the Decision).*

However, the Commission recognises that there is scope for improvement in this area, and has revised its Guidelines for financial year 2008 accordingly. It will also continue to closely monitor the situation (via 7 audit missions to paying agencies and 6 audit missions to certification bodies in 2008).

5.45. *In 2007, two audits covering debts were carried out to the Italian paying agency AGEA. The Decision clearing AGEA's accounts which were disjoined for the financial year 2006 was taken on 30 April 2008. This means that the audits carried out in 2007 covered some 41 % of the amounts included in the first and second clearance decisions for financial year 2006 (the latter taken after the Court's audit).*

⁽²⁶⁾ Annex III to Commission Regulation (EC) No 885/2006 (OJ L 171, 23.6.2006, p. 90).

⁽²⁷⁾ Annual Report concerning the financial year 2006, paragraph 5.61.

⁽²⁸⁾ Article 11 of Regulation (EC) No 885/2006.

⁽²⁹⁾ Paragraph 5.61.

⁽³⁰⁾ Article 31 of Council Regulation (EC) No 1290/2005 (OJ L 209, 11.8.2005, p. 1).

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5.47. The Court in its 2006 and previous annual reports indicated the limitations which are partly inherent in the clearance system such as the retroactive and multi-annual nature of the conformity clearance and the fact that the Member States, and not the final beneficiaries, are effectively charged with the financial corrections. In addition, the Commission's method of calculating the conformity adjustments, largely based on the use of a flat-rate corrections, means that no valid link can be made between the amounts thus recovered and the real amount of irregular payments ⁽³¹⁾. These limitations were found to persist in 2007.

5.48. The Court's audit of the conformity decisions taken in 2007 found that:

- (a) expenditure was not excluded from EU financing when in fact it should have been and expenditure had not been covered by a conformity audit in time to allow recovery of the full amount of the possible irregularities found;

THE COMMISSION'S REPLIES

5.47. *What the Court describes as limitations are inherent to the system laid down in Community legislation and was not objected to by the Court in the context of the adoption of Council Regulation (EC) No 1290/2005.*

While financial consequences are only determined at the end of the procedures, the preliminary findings of the Commission's audits carried out in a given year are already known by the end of that year. Since the audits cover the Member States' management and control systems, they do not only provide information on the expenditure audited but indirectly also on future expenditure. Furthermore, normally the corrections take into account expenditure effected after the date of the audit and are therefore not only retro-active.

The conformity clearance is designed to exclude expenditure from Community financing which has not been effected in compliance with Community rules. In contrast, it is not a mechanism by which irregular payments to beneficiaries are recovered, which according to the principle of shared management is the sole responsibility of Member States.

Where undue payments to beneficiaries can be identified as a result of the conformity clearance, Member States are required to follow them up by recovery actions against these beneficiaries. However, even where recoveries from beneficiaries are not needed because the financial correction only relates to deficiencies in the Member States' management and control system and not to undue payments, these corrections are an important means to improve the Member States' systems and thus to prevent or detect and recover irregular payments to beneficiaries.

Flat-rates take account of the severity of the deficiencies in the national control systems in order to reflect the financial risk for the Community. Therefore the Commission considers there to be a valid link between this type of correction and the amount of irregular payments to final beneficiaries.

5.48.

- (a) *The Commission considers that the expenditure which it has excluded from Community financing as a result of its conformity audits is sufficient to cover the risk for the Funds.*

The legal rule which limits the possibility of financial corrections in time (24 months rule) is a deliberate choice of the Community legislator with a view to ensuring legal certainty for Member States. It is inherent in the application of this rule that certain expenditure cannot be subject to financial corrections although it may be affected by deficiencies. The Commission has repeatedly proposed an extension of this time limit, but these proposals were turned down by both the Council and the European Parliament.

⁽³¹⁾ Annual Report concerning the financial year 2006, paragraph 5.63.

THE COURT'S OBSERVATIONS

- (b) for two of the corrections examined, six years have elapsed between the initial audit and the clearance decision, with the result that ineligible expenditure was only excluded from the accounts at the end of this procedure.

Policy areas Environment, Fisheries, Health and Consumer Protection

5.49. Environment, Fisheries and Maritime Affairs as well as Health and Consumer Protection are managed by the Commission under specific control systems. The Court's audit of these policy areas detected the following system weaknesses:

- (a) for environmental measures, projects financed by the main fund (LIFE projects) included ineligible expenditure. Important delays in concluding audits still remained. However the situation improved in 2007. The Annual Activity Report of the Directorate-General for the Environment (DG ENV) recognises these weaknesses by establishing a specific reservation;
- (b) in the fisheries policy area, the lack of appropriate legal rules and poor documentation of expenditure relating to data collection for fisheries management increase the risk that irregular payments are made. On the other hand liabilities arising from particular cases of renewed bilateral fisheries agreements have not been covered in a timely manner by the commitment of the corresponding appropriations;

THE COMMISSION'S REPLIES

- (b) *The two cases referred to by the Court were very complex and are not representative of the Commission's conformity clearance work.*

5.49.

- (b) *The legal rules that the Court is referring to as regards data collection for fisheries management have been changed in 2008 ⁽⁹⁾. The corresponding implementing Commission Regulation and Decision will be adopted in the course of 2008. The new legal basis contains clear rules and should address the concerns of the Court. As regards the current situation, procedures have been put in place to address the weaknesses identified by the Court with regard to documentation.*

Budgetary commitments covering the fisheries agreements can be made only after the legal basis (Council decision and/or regulation) has been adopted. This explains why, when it has not been possible to adopt the legal basis before the provisional entry into force of the new protocol (which is often the case, even though the lengthy periods required for negotiation and adoption have been built in), the budgetary commitment post-dates the legal commitment (provisional application of the new protocol). The Commission will continue to examine alternative procedures in order to take into account the remarks of the Court while bearing in mind the specific constraints linked to the fisheries agreements.

⁽⁹⁾ Council Regulation (EC) No 199/2008.

THE COURT'S OBSERVATIONS

- (c) in the health and consumer protection area payments were made for veterinary measures in the absence of all the necessary supporting documentation.

Overall conclusions and recommendations

5.50. Based on its audit work, the Court concludes that the transactions underlying the expenditure declared for the policy group taken as a whole are affected by a material level of error of legality and/or regularity (see paragraphs 5.12 and 5.13).

THE COMMISSION'S REPLIES

The Council reached a political agreement on 24 June on the Commission's proposal on fishing authorisations for Community vessels outside Community waters. The new regulation foresees the continuity of fishing operations on a transitional basis before the formal adoption of the new protocol by the Council.

- (c) *The Court's statement refers to the reception of vaccines and tests for which no written confirmation of delivery has been requested by the Commission. Nevertheless, the Commission considers that, based on its contacts with the Member States and its internal control procedures (including the signing of the 'Conforme aux faits' by two staff members), this lack of formal documentation relating to the reception of these goods and tests, does not put at risks its payments.*

A Commission decision⁽¹⁰⁾ has recently been adopted which strengthens the financial reporting requirements set out in Commission Decision 2002/677/EC.

5.50-5.51. *The Commission aims to ensure that supervisory and control systems are effective in detecting and correcting errors, with due regard to the costs and benefits of the checks which have to be made on the spot.*

As regards agriculture and rural development, the Commission underlines the Court's finding that the most likely overall error rate is not significantly different from last year's, as reported in its 2006 statement of assurance. Control statistics received from Member States, indicate as well that the error rate found at the level of final beneficiaries under the EAGF, which accounts for about 85 % of total agriculture and rural development expenditure, is below the materiality threshold.

The Integrated Administrative Control System (IACS) covering most of agricultural expenditure is effective in limiting the risk of irregular expenditure, where accurate and reliable data is introduced and the system is properly implemented.

The 2007 agriculture and rural development expenditure likely to be excluded from Community financing by future conformity decisions, amounts to an estimated sum of 439 million euro, together with the 152 million euro of recoveries from final beneficiaries.

⁽¹⁰⁾ Sanco 1182/2008 rev.3.

THE COURT'S OBSERVATIONS

5.51. The Court's overall assessment of the supervisory and control systems for the policy areas covered by this chapter is that they are partially effective.

5.52. The Court concludes, however, that IACS continues to be effective in limiting the risk of irregular expenditure where properly implemented and if accurate and reliable data is introduced as regards SPS payments based upon allocated entitlements (see paragraphs 5.20 and 5.21). The recent introduction in SPS of support schemes, such as those related to olive oil (see paragraph 5.14), is a positive development although in the short term might lead to a higher frequency of errors.

5.53. Some 20 percent of payments audited at final beneficiary level again revealed incorrect payments, a limited number of which had a high financial impact. Furthermore, the Court identified errors in interpreting the provisions of the regulations. If not corrected, there will be significant cumulative effects of all such errors over a number of years.

THE COMMISSION'S REPLIES

As described in the Annual Activity Report (AAR) 2007 the Directorate-General for Health and Consumers is confident that its transactions are not affected by a material level of error of legality and regularity. Furthermore, as explained in the AAR 2007 the residual error rate is 1,6 % which is below the materiality threshold of 2 %.

As stated in the AAR 2007 of the Directorate General for Fisheries and Maritime Affairs, a reasonable assurance on the regularity and legality of DG Fisheries and Maritime Affairs expenditure can be given and weaknesses detected are not material enough to justify a reservation.

DG ENV made a specific reservation in the Annual Activity Report on the eligibility of expenditure declared by the beneficiaries of action grants.

5.51. *As stated in the Annual Activity Report (AAR) 2007 of the Directorate General for Fisheries and Maritime Affairs under the conclusion on the effectiveness of internal control system, there is a reasonable assurance that the internal control systems in the DG function effectively.*

In its AAR 2007, the Management of the Directorate-General for Environment 'feels confident about the overall state of internal control and financial and operational management in DG ENV'. This conclusion is also confirmed by the results of the analysis of the subdelegated authorising officers and management reports to the Director General which were requested from all of them in January 2008. The Internal Audit Capability of DG ENV has not discovered material weaknesses in the financial control systems or serious flaws in the management systems during its 2007 audits. The weaknesses flagged by the Management in 2007 were due to specific circumstances and will be further addressed in 2008.

5.52-5.53. *The audits carried out by the Commission services showed that in general the calculation of entitlements was performed in accordance with the legislation and administrative and on-the-spot checks are generally operating well. Where problems were noted these are followed up in the conformity clearance.*

As regards frequency and impact of errors, the IACS statistics received from the Member States (except Greece) and verified and validated by the certification bodies show that the frequency of errors including financial year 2007 is steadily decreasing and the financial impact of the errors is limited to only 0,83 % of the expenditure concerned.

THE COURT'S OBSERVATIONS

5.54. Although the clearance of accounts systems (as well as post-payment checks) have the objective of excluding expenditure which does not comply with EU rules, at present they fail to do so at the level of payments to final beneficiaries; rather they are borne by Member States so that no valid link can be made between the amounts excluded and the real amount of irregular payments.

5.55. The Commission's conformity decisions are not complete for any year later than 2000. Since the decisions in respect of 2007 have yet to be taken, the expenditure is subject to possible corrections in subsequent years following verifications made by the Commission. Globally, however, the corrections made in subsequent years do not normally change the order of magnitude of the payments reported by the Member States.

5.56. The Court recommends that the systems weaknesses leading to such errors are resolved. In this regard, the most urgent issues to address concerning the reliability of payments made under the SPS are:

- (a) improving the identification, registration and management of the entitlements;

THE COMMISSION'S REPLIES

5.54. *The conformity clearance is designed to exclude expenditure from Community financing which has not been effected in compliance with Community rules. In contrast, it is not a mechanism by which irregular payments to beneficiaries are recovered, which according to the principle of shared management is the sole responsibility of Member States.*

Where undue payments to beneficiaries can be identified as a result of the conformity clearance, Member States are required to follow them up by recovery actions against these beneficiaries. However, even where recoveries from beneficiaries are not needed because the financial correction only relates to deficiencies in the Member States' management and control system and not to undue payments, these corrections are an important means to improve the Member States' systems and thus to prevent or detect and recover irregular payments to beneficiaries.

The Commission considers there to be a valid link between its financial corrections and the level of irregular payments to final beneficiaries.

5.55. *At the end of 2007, only 24 out of around 1 400 audits carried out in the years 2003 and before, allowing financial corrections of expenditure from the period prior to 2002, had not been closed. The financial corrections related to these audits as regards expenditure from the period prior to 2002 are estimated to be around 6 million euro. This means that the conformity work on expenditure incurred in the years 2001 and before had largely been completed.*

As regards the magnitude of the financial corrections, the 2007 agriculture and rural development expenditure likely to be excluded from Community financing by future conformity decisions, amounts to an estimated sum of 439 million euro, together with the 152 million euro of recoveries from final beneficiaries ⁽¹¹⁾.

5.56. *Most of the weaknesses referred to by the Court are known and followed up in the conformity clearance. Weaknesses are not due to unclear legal provisions but to the weaknesses in implementing them.*

- (a) *Member States are encouraged to improve their systems and to work closely together with the Commission services and JRC on the issues mentioned.*

⁽¹¹⁾ In 2007, 607 million euro was recovered by financial correction and 247 million euro recovered from final beneficiaries by Member States (see chapter 6 of the notes to the annual accounts 2007).

THE COURT'S OBSERVATIONS

- (b) eliminating from the database ineligible areas and beneficiaries and ensuring up-to-date information on land parcels (e. g. orthophotos);
- (c) clarifying and simplifying the rules underpinning the measures — in particular the use of the national reserve.

5.57. Further significant efforts are also required to ensure that beneficiaries respect their obligations in the area of rural development which is particularly prone to errors because of the often complex rules and eligibility conditions.

5.58. Finally, it is necessary to overcome the system's weaknesses identified as affecting the policy areas of environment, fisheries, health and consumer protection.

THE COMMISSION'S REPLIES

- (b) *Guidelines on recording of eligible areas and ensuring up-to-date information have been established by the Commission services (DG AGRI and JRC) already in 2002. These guidelines have been discussed with the Member States at different occasions. Where it is found that the non respect of these Guidelines can lead to irregular payments, action is taken under the conformity clearance and Member States are requested to detail an action plan to resolve the issues. In this, the Commission services (DG AGRI and JRC) are providing the necessary assistance.*
- (c) *Simplification is proposed in the Health Check proposal: by further decoupling some partial payments and by allowing Member States to gradually shift towards flatter payment rates per entitlement, SPS will become more effective, efficient and simple.*

5.57. *The Commission has given in its audit programme 2008 priority to the audit of agri-environmental measures.*

The Commission shares the view of the Court that rural development measures, in particular due to the inherent complexity of agri-environmental measures, are prone to a higher incidence of errors than EAGF payments. Agri-environmental measures are complex by nature and that there is only very limited scope for simplification of these measures without jeopardising their objectives.

The Commission, therefore, considers that due to the added value of these measures and their high complexity, the tolerable risk of errors should be higher.

Despite these considerations, important improvements of the rural development control framework have been introduced for the EAFRD programming period 2007-2013. As an example, Member States shall now ensure that all the eligibility criteria established by Community legislation or by the rural development programmes can be controlled according to a set of verifiable indicators to be established by them. As eligibility criteria are often complex, different rules and guidelines have been produced by the Commission services to assist Member States in their interpretation.

Moreover, the application of the IACS has been further reinforced for area and animal related rural development measures under Axis 2 that constitute 44 % of the total expenditure programmed.

5.58. *The Directorate-General for Health and Consumers refers to its statement in paragraph 5.51.*

See reply in 5.51 for fisheries.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

FOLLOW-UP OF PREVIOUS OBSERVATIONS

The common organisation of the market in raw tobacco

5.59. In its Special Report No 7/2004 ⁽³²⁾ the Court identified a number of shortcomings, notably unreliable data, inadequate analysis of the market situation, as well as a failure to meet objectives set, such as encouraging the conversion of production to other sectors. The Court made a number of recommendations which were supported by the Parliament and the Council.

5.60. The CMO for raw tobacco has since been reformed in the context of the 2003 general reform of the CAP. The Commission has largely taken into account the Court's recommendations, namely regarding the collection and use of more complete and reliable data. Furthermore, full decoupling of the aid from production is gradually being introduced. This, together with the financing of reconversion measures, will when fully implemented, address the weaknesses of the market measures and are themselves an incentive for producers to voluntarily give up tobacco production.

The Commission's management and supervision of the measures to control foot-and-mouth disease

5.61. In its Special Report No 8/2004 ⁽³³⁾, the Court noted that the Commission and the Council had already remedied many of the legislative weaknesses highlighted by the Court's audit. However, it recommended further measures, notably:

- (a) outside crisis periods, regular evaluation of the prevention and control arrangements and increased supervision of their implementation;
- (b) a study of ways of involving farmers more closely in rapid notification of the disease and compliance with movement restrictions;

5.61.

⁽³²⁾ OJ C 41, 17.2.2005, p. 1.

⁽³³⁾ OJ C 54, 3.3.2005, p. 1.

THE COURT'S OBSERVATIONS

- (c) clarification of the financial framework applicable to epidemics of animal disease, combined with maximum reduction of the financial risks to the EU budget.

5.62. The Commission undertook a major evaluation of the prevention and control measures in 2006 and took a series of initiatives which partially address the Court's recommendations.

5.63. Nevertheless, the Court considers that further efforts are needed to:

- (a) simplify legislation concerning the health and welfare of animals ⁽³⁴⁾;

THE COMMISSION'S REPLIES

- (c) *In the Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions 'A new Animal Health Strategy for the European Union (2007-2013) where "Prevention is better than cure" (COM(2007) 539 final) it expected to develop a harmonised EU framework of the criteria for responsibility and cost-sharing. This is to be achieved by a revision of the EU financial instrument for animal disease financing (Council Decision 90/424/EEC) in the framework of the action plan of the new animal health strategy. Preparatory work has already started. Further actions, including a feasibility study that will include a consultation process are planned.*

5.62. *In December 2004, the Commission launched an external evaluation to thoroughly review the outcomes of EU action on animal health and the direction it may wish to take in the future. Based on the evaluation's results and a wide stakeholder consultation, the Commission presented its proposal for a new animal health strategy in September 2007 ⁽¹²⁾. It was the first time that the Commission set out its strategic aims and objectives for animal health.*

5.63. *The Council (in December 2007), the European Economic and Social Committee (January 2008) and the European Parliament (May 2008) have welcomed the development of a strategic approach to EU animal health policy and support the overall aims, objectives and principles set out in the Animal Health Strategy, which covers the period 2007-2013. Based on the results of discussions in these EU inter-institutional forums, the Commission will adopt in the near future its Action Plan on Animal Health to deliver the strategy's vision over the next five years and beyond.*

- (a) *In the framework of the Better Regulation policy, major actions have already been undertaken to simplify the existing legal framework, including for example the new Directive 2006/88/EC on aquaculture animals ⁽¹³⁾ and the proposal for a Council Directive simplifying procedures of listing and publishing information in*

⁽³⁴⁾ Communication on a new Animal Health Strategy (2007-2013) COM(2007) 539/F, 19.9.2007.

⁽¹²⁾ COM(2007) 539 adopted on 19 September 2007 http://ec.europa.eu/food/animal/diseases/strategy/docs/animal_health_strategy_en.pdf

⁽¹³⁾ Council Directive 2006/88/EC of 24 October 2006 on animal health requirements for aquaculture animals and products thereof, and on the prevention and control of certain diseases in aquatic animals (OJ L 328, 24.11.2006, p. 14).

THE COURT'S OBSERVATIONS

- (b) increase the human resources dedicated to the control of the application of EU legislation taking into account the enlargement of the Union;
- (c) remedy the persistent weaknesses in the contingency plans, as highlighted namely in Food and Veterinary Office reports;
- (d) improve the organisation and follow-up of real time alert exercises;
- (e) reduce the frequent delays in the notification of bovine movements and their registration in the central database and improve the identification and movement legislation for pigs;

THE COMMISSION'S REPLIES

the veterinary and zootechnical fields and amending 22 existing Council Directives ⁽¹⁴⁾, which is currently at the final stage of procedure for adoption by the Council. However, as explained in its Communication on the new Animal Health Policy Strategy, the Commission also intends to bring forward a proposal for a new animal health law that would simplify considerably existing legislation.

- (b)** *In the food safety and animal health area, the Commission's Food and Veterinary Office (FVO) works to assure effective control systems and to evaluate compliance with EU standards within the EU, and in third countries in relation to their exports to the EU. The FVO does this mainly by carrying out inspections in Member States and in third countries exporting to the EU.*

The FVO carries out a total of about 250 to 270 missions per year.

Recruitment is ongoing according to the requirements for recruiting preferentially experts from the recently acceded Member States.

- (c)** *This point will be followed up.*
- (d)** *The Commission is currently gathering updated information from the Member States to ensure a proper follow-up to this recommendation.*
- (e)** *The shortcomings reported by the FVO are related with the implementation of the relevant Community Acts on identification of animals, registration of holdings and movement records; they do not question the provisions in the respective Regulations and the Directive.*

⁽¹⁴⁾ Proposal for a Council Directive simplifying procedures of listing and publishing information in the veterinary and zootechnical fields and amending Directives 64/432/EEC, 77/504/EEC, 88/407/EEC, 88/661/EEC, 89/361/EEC, 89/556/EEC, 90/4para27/EEC, 90/428/EEC, 90/429/EEC, 90/539/EEC, 91/68/EEC, 92/35/EEC, 92/65/EEC, 92/66/EEC, 92/119/EEC, 94/28/EC, 2000/75/EC, Decision 2000/258/EC and Directives 2001/89/EC, 2002/60/EC, and 2005/94/EC. (COM(2008) 120 final — 2008/0046 (CNS)).

THE COURT'S OBSERVATIONS

- (f) incorporate the food hygiene requirements adopted in 2004 in the provisions for imported meat.

5.64. As regards the greater involvement of farmers in the rapid notification of the disease, limited progress has been achieved to date.

5.65. Finally, as regards the clarification of the financial framework, the Commission adopted measures in 2005 fixing limits on compensation, based on market prices. However, further measures are necessary, given that payment of national aid varies greatly among the Member States.

Measurement of farm incomes by the Commission

5.66. In its Special Report No 14/2003 ⁽³⁵⁾ on the evaluation of farmers' income by the Commission, the Court concluded that the EU statistics did not provide sufficiently exhaustive information on the disposable incomes of agricultural households and did not allow an assessment to be made of the living standard of the agricultural community. This was notwithstanding the fact that three separate instruments were available, all intended to determine agricultural income, but which were not designed for the same purpose. The Court recommended that the Commission evaluate the statistics available concerning the situation of holdings and agricultural households and define precisely the statistical framework to monitor the achievements of the objectives of the common agricultural policy, notably that concerning a reasonable standard of living for farmers. The European Parliament and the Council supported the Court's recommendations.

THE COMMISSION'S REPLIES

- (f) *The Commission prepared an appropriate proposal already in the second half of 2007 (SANCO/10018/2007) and received a favourable opinion of Member States at the SCoFCAH ⁽¹⁵⁾ meeting of 10 September 2007. The document is now in the legislative procedure for formal adoption by the Commission and subsequent publication in the Official Journal.*

5.64. *All outbreaks of major contagious animal diseases (classical swine fever, foot and mouth disease, avian influenza) that have occurred in the EU in the last 5 years have led to very limited costs for the Community budget and have been successfully eradicated. One of the reasons for these results is that — in general — notification of disease has been done in a timely manner. Member States have often not (fully) compensated those farmers that have not fully co-operated with the authorities or not reported the disease in a timely manner in order to discourage such behaviour.*

5.65. *The ceilings specified in the legislation provide an overall idea of the compensation granted by the Member States.*

However, the basic rule remains that the compensation should never exceed the market value of the animal. Correct application of the legislation prevents over- and undervaluations.

The legislation concerning compensation and state aid is harmonised and is identical for all EU Member States. The difference observed in this case stems from the different made of the instruments available.

⁽³⁵⁾ OJ C 45, 20.2.2004, p. 1.

⁽¹⁵⁾ SCoFCAH: Standing Committee of the Food Chain and Animal Health.

THE COURT'S OBSERVATIONS

5.67. In the meantime, the Commission has taken a number of initiatives, inter alia, to harmonise the statistical methods adopted by the Member States, notably concerning the Farm Accountancy Data Network (FADN). In addition, the Commission took a series of initiatives to improve the reliability of the other instruments available, namely the EAA and the IAHS. Furthermore, the Commission undertook feasibility studies to establish a more comprehensive European statistical framework. However, progress to date has been slow, largely through a lack of consensus between Member States as to the priority to be accorded to the project, given the apparently prohibitive costs of collecting more complete information on agricultural incomes, including those arising from off-farm activities. The Court reiterates that more complete statistics and indicators are indispensable in order to follow more closely the performance of the common agricultural policy of which approximately two-thirds of the budgetary resources are devoted to revenue support for farmers.

THE COMMISSION'S REPLIES

5.67. The evaluation of the feasibility study has been included in the community statistical programme 2008-2012. A first discussion in the Permanent Committee for Agricultural Statistics has shown that Member States are cautious due to the existing conceptual, technical and financial difficulties. It was decided to maintain the FADN and EAA as primary sources of information on agricultural income.

Assessment of supervisory and control systems — Direct coupled payments — managed under IACS

Member State	Area Aid				Animal Premiums				Overall assessment
	Administrative procedures and controls to ensure correct payment	Risk analysis and selection procedures for inspections	Inspection methodology, quality control and reporting of individual results	Preparation and reliability of statistics on inspections and results	Administrative procedures and controls to ensure correct payment	Risk analysis and selection procedures for inspections	Inspection methodology, quality control and reporting of individual results	Preparation and reliability of statistics on inspections and results	
Germany (Bavaria)					n/a	n/a	n/a	n/a	
Spain (Castilla y Leon)	1	2	3			14	4		
Italy (AGEA)	5	n/v	3		n/a	n/a	n/a	n/a	
Portugal		n/v	6		n/v		7		
France		8				9	10		
Greece	1/11		12	13	n/a	n/a	n/a	n/a	

Legend

	Effective
	Partially effective
	Not effective
n/a	Not applicable
n/v	Not verified




The result of transaction testing

Sample estimate of proportion of transactions affected by an error	31 %
error rate	Between 2 % and 5 %

- 1 The geographic information system (GIS) on which the management of EU aid schemes is based does not always contain complete and reliable information about eligible/non-eligible areas by reference parcel.
- 2 The Spanish authorities have not provided evidence that any evaluation of the well-foundedness of the risk criteria and their specific weightings was carried out for the 2006 year.
- 3 The results of the national on-the-spot checks and their incorporation into the GIS are not reliable (permanent ineligible features or different types of land use were not identified by the inspectors, GIS was then not updated and this results in overpayments to farmers).
- 4 Certain weaknesses were found in the administrative applications relating to the on-the-spot animal checks such as the format of the control reports and the registers for holdings.
- 5 The nature of AGEA's monitoring does not ensure that it is in command of the sound operation of the delegated responsibilities for the control and management. Amendments accepted after the deadline, payments issued before the final results of the on-the-spot control were found.
- 6 Some weaknesses in the on-the-spot control procedures have been identified (ineligible areas not identified, eligibility criteria not checked).
- 7 Some weaknesses in the on-the-spot control procedures have been identified (control work on animal registers not properly carried out or not documented).
- 8 The risk parameters were not evaluated for traditional on-the-spot checks. These checks represent 20 % of on-the-spot controls, the rest being carried out by remote sensing, in respect of which there is an evaluation.
- 9 No evaluation of the effectiveness of the parameters for the risk analysis used in previous years.
- 10 The control procedures provide for marking the animals present on an extract from the national computerised database (NCDB) and not for a separate count of all the animals present.
- 11 Input errors of claim data identified, claim data modified after submission date.
- 12 Measurement methods, results and tolerances applied are not documented in the control reports.
- 13 As at 1 April 2008 control statistics for 2006 had not been submitted to the Commission (the deadline was July 2007).
- 14 The evaluation in respect of animal aid schemes only covered the specific weighting of risk factors and not the nature of these factors.

IACS Monitoring elements — Single Payment Scheme (SPS) (*)

Member State	Administrative procedures and controls to ensure correct payment	Risk analysis and selection procedures for inspections	Inspection methodology, quality control and reporting of individual results	Preparation and reliability of statistics on inspections and results	Overall assessment
Finland	4/13/15/21	23	25		
France	2/4/6/7/[11]/12/13/15/17	22/23		26	
Netherlands	2/5/6/8/10/13/14/15/16	24			
Portugal	3/5/6/14/15/17	22/23			
Spain (Andalusia)	11/15	22			
Sweden	2/7/9/13/17	22			
UK (England)	1/6/13/14/15/17/18/19/20	24		26	

	Effective
	Partially effective
	Not effective

- 1 No orthophotos available for administrative cross-checks, which although not compulsory, significantly increases the reliability of data used for cross-checks.
- 2 Ineligible features visible on air-born photos or declared by the farmer are not eliminated from the eligible area recorded in the LPIS.
- 3 Forest parcels are not systematically excluded from the eligible area.
- 4 Eligibility of new parcels not systematically checked.
- 5 Minimum size for the eligibility of agricultural parcels not defined.
- 6 The Land Parcel Identification System is not adequately updated by on-the-spot inspection results and/or data held in topographical database.
- 7 Administrative cross-checks partially based on outdated orthophotos.
- 8 IACS database of entitlements not reliable, no reliable figures provided as regards the up to date numbers and values of entitlements recorded in the database for 2006 and 2007, entitlements that failed to respect minimum activation requirements not withdrawn.
- 9 No final administrative cross-check at national level before payments were authorised.
- 10 The Netherlands initially allocated entitlements in excess of the national ceiling of 4,9 million euro. Payments were made on this basis to individual farmers.
- 11 SPS payments were authorised to farmers who did not have payment entitlements.
- 12 Payments are not systematically blocked until all anomalies are cleared or necessary documents are available.
- 13 Claim registration procedures do not provide sufficient proof of the actual date of receipt and/or are not adequately controlled.
- 14 Incorrect application of late claim penalties.
- 15 Systematic incorrect calculation of payments where area determined is not sufficient for all entitlements declared.
- 16 Non-application of EU provisions on sanctions in cases of over declaration of areas.
- 17 No or insufficient administrative cross-checks whether area declared for set-aside meets the legal conditions.
- 18 Insufficient management control on changes made to the database.
- 19 The same parcel can be claimed by different farmers under different EU aid schemes.
- 20 The reference parcel area can be overshoot by a tolerance of up to 2 %.
- 21 Vegetable gardens were paid up to maximum of 0,3 ha per claim without entitlements (719,62 ha, 134 535,85 euro).
- 22 Selection of inspections partially based on outdated application data and/or based on an incomplete population of applications.
- 23 Inspection rate was not increased during the year.
- 24 Inspections chosen on the basis of the risk analysis showed a lower incidence of error than randomly selected inspections.
- 25 Application of measurement methods with insufficient precision.
- 26 Significant differences between statistics reported to the Commission and the underlying data transmitted to the auditors.

(*) Aspects relevant to cross-compliance are not included.

Follow-up of key Statement of Assurance observations

	Court observation in the Annual Report 2006	Action taken	Court analysis	Commission reply
IACS	For the fifth consecutive year the Director General's declaration contains a reservation concerning insufficient implementation of the IACS in Greece. For 2006 the Commission and the Court have confirmed continuing failure to implement key controls (5.11 (*)).	<p>According to its replies, the Commission continues with an intensive audit programme and as long as necessary will impose financial corrections on Greece.</p> <p>Moreover, the Commission closely monitors and supervises the Greek action plan that has been drawn up by the Greek authorities on the explicit request of and in close cooperation with the Commission in order to remedy the above deficiencies. The action plan contains strict deadlines for the implementation of the different actions which should produce their first results as of financial year 2007 (claim year 2006).</p>	<p>Weaknesses in administrative controls in the direct coupled payments have been identified in DAS 2007 audit in Greece, Italy, Spain and Portugal: wrong input of application data, payment for multiple incompatible aid schemes on the same parcel and a failure to correctly apply penalties and sanctions, leading to over-payments (5.27(a) (**)).</p> <p>The LPIS in Greece is incomplete and contains errors in the referencing of parcels. Furthermore, in some countries the graphical layer of the LPIS (GIS) contains only aerial photos that are more than five (France, and Sweden) years old. In Portugal the update is carried out with significant delays (5.30(b), 5.30(c) (**)).</p> <p>The 2007 Annual Activity Report of the Director General for Agriculture contains again a reservation in respect of insufficient implementation of the IACS in Greece.</p>	<i>The issues named in the Annual Report 2007 are generally already followed up through conformity procedures.</i>
SPS	<p>The United Kingdom allocated entitlements to landlords who let out their land for most of the year (5.20 (*)).</p> <p>Contrary to the rules some Member States have extended the provision concerning consolidation of entitlements to all cases where a farmer in 2005 had fewer hectares than entitlements (5.24 (*)).</p> <p>The SPS has had a number of side-effects: aid has been paid to landlords and new beneficiaries (5.28 (**)); in many Member States 'farmers' have been allowed to keep their windfall profits (5.30 (**)); inappropriate investment criteria have led to questionable allocation of extra entitlements (5.34 (**)).</p>	According to the Commission's reply, the issues named in the Annual Report concerning the financial year 2006 will be followed up through conformity procedures.	<p>The audit found systematic shortcomings in calculation of the entitlements due to:</p> <ul style="list-style-type: none"> — allocation of the entitlements in excess of the national ceiling (Netherlands) (5.22(b) (**)), — allocation of entitlements for non-eligible production, land or investment (5.26(b), 5.22(c), (d) (**)), — non-respect or incorrect application of regulations/special rules (5.22(e), 5.24(b), 5.25 (**)). <p>The re-performances of controls carried out by the Court found a number of specific weaknesses in the quality of the on-the-spot controls and identified ineligible areas or parcels that should have been excluded by the national inspectors. (Greece, Italy, Spain, Portugal) 5.28 (**).</p> <p>The Court concludes, however, that IACS continues to be effective in limiting the risk of irregular expenditure where properly implemented and if accurate and reliable data is introduced as regards SPS payments based upon allocated entitlements. The recent introduction in SPS of support schemes, such as those related to olive oil, is a positive development although in the short term might lead to a higher frequency of errors (see paragraph 5.52 (**)).</p>	<p><i>See reply to paragraph 5.22(b).</i></p> <p><i>The issues named in the Annual Report 2007 are generally already followed up through conformity procedures.</i></p>

	Court observation in the Annual Report 2006	Action taken	Court analysis	Commission reply
Olive oil	The on-the-spot visits in the main producer Member States revealed general problems which affect the reliability and accuracy of GIS and consequently the correct calculation of entitlements under the SPS (5.84 (*)).	According to the Commission's reply in the Annual Report concerning the financial year 2006, some 180 million euro of financial corrections have already been applied by the Commission since financial year 2000 and more significant corrections are in the pipeline. As of 1 January 2006, the olive oil production aid has been fully decoupled and integrated in the single payment scheme (only Spain kept a small element of coupled aid).	The impact of the accuracy of the olive oil GIS on the integration of the production aid scheme into the SPS has been confirmed in Greece and Italy where four out of five olive oil SPS transactions audited contained errors, some of which led to significant over payments (5.14c (**)).	<i>Further financial corrections on olive oil production aid have been applied in 2007 and 2008.</i> <i>See also reply to paragraph 5.14(c).</i>
Ex-post scrutiny	The conformity unit responsible for rural development did not carry out any audits covering Regulation (EEC) No 4045/89 issues (5.50 (*)). The Commission still does not know how many of the potential irregularities initially reported under Regulation (EEC) No 4045/89 resulted in recovery or why they did not (5.52 (*)). Backlogs in completing post-payment checks persist in Germany, Italy and Spain (5.53 (*)).	N/A The Commission has introduced the obligation for the certifying bodies to verify and report on the Paying Agencies' follow up of the potential irregularities reported. (5.40-5.45 (**)). There is still a limited number of scrutinies not completed from each of the precedent scrutiny periods dating back as far as 2000/2001 (5.34 (**)).	The Court noted (again) a limited coverage of rural development measures both at the Commission and Member States level (5.35 (**)). The Court's analysis of the certifying bodies' reports has shown a need for improvements in the verification and reporting by the Paying Agencies on the follow up of the potential irregularities reported (5.36 (**)). The timely execution of the scrutiny programme has improved in 2007 (5.34 (**)).	<i>See reply to paragraph 5.35.</i> <i>See reply to paragraph 5.36.</i>
Clearance of the accounts	Although the clearance of accounts systems as well as post-payment checks have the objective of excluding expenditure which does not comply with Community rules, at present they fail to do so at the level of payments to beneficiaries. (5.76 (*)).	N/A	The Court reiterates its opinion from the previous Annual Report on the clearance of the accounts system.	<i>The Commission disagrees and refers to its reply to paragraph 5.47.</i>
Export refund:	The Court's own audit of physical and substitution checks (export refunds) led to Special Report No 4/2007 of 21 June 2007. An analysis carried out by the Court shows that the information in respect of physical and substitution checks is not reliable (5.55 (*)).	The Council and Commission acted promptly on the recommendations made in the Special Report by amending the relevant legislation. (5.38 (**)).	The particular weakness concerning the reintroduction of exported goods into Community territory following transportation on a non regular shipping line, has not yet been addressed (5.38 (**)).	<i>See reply to paragraph 5.38.</i>
Rural development	For agri-environmental measures the Court continues to find a high incidence of errors because farmers do not meet their commitments or the key eligibility conditions are not checked by the authorities (5.44 (*)).	The Commission considers that the high incidence of errors in agri-environmental measures found by the Court is not representative for the total of rural development expenditure.	The Court reiterates that Rural Development expenditure is particularly prone to errors and notes that, in recognition of this, the 2007 Annual Activity Report of the Director General for Agriculture contains a global reservation in respect of that expenditure (5.12 (**)). Further significant efforts are required to ensure that beneficiaries respect their obligations in the area of rural development which is particularly prone to errors because of the often complex rules and eligibility conditions (5.57 (**)).	<i>See reply to paragraph 5.12.</i> <i>See reply to paragraph 5.57.</i>

(*) paragraph number in the ECA Annual Report 2006.

(**) paragraph number in the ECA Annual Report 2007.

ANNEX 5.3

Paying agency accounts disjoined for 2007

Member State	Paying agency	Accounts disjoined ⁽¹⁾		
		EAGF (million euro)	EAFRD (million euro)	TRDI (million euro)
Austria	AMA		79,00	
Belgium	ALV		25,00	
Belgium	Région Wallone		14,00	
Germany	Baden-Württemberg		52,00	
Germany	Bayern		159,00	
Estonia	PRIA	38,00		41,00
Greece	OPEKEPE	2 378,00	194,00	
Finland	MAVI	580,00	217,00	
Italy	ARBEA	101,00		
Malta	MRAE	2,00		4,00
Netherlands	Dienst Regelingen	1 050,00		
Portugal	IFADAP	6,00		
Portugal	INGA	528,00		
Portugal	IFAP	197,00	90,00	
Total		4 868,00	830,00	45,00

⁽¹⁾ Accounts which the Commission considered not to be able to clear in its decisions of 30 April 2008. This due to reasons attributable to the Member States concerned which require additional inquiries.

Source: Commission Decisions 2008/395/EC, 2008/396/EC and 2008/397/EC (OJ L 139, 29.5.2008).

CHAPTER 6

Cohesion

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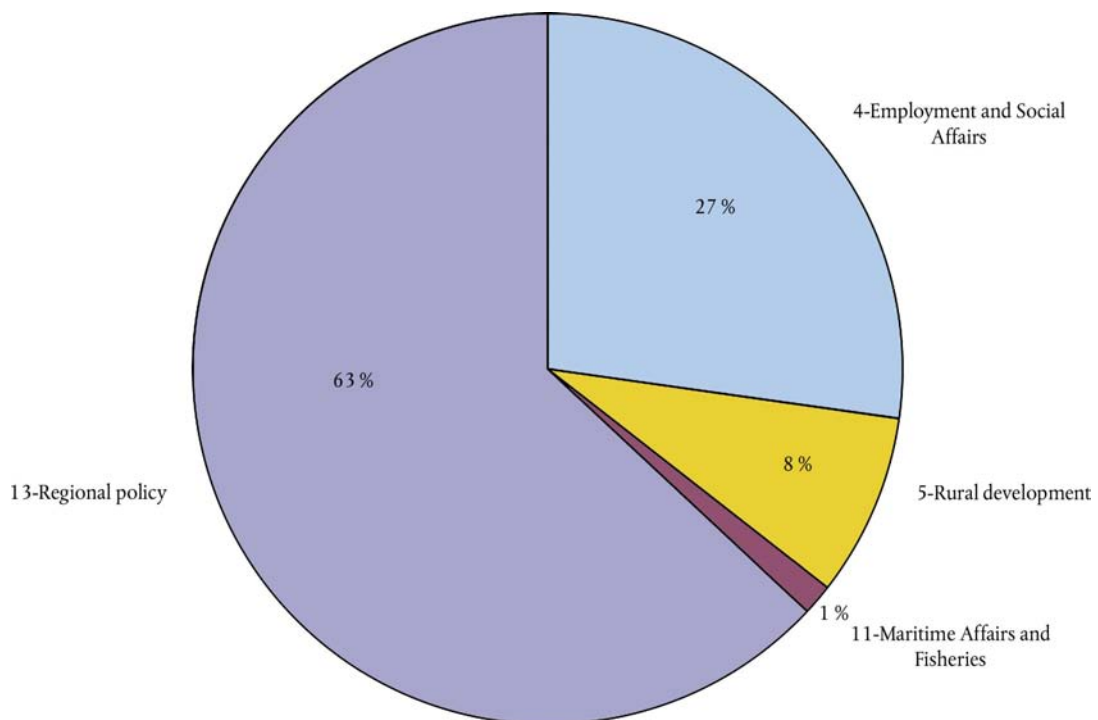
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INTRODUCTION

6.1. This chapter presents the Court's findings on two policy areas which promote economic and social cohesion: 4 — Employment and Social Affairs and 13 — Regional Policy. It also reports on 2000-2006 expenditure on rural development and fisheries (parts of policy areas 5 — agriculture and rural development, and 11 — fisheries). In 2007 commitments totalled 45 575 million euro and payments totalled 42 015 million euro. The distribution of payments by policy area is given in **Graph 6.1**.

Graph 6.1 — Cohesion — breakdown of payments by policy area



Total payments in 2007: 42 015 million euro

Source: 2007 annual accounts.

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Specific characteristics of Cohesion Policies

6.2. EU spending on cohesion is planned in multiannual 'programming periods'; payments relating to each programming period continue for some years beyond the end of the programming period. This chapter relates to payments in respect of the 2000-2006 programming period as they comprise the bulk of the expenditure (84 %) ⁽¹⁾. Matters related to the 2007-2013 period are covered in paragraphs 6.18 to 6.20.

6.3. EU funding of cohesion policies takes the form of co-financing: Member States must also contribute to the cost of the projects supported. The Community's support comes from a series of 'funds' in the budget: the structural funds (see paragraph 6.5) and the Cohesion Fund (see paragraph 6.6).

Policy objectives and instruments: 2000-2006

6.4. In the programming period 2000-2006, Cohesion Policies expenditure was directed to three objectives:

- (a) structural adjustment of regions whose development was lagging behind (Objective 1);
- (b) economic and social conversion of areas facing structural difficulties (Objective 2);
- (c) modernisation of systems of education and employment (Objective 3);

and to a series of more specific 'Community Initiatives' covering, for example interregional cooperation in the EU and urban regeneration.

6.5. Funding is provided by four Structural Funds:

- (a) the European Regional Development Fund (ERDF) supports Objectives 1 and 2 by co-financing investment in infrastructure, the creation or maintenance of jobs, local development initiatives and the activities of small and medium-sized enterprises;

⁽¹⁾ Payments related to the period 2007-2013 consisted of advances only and they comprised 16 % of the expenditure.

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- (b) the European Social Fund (ESF) supports Objectives 1, 2 and 3 by granting financial assistance to combat unemployment, develop human resources and promote integration into the labour market;
- (c) the European Agricultural Guidance and Guarantee Fund — Guidance section (EAGGF-Guidance), co-finances rural development projects; and
- (d) the Financial Instrument for Fisheries Guidance (FIFG) co-finances measures towards a sustainable balance between fishery resources and their exploitation and strengthening the competitiveness and the development of the fisheries sector.

6.6. In addition the Cohesion Fund supports the improvement of environment and transport infrastructure in Member States whose gross national product per capita is below 90 % of the European Union average ⁽²⁾.

How the money is spent

6.7. The Structural Funds co-finance *projects* within the framework of *operational programmes*. For 2000-2006 there were 545 operational programmes, varying in size from under 500 000 euro to over 8 billion euro. Project expenditure within these programmes varied from a few hundred euro to an individual beneficiary, up to hundreds of millions of euro for a major infrastructure project. Under the Cohesion Fund there are no operational programmes, only projects for the 2000-2006 programming period. For this period there were 1 094 Cohesion Fund projects. They ranged from 50 000 euro to over 1 billion euro.

6.8. The co-financing of a project by a Structural Fund or the Cohesion Fund generally takes the form of the *reimbursement* of costs ⁽³⁾ based on an *expenditure declaration* by the project promoter ⁽⁴⁾. A project promoter usually submits several interim expenditure declarations and a final one at the end of the project.

⁽²⁾ Council Regulation (EC) No 1164/94 (OJ L 130, 25.5.1994, p. 1).

⁽³⁾ Depending on the type and complexity of the project there can be many items and types of costs supporting a reimbursement request.

⁽⁴⁾ Project promoters are final beneficiaries and final recipients which range from private individuals to associations, private or public companies to local, regional or national bodies.

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Supervisory and control systems

6.9. Responsibility for the regularity of spending on Cohesion Policies starts in a Member State, but the Commission bears the ultimate responsibility for correct implementation of the budget.

6.10. There are two levels of control over Cohesion Policies projects. The first is the control system in the Member State. It is intended to prevent or detect and correct the incorrect reimbursements of project costs and other irregularities. The second level is the Commission's supervision. It is intended to ensure that Member State control systems are established and operating as required and mitigate the risk of control failures in the Member States.

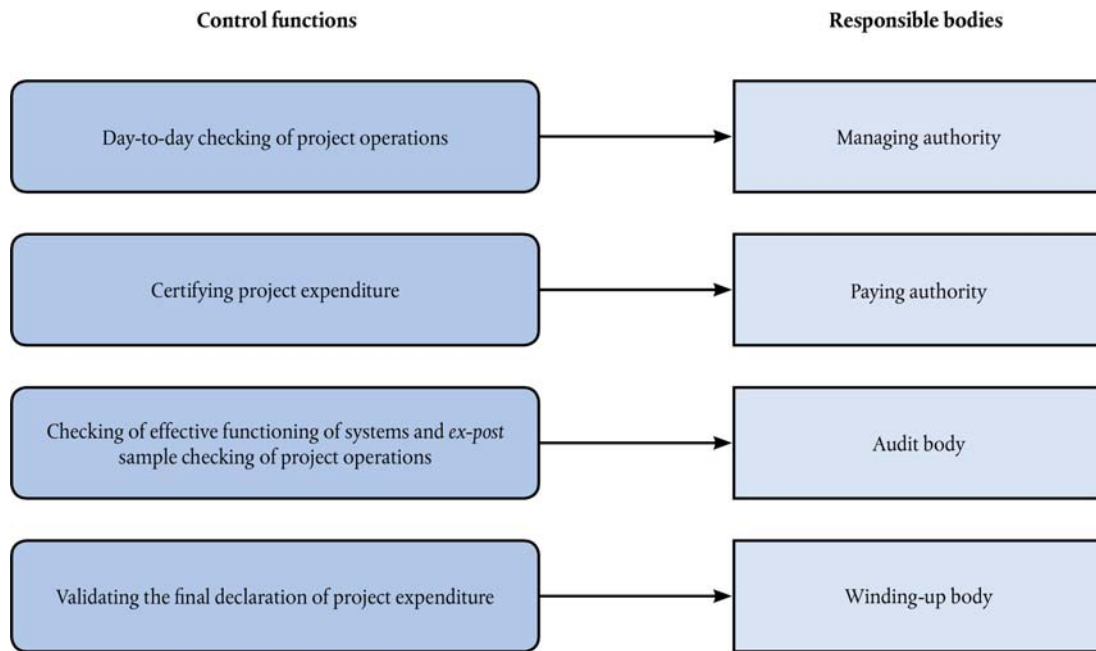
6.11. For the programming period 2000-2006, the control system in the Member State comprises four key control functions. They must be clearly defined and assigned to bodies which, except for the audit body and winding up body, must be independent of each other. See **Figure 6.2**.

6.12. Arrangements vary between the Member States. In some Member States the control functions are centralised at the national level. In others the control functions are delegated through intermediate bodies to an entity at a regional or local level or to a sector specific entity (decentralised controls).

6.13. The Commission's supervision comprises mainly *ex-post* audits, and the imposition of financial corrections when serious control weaknesses are detected.

6.9. *Member States are responsible under the sectoral regulations for ensuring that expenditure declared to the Commission for co-financing is regular. The Commission under shared management arrangements, has a supervisory role to verify the effective functioning of Member States' control systems, and to take corrective measures where it concludes that this is not the case, in order to assume its responsibility for the implementation of the budget (Article 53b(4) of the Financial Regulation). The Commission performs its supervisory role through its audit activity but also through programme negotiations, monitoring committees, annual meetings with managing and audit authorities, guidance and seminars. Further strengthening of the Commission's supervision is introduced through the Action Plan adopted by the Commission on 19 February 2008.*

6.13. *The Commission refers to its reply under paragraph 6.9.*

Figure 6.2 — Key controls in Member State

6.14. A Commission audit can be an effective supervisory instrument:

- (a) if it is based on an assessment of the risk of failures in a Member State's control system;
- (b) if it provides an operationally useful result; that is, if it provides either a sound basis for corrective action or reasonable assurance that there is no need for such action; and
- (c) if there is appropriate and timely corrective action based on the audit result.

6.14.

- (c) *Corrective action resulting from Commission audits may be the effective implementation of remedial actions by the national authorities and/or the application of a financial correction by the national authorities, as well as a financial correction applied by the Commission during programme implementation or at closure.*

The Court assesses these audits based on the abovementioned criteria.

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Financial Corrections

6.15. The Commission has maintained the position that most of the errors detected and reported by the Court in its annual reports are likely to be detected and corrected by the multi-annual corrective system ⁽⁵⁾. However, the Commission is not in a position to provide sufficient evidence for corrections by the Member States. The systems for applying the financial corrections are discussed in Chapter 3 (see paragraphs 3.21 to 3.29 and Diagram 3.2) and the actual financial corrections made in Chapter 1 (see paragraphs 1.36 and 1.38).

6.15. *The Commission has made substantial efforts to improve the quality of data provided by Member States and is currently carrying out work to verify the completeness and accuracy of this data. As indicated in the Commission's reply to paragraph 3.25, there has therefore been progress in producing reliable evidence of the operation of the multi-annual corrective mechanisms.*

Types of error in Cohesion Policies projects

6.16. There is a high risk that the costs of Cohesion Policies projects are incorrectly declared and, consequently, incorrectly reimbursed. In the context of this report, an incorrect reimbursement is an *over-reimbursement*. It may be a result of:

- (a) an eligibility error — the expenditure reimbursed does not comply with an eligibility rule defined in the specific regulations governing the expenditure;
- (b) an occurrence error — the expenditure reimbursed includes a cost which is not actually incurred or which is not documented;
- (c) an accuracy error — when a cost is incorrectly calculated; or
- (d) a multiple error — when the expenditure reimbursed is affected by more than one of the above type.

6.16. *Payments under the Cohesion Policies are subject to a high inherent risk because of the number of bodies involved in implementation at different levels and the high number of beneficiaries and co-financed operations linked to the overall volume of funds. If the first level management verifications and the certification function are working properly, this risk can be adequately addressed.*

6.17. A project may also be affected by *compliance errors*. They are mainly errors in public procurement procedures and failures to meet publicity requirements. These are classified as non quantifiable errors. However, serious cases of non respect of public procurement procedures affecting the conditions of payments are classified as eligibility errors (see paragraphs 1.9 to 1.11).

⁽⁵⁾ See for example Annual Report concerning the financial year 2006, paragraph 6.39, the Commission's reply.

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2007-2013 period

6.18. For the 2007-2013 programming period, there are three objectives (the Convergence objective, the Regional competitiveness and employment objective and the European territorial cooperation objective). There are three funds: regional development, social and cohesion. The programmes are designed to reinforce the attractiveness of the Member States and their regions and cities; promote innovation, entrepreneurship, employment and the knowledge-based economy; develop regional economies and create new and better jobs.

6.19. 2007, the first year of the new programming period, was basically a preparatory phase, in which no expenditure was declared for reimbursement. Payments for the year were 6,8 billion euro, representing prefinancing payments of 2 % on approved programmes (2,5 % for Cohesion Fund projects in the new Member States). As there were no reimbursements for the 2007 financial year, the Court's detailed audit work covered 2000-2006 projects and programmes only.

6.20. In the Regulations relating to the 2007-2013 programming period⁽⁶⁾, control provisions are further refined and strengthened and the respective responsibilities of Commission and Member States further clarified. The audit provisions are considerably amplified for the new programming period. The Member States are required to submit an audit strategy paper⁽⁷⁾ and a compliance statement with each operational programme's systems description for acceptance to the Commission. Annual control reports based on systems audit and the audit of a representative sample of transactions resulting in an annual audit opinion are also required.

⁽⁶⁾ Notably Council Regulation (EC) No 1083/2006 (OJ L 210, 31.7.2006, p. 25) and Commission Regulation (EC) No 1828/2006 (OJ L 371, 27.12.2006, p. 1).

⁽⁷⁾ Although for smaller programmes (less than 750 million euro and 40 % EU financing) this is not required.

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SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Audit Scope

6.21. The Court audited 180 interim reimbursements ⁽⁸⁾ made in the year 2007 (for the 2000-2006 programming period) to 176 Structural Funds projects (99 ERDF, 56 ESF, 21 EAGGF) and 4 Cohesion Fund projects. The 176 Structural Funds projects were carried out within 16 operational programmes from 10 Member States. For each operational programme the respective Member State has set up at least one control system as illustrated in **Figure 6.2**. The Court assessed those control systems in terms of compliance with regulations and their effectiveness for managing the risk of legality and regularity. The Court also assessed part of the Commission's supervisory activity, analysing 20 audits undertaken by the Commission.

Audit Findings***Legality and regularity of underlying transactions***

6.22. A summary of findings on the legality and regularity of EU funding of Cohesion Policies projects is presented in **Tables 6.1** and **6.2**.

6.23. **Table 6.1** shows that only 46 % of projects in the Court's representative statistical sample were found to be free from error of legality and regularity (31 % in 2006).

6.24. **Table 6.2** analyses the errors affecting reimbursement by their type. The distribution is broadly similar to year 2006.

6.23. *The application of certain rules relating to the eligibility of expenditure can give rise to differing interpretations. Of the 97 projects cited by the Court in Table 6.1 as affected by error, the Commission considers that there are seven projects for which the circumstances of the errors identified by the Court do not provide a basis for applying financial corrections, or other follow-up actions.*

⁽⁸⁾ The audit of each reimbursement includes the checking of a large number of underlying invoices and other documents.

Table 6.1 — Cross-tabulation of compliance by correctness of reimbursement ⁽¹⁾

Projects where compliance errors were	Projects which were		Total
	incorrectly reimbursed	correctly reimbursed	
present	29 cases 16 %	27 cases 15 %	56 cases 31 %
not present	41 cases 23 %	83 cases 46 %	124 cases 69 %
Total	70 cases 39 %	110 cases 61 %	180 cases 100 %

⁽¹⁾ Compliance errors are non-quantifiable errors (see paragraphs 1.9 to 1.11).

Table 6.2 — Analysis of errors affecting reimbursement by type

Correctness of reimbursements	Fund				Total
	ERDF	ESF	EAGGF	Cohesion Fund	
Eligibility error	18 cases 18 %	7 cases 13 %	3 cases 14 %	2 cases 50 %	30 cases 17 %
Occurrence error	5 cases 5 %	0 cases 0 %	3 cases 14 %	0 cases 0 %	8 cases 4 %
Accuracy error	8 cases 8 %	4 cases 7 %	0 cases 0 %	0 cases 0 %	12 cases 7 %
Multiple error	5 cases 5 %	15 cases 27 %	0 cases 0 %	0 cases 0 %	20 cases 11 %
Correct reimbursement	63 cases 64 %	30 cases 54 %	15 cases 72 %	2 cases 50 %	110 cases 61 %
Total	99 cases 100 %	56 cases 100 %	21 cases 100 %	4 cases 100 %	180 cases 100 %

6.25. In the Court's audit sample the most frequent causes of incorrect reimbursements from the ERDF were eligibility errors:

(a) inclusion of costs which should not have been reimbursed due to their nature, and

(b) serious failure to respect rules of procurement.

6.25. The Commission is following up the findings in order to ensure that appropriate measures are taken.

(b) The Commission also notes breaches of public procurement rules as a major source of irregularities, which is why it has targeted its own audit work on this risk area and taken other actions such as the issuing of guidance to Member States on the financial correction levels to apply.

THE COURT'S OBSERVATIONS

Example:

A university situated in an Objective 1 area had work on a robotics project carried out in a laboratory outside the Objective 1 area. This was not allowed under the national legislation on state aid for research under which the ERDF co-financed the project, rendering the expenditure ineligible.

The owners of a holiday village failed to hold a public tender for renovation work for which they were receiving subsidies totalling 63 % of the costs, including a 33 % tax rebate and a 25 % grant from ERDF. As the EU public procurement rules apply to projects of private firms as from 50 % of financing with public funds, the breach made the project ineligible for EU support.

6.26. For ESF the most common errors were:

- (a) lack of evidence that the overheads or staff costs were in fact relevant to the project;
- (b) overestimation of the staff cost or overheads;
- (c) inclusion of ineligible costs (eligibility errors).

Example:

In one project, there was insufficient evidence that the external staff costs were relevant to the project: there were monthly records showing the daily presence of the staff concerned but no daily time sheets describing their concrete daily activities. In the absence of detailed time recording to justify the working days charged, the costs in question may not be charged to the project. The expenditure was therefore considered ineligible.

In another project the staff costs were overestimated: costs relating to several members of staff were charged entirely to the co-financed ESF project but the staff in question were also involved in other activities outside the co-financed project.

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6.26. *The Commission is following up the findings in order to ensure that appropriate measures are taken.*

- (a) and (b)** *The Commission often encounters this type of error. The regulatory framework for the 2007/2013 period foresees a simplification in this respect, whereby overheads may be declared on a flat-rate basis, as a proportion of direct costs, without further detailed justification.*
- (c)** *The Commission has already recommended that Member States step up their information activities directed at beneficiaries. This, together with improved day-to-day management checks, should help reduce the frequency of this type of error.*

THE COURT'S OBSERVATIONS

6.27. A material level of error was found in the reimbursement to Cohesion Policies projects for the programming period 2000-2006 in budget year 2007. The proportion of projects in the sample affected by quantifiable and/or non-quantifiable errors (see paragraphs 1.9 to 1.11) is 54 % ⁽⁹⁾. The Court estimates that at least 11 % of the total amount reimbursed should not have been reimbursed.

Assessment of supervisory and control systems

6.28. The Court's findings on the management and supervisory systems in the Member States for the 16 operational programmes which it assessed are set out in **Annex 6.1**. In 11 cases, the Court rated management systems as 'partially effective', in three cases as 'not effective' and in two cases as 'effective'. The continued high level of error identified by the Court's substantive testing of underlying transactions similarly suggests that systems in general in the Member States were only partially effective in managing the risk of illegality and irregularity in reimbursements.

6.29. The main weaknesses identified by the Court were:

- (a) managing authorities — insufficient day-to-day checks of the reality of expenditure, failure to identify expenditure declarations not supported by appropriate evidence and failure to identify weaknesses in tender procedures;
- (b) paying authorities — failure to identify when Managing Authorities had not carried out adequate day-to-day checks;
- (c) audit bodies — failure to carry out sufficient checks to obtain assurance on the effective functioning of the control systems.

THE COMMISSION'S REPLIES

6.27. *Many of the non-quantifiable errors, even if they had been detected beforehand, would have had no impact on the reimbursement. Examples include delays in publication of contract award notices, and weaknesses in the documentation of tender evaluation committees.*

The estimation given by the Court for the amount which should not have been reimbursed includes cases where the Commission does not consider that the circumstances identified by the Court provide a basis for the application of financial corrections, or at least not at the level proposed.

6.28. *The Court's findings represent a significant improvement from 2006 when the Court assessed 13 out of 19 systems as ineffective. Last year the Court said that its sample gave a general picture of the effectiveness of the control systems in the Member States which it presented as generally ineffective or only moderately effective. The general picture for 2007 from the Court's sample is better, and indicates that not all systems are ineffective, but that there is a clear gradation in their effectiveness.*

For three programmes the Annual Activity Reports by Commission's DGs gave a more positive assessment than that of the Court in Annex 6.1.

6.29.

- (c) *The work of the winding up bodies is assessed as 'effective' by the Court in 14 programmes out of the 16 audited.*

⁽⁹⁾ See **Annex 6.2**. In 2006, the corresponding figure was 69 %.

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6.30. The Court assessed 20 audits carried out by the Structural Actions Directorates-General (Directorate-General for Regional Policy (DG REGIO), Directorate-General for Employment, Social Affairs and Equal Opportunities (DG EMPL), Directorate-General for Agriculture and Rural Development (DG AGRI) and Directorate-General for Maritime Affairs and Fisheries (DG MARE)). In the majority of cases the audits have been adequately planned and carried out, but in six of the cases appropriate corrective action had been taken late. In three cases the weaknesses in audit documentation made assessment of the audit result difficult. This reduces the effectiveness of this key supervision procedure.

6.31. The main objective of Commission supervision is to ensure that Member States establish and operate control systems in compliance with the underlying regulations. The findings set out above indicate that this objective is not fully achieved.

Overall conclusion and recommendations

Overall conclusion

6.32. Based on its audit work (see paragraph 6.21) the Court concludes that the reimbursement of expenditure to Cohesion Policies projects is affected by a material level of error of legality and/or regularity. The Court's assessment of the supervisory and control systems in the Member States is that they are 'partially effective' and that the Commission's supervisory systems are also 'partially effective' in ensuring the legality and regularity of reimbursements of expenditure.

THE COMMISSION'S REPLIES

6.30. *The Commission considers that in most cases appropriate corrective measures to follow up the audit results were taken in a reasonable time period, that the audit documentation was adequate, and that there were therefore operationally useful results from the audits. Under the Action Plan for the structural actions the Commission has committed itself to taking measures to increase the impact of its audit work by speeding up the application of suspensions and financial corrections.*

6.31. *The Court's findings show that the Commission's actions have not yet had the desired impact on preventing errors in reimbursements. The findings do not relate to the effectiveness of the Commission's actions in mitigating the risks arising from weak control systems in Member States. The Commission verifies whether or not the control systems set up by Member States function effectively. Where it finds evidence of deficiencies it takes measures to mitigate the risk. The measures include requiring Member States to implement remedial action plans, suspension of payments and the application of financial corrections. The responsible DGs have in their Annual Activity Reports (AAR) categorised in detail the assessment of all systems and have indicated the corrective actions under way for all of the programmes affected by material deficiencies.*

6.32. *At this closing stage of the 2000-2006 programme implementation, there are limited possibilities for the Commission to take actions to prevent errors and it is focusing on actions to mitigate the risks from weak national management and control systems.*

The Directorates-General responsible for Structural Policies have set out the results of their assessments of the effective functioning of the systems in 545 national programmes in their respective AARs, which show a marked gradation as follows: about 37 % of systems work well, about 51 % of systems work but need improvement and about 12 % of systems are ineffective. The Commission has invested substantial resources in order to achieve a high audit coverage, it has brought about substantial improvements in national systems through the application of 'action plan' procedures, it has suspended payments and applied financial corrections. Implementing the Action Plan adopted in February 2008 is further strengthening the Commission's supervisory role.

THE COURT'S OBSERVATIONS

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Recommendations

6.33. As last year, the need persists to reinforce the prevention of errors in the early stages of a project through working with the project promoters and ensuring that the first level controls are functioning effectively, meaning the following:

- (a) managing authorities/intermediate bodies should make early contact with project promoters in order to familiarise them with the requirements, help them in setting up their systems and make them aware of the risks of error;
- (b) managing authorities/intermediate bodies should select and train staff capable of detecting the errors in the project cost declarations and in the beneficiaries' procedures and should equip them with checklists covering all the risks;
- (c) the Commission should effectively supervise primary controls in the Member States, on the basis of a risk analysis following an assessment of the control effectiveness of the various managing authorities/intermediate bodies;
- (d) the Commission and the Member States should give special attention for the effective functioning of the feedback mechanisms (managing authority/intermediate body to beneficiaries, paying authority to managing authority, audit body to managing and paying authority) aiming at eliminating the systemic causes of errors found.

6.34. The Court also repeats the recommendation to the Commission to use the simplifications provided for in the regulations and rules governing expenditure where possible, without undermining the effectiveness of the spending. This would reduce the risk of errors and reduce the administrative burden of project promoters.

6.35. In addition, in preparing and implementing the 2007-2013 period, the Commission should make maximum use of the work of the audit authorities in the Member States, but at the same time monitor this work in order to ensure that it is up to standard, by both reviewing and reperforming the concrete audit work at the basis of the reports sent to the Commission. This will require a considerable effort and corresponding resources.

6.33. *The guidance document on management verifications issued by the Commission in June 2008 in line with the Action Plan of February 2008 underlines the importance of preventive measures by the managing authorities through an effective communication strategy with beneficiaries, as well as by giving detailed guidance and good practice on the administrative and on-the-spot verifications to be carried out to obtain reasonable assurance on the regularity of expenditure declared.*

(a) and (b) *These recommendations are covered in the guidance document and their implementation is being followed up by the Commission.*

(c) *The Commission is, and will continue to do this, in line with point 1.1 of the Action Plan.*

(d) *This is built into the requirements of the regulations for the 2007-2013 period through the work of the audit authority, as well as being subject of specific reference in the guidance documents on management verifications and on the functions of the certifying authority.*

6.34. *This recommendation has been incorporated as point 4.3 in the Commission's Action Plan and implementation is under way.*

6.35. *After conclusion of the compliance assessment procedure which will give assurance on the set-up of the 2007-2013 systems, the Commission audit approach for the period is to review the work of the audit authorities in order to conclude whether it can rely on their work, and thus on their annual audit opinions in line with Article 73 of Council Regulation (EC) No 1083/2006.*

THE COURT'S OBSERVATIONS

6.36. The Commission should make effective use of the corrective instruments at its disposal in order to ensure the correct use of EU funds:

- (a) by ensuring a systematic application of the legal provisions in respect of error correction and systems compliance;
- (b) by making full use of all the instruments foreseen to that effect, like payment suspension, financial corrections and recoveries.

This will require a significant increase in the amount of field work in the Member States and therefore cannot be done without facing the resource implications.

FOLLOW-UP OF PREVIOUS OBSERVATIONS

6.37. A summary of the results of the Court's follow-up of key observations in recent Annual Reports can be found in **Annex 6.3**.

THE COMMISSION'S REPLIES

6.36. *In line with point 8 of the Action Plan, the Commission has taken steps to increase the impact of its audit work through speeding up the procedures for the application of suspension of payments and financial corrections. For the period 2007-2013 it will make use of the additional procedure available for interruption of payments for a six-month period.*

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

ANNEX 6.1

Assessment of supervisory and control systems

Programme	Key internal control				Overall assessment
	Managing authority	Paying authority	Audit body	Winding-up body	
EAGGF — Portugal					
EAGGF — Spain					
ESF — Denmark — obj. 3					
ESF — Greece — Health					
ESF — Italy — Campania					
ESF — Portugal — Norte					
ESF — Spain — Entrepreneurial initiative					
ERDF — Spain — Competitivity					
ERDF — Czech Republic — Industry and enterprise					
ERDF — Germany — Mecklenburg Vorpommern — obj. 1					
ERDF — Greece — Information society					
ERDF — France — Martinique					
ERDF — UK/Ireland — Peace II					
ERDF — Italy — Research					
ERDF — Czech Republic — Infrastructure					
ERDF — Slovakia — Basic infrastructure					

Legend

	Effective
	Partially effective
	Not effective

ANNEX 6.2

Results of transaction testing

Sample estimate of the proportion of transactions affected by error	54 %
Error rate	Above 5 %

Follow up of key Statement of Assurance observations

Court observation	Action taken	Court analysis	Commission reply															
1. <i>The Commission's actions to improve the management of Cohesion projects</i>																		
<p>Over the past few years the Court have repeatedly detected a material level of error in Cohesion projects. The Court has assessed the control systems in the Member States as ineffective or moderately effective and identified that the Commission's own supervision is not effective at preventing errors at Member State level.</p> <p>(See e.g. the Annual Reports concerning the financial year 2006, paragraphs 6.37 to 6.45, financial year 2005, paragraphs 6.38 to 6.45, financial year 2004, paragraph 5.47 to 5.54, and financial year 2003, paragraphs 5.55, 5.56 and 5.66 to 5.69).</p>	<p>In early 2008 the Commission adopted an action plan to strengthen its supervisory role under shared management of structural actions (COM(2008) 97 final, published 19.2.2008).</p>	<p>The Court welcomes the Commission's initiative, and takes note of the actions already launched. However, the Court considers that it is premature to assess the impact of the Commission's actions. The Court will report on these issues in the Annual Report concerning the financial year 2008.</p>																
2. <i>Statement of Assurance 2005: Follow-up by the Commission to the Court's observations</i>																		
<p>In 2005, the Court identified a material level of errors in the project expenditure declarations across all audited programmes. Of the 95 projects audited from the 2000 to 2006 programming period, 60 were affected by material error. Similarly for the programmes of the 1994 to 1999 period, of the 65 projects examined 33 contained material errors.</p> <p>(Annual Report concerning the financial year 2005 paragraphs 6.13 to 6.15 and 6.26 to 6.28).</p>	<p>The Commission had in its reply committed itself to follow up the Court's findings and to ensure that required corrections are applied.</p> <p>(Annual Report concerning the financial year 2005 paragraphs 6.13 and 6.26, the Commission's replies)</p>	<p>The Court examined the follow-up by the Commission to the observations following from 15 audits carried out by the Court and reported upon in the Statement of Assurance concerning the financial year 2005. Eight of these concerned ERDF, one Cohesion Fund and six ESF ⁽¹⁾.</p> <p>The Court's analysis shows that eight cases received a timely and satisfactory follow-up, six were partially satisfactory and one case was unsatisfactory</p> <table border="1" data-bbox="1050 794 1505 1015"> <thead> <tr> <th data-bbox="1050 794 1263 858">Rating: follow-up was</th> <th data-bbox="1263 794 1386 858">DG REGIO</th> <th data-bbox="1386 794 1505 858">DG EMPL</th> </tr> </thead> <tbody> <tr> <td data-bbox="1050 858 1263 898">Satisfactory</td> <td data-bbox="1263 858 1386 898">5</td> <td data-bbox="1386 858 1505 898">3</td> </tr> <tr> <td data-bbox="1050 898 1263 938">Partially satisfactory</td> <td data-bbox="1263 898 1386 938">4</td> <td data-bbox="1386 898 1505 938">2</td> </tr> <tr> <td data-bbox="1050 938 1263 978">Unsatisfactory</td> <td data-bbox="1263 938 1386 978">0</td> <td data-bbox="1386 938 1505 978">1</td> </tr> <tr> <td data-bbox="1050 978 1263 1015">Total</td> <td data-bbox="1263 978 1386 1015">9</td> <td data-bbox="1386 978 1505 1015">6</td> </tr> </tbody> </table> <p>The main problems detected by the court were:</p> <ul style="list-style-type: none"> (a) significant delays in follow-up; (b) observations on systems and formal errors were not followed up. 	Rating: follow-up was	DG REGIO	DG EMPL	Satisfactory	5	3	Partially satisfactory	4	2	Unsatisfactory	0	1	Total	9	6	<p><i>The Commission ensures that appropriate corrective measures are taken in all cases arising from the Court's audits. Whilst accepting that delays in follow-up have in a few instances occurred, the Commission does not agree with the Court's analysis in a number of cases. For example, the Commission cannot impose corrections on Member States with regard to individual errors identified by the Court in its 2005 audits, in cases where the Member State has presented sufficient post-audit evidence or arguments.</i></p>
Rating: follow-up was	DG REGIO	DG EMPL																
Satisfactory	5	3																
Partially satisfactory	4	2																
Unsatisfactory	0	1																
Total	9	6																

⁽¹⁾ ERDF and Cohesion Fund are managed by DG REGIO and ESF by DG EMPL.

CHAPTER 7

Research, Energy and Transport

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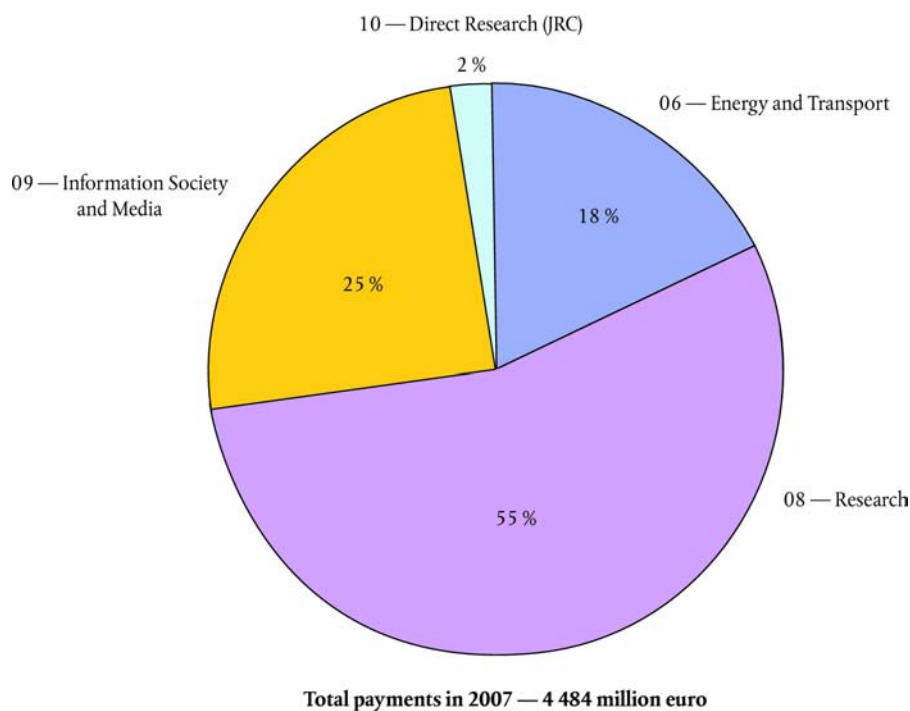
THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

INTRODUCTION

7.1. This chapter covers the Court's findings on policy areas: 06-Energy and Transport; 08-Research; 09-Information Society and Media; and 10-Direct Research. In 2007, commitments totalled 6 795 million euro (7 340 million in 2006) and payments totalled 4 484 million euro (6 493 million in 2006). The distribution of payments by policy area is given in **Graph 7.1**. More detailed information on spending for the year is provided in **Annex I** of this report.

Graph 7.1 — Research, Transport and Energy — breakdown of payments by policy area



Source: 2007 annual accounts.

Specific characteristics of Research, Energy and Transport

7.2. Research policy is directed towards the achievement of the European Research Area, contributing to the implementation of the Lisbon strategy for employment, international competitiveness and economic and social cohesion, by promoting the EU as an area of education, training, research and innovation.

THE COURT'S OBSERVATIONS

7.3. Energy and transport policies aim, within environmental constraints, to support economic growth, safety and security of supply by focusing on the completion of the EU internal market, shifting the balance towards sustainable modes of transport and developing the integrated trans-European network.

7.4. Information society and media policies are focused on the EU's i2010 strategic initiative ⁽¹⁾, supporting innovation and competitiveness through research and development of information and communication technologies, and contributing to a stronger European audiovisual sector.

7.5. The bulk of the expenditure is for research and technological development projects in all the policy areas ⁽²⁾. Research funding is provided in multiannual Framework Programmes (FPs), which have multiple funding schemes, supporting various thematic areas and types of projects.

7.6. The funding is under direct, centralised management ⁽³⁾: the Commission generally makes payments to beneficiaries without the involvement of national, regional or local authorities in the Member States. Beneficiaries may be research institutes, universities, public administrations, companies or individuals.

7.7. Research projects usually involve the beneficiaries or participants ⁽⁴⁾ working on a project as a consortium across a number of Member States. Each project partner signs a grant agreement with the Commission. One partner in each project is nominated as 'project coordinator', to maintain contact with the Commission and oversee the financial and administrative aspects of the contract.

⁽¹⁾ The i2010 strategy brings together all EU policies, initiatives and actions that aim to boost the development and use of digital technologies. i2010 is part of the Lisbon strategy to make Europe a more competitive and dynamic knowledge-driven economy. Most of the funding is provided by the research Framework Programmes.

⁽²⁾ Direct research expenditure supports the EU Joint Research Centre (JRC: 2 % of total payments in 2007), which is a Directorate-General of the Commission. It has seven research institutes and provides scientific and technical support for the conception, development, implementation and monitoring of EU policies.

⁽³⁾ Four Directorates-General in the Commission are principally responsible for managing research funding: Directorate-General for Research (DG RTD) and Directorate-General for Information Society and Media (DG INFSO) are the main departments concerned; Directorate-General for Energy and Transport (DG TREN) and Directorate-General Enterprise (DG ENTR) are also involved. Under the Seventh Framework Programme the Research DGs intend to implement a part of their budget by indirect centralised management.

⁽⁴⁾ Projects have on average around 20 participants, although the number of participants may reach up to 95.

THE COMMISSION'S REPLIES

7.5-7.10. *The internal control system used to manage the Research Framework Programmes can be divided in four distinct stages:*

Evaluation of proposals

The overall control objective is to select only those proposals that portray scientific excellence and that clearly address the operational objectives set out in the specific work programmes adopted by Parliament and Council.

Proposal selection and contract negotiation

The objective of the negotiation phase is to agree a contract for each of the retained scientific research proposals. Such contracts are the legally binding instrument for ensuring both the scientific and financial management of the project.

Project and contract management

The purpose of this stage is to ensure that — prior to any payment — all applicable contractual and regulatory requirements, both of an operational and financial nature, have been respected.

Financial audits and other ex-post controls

The purpose of this stage is to ensure the detection and correction of the main systemic errors on a multi-annual basis, which would not have otherwise been detected by ex-ante controls. Ex-post controls substantially contribute to ensuring the legality and regularity of transactions on a multi-annual basis, and aim to keep the residual error rate below the materiality threshold level.

THE COURT'S OBSERVATIONS

7.8. Grants to research projects range from about 20 000 euro paid in support of individual researchers up to 30 million euro for major integrated projects involving large consortia of partners. Although there are more than 15 000 beneficiaries, the 200 largest receive around 40 % of total payments.

7.9. Expenditure on the Trans-European Networks (TEN) Energy and Transport programme supports major energy and transport projects (67 in 2007 with an average grant of 2,4 million euro). The beneficiaries are usually Member State authorities but may also be public or private companies.

7.10. For both research and TEN projects, the grants are usually paid in instalments: an advance upon signature of the grant agreement or contract, followed by interim and final payments which reimburse eligible expenditure reported by the beneficiaries in periodic cost statements.

7.11. The principal risk to legality and regularity is that beneficiaries overstate eligible costs in their cost statements, and that this is not prevented, or subsequently detected and corrected, by the supervisory and control systems of the Commission (audit certification of cost statements, desk checks before reimbursement, ex-post audits).

7.11. *The risk that beneficiaries make cost overstatements largely stems from the inherent complexity of the funding mechanisms provided by the applicable regulatory framework, which are based on the reimbursement of actual costs. Resulting errors can mainly be detected by carrying out on-the-spot audits and desk controls. Therefore the Commission has adapted its internal control system to increase assurance on the legality and regularity of the expenditure on a multi-annual basis through a higher number of audits and significantly increased coverage in terms of budget (see also replies to paragraphs 7.15, 7.16, 7.20, 7.21, 7.26 and 7.29).*

The impact of the multi-annual audit programme will gradually increase over the four-year implementation period.

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Audit scope

7.12. The specific assessment ⁽⁵⁾ is based on:

- (a) substantive testing ⁽⁶⁾ of underlying transactions on a representative statistical sample of 180 payments ⁽⁷⁾ made by the Commission in 2007;

⁽⁵⁾ Chapter 10 of this report covers research expenditure in policy area Enterprise.

⁽⁶⁾ Checks of invoices and other supporting evidence. Cost statements submitted to the Commission for reimbursement consist mainly of personnel and indirect costs, together with travel, consumables and other direct costs.

⁽⁷⁾ These consist of 59 advances (39 FP6, 13 FP7, 1 TEN-T, 6 other) paid to beneficiaries by the Commission upon conclusion of the grant agreement; 12 payments other than to projects, such as invoices for services provided by external experts evaluating project proposals; 109 interim and final reimbursements (85 FP6, 11 FP5, 6 TEN-T, 1 TEN-E, 6 other).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

- (b) assessment of the operation of selected aspects of the supervisory and control systems:
- (i) desk checks of cost statements before reimbursement of expenditure by DG TREN;
 - (ii) audit certification of cost statements;
 - (iii) *ex-post* audits of cost statements.

7.13. The Court also followed up previous observations:

- (a) the principal errors reported in the Statement of Assurance for 2005;
- (b) weaknesses in the audit certification system;
- (c) persistent late payments to beneficiaries by the Commission.

Legality and Regularity of underlying transactions

7.14. The Court found a material level of error of legality and/or regularity in its sample of audited payments. The results of the Court's substantive testing are summarised in **Table 7.1** and **Annex 7.1**.

Table 7.1 —The results of substantive testing

Payment type	Payments with quantifiable error	Payments with non-quantifiable error only	Payments with correct amount reimbursed but procedural weaknesses	Total payments with errors	Payments without errors	Total
Advances	0	0	8	8	51	59
Interim and final reimbursements	61	6	10	77	32	109
Other	0	0	1	1	11	12
Total	61	6	19	86	94	180

THE COURT'S OBSERVATIONS

7.15. The table shows that 86 payments (48 %) in the Court's sample were affected by error. Most errors concern the reimbursement by the Commission of overstated eligible costs declared by beneficiaries in their cost statements.

7.16. The main types of error were:

- (a) overstatement of eligible personnel and indirect costs (45 % of error cases);
- (b) declaration of other ineligible costs (20 % of error cases);
- (c) inadequate supporting evidence to justify costs claimed (16 % of error cases);
- (d) declaration of budgeted amounts rather than actual costs (6 % of error cases); and
- (e) declaration of costs not attributable to the project (13 % of error cases).

7.17. The cases of non-quantifiable error concern the non-observance of a condition for payment having a direct financial impact, the exact amount of which could not be determined due to a lack of supporting evidence for the expenditure declared. As an example, in one case the audited beneficiary failed to provide adequate evidence to substantiate the claimed costs, in breach of the terms of the grant agreement. In the absence of essential supporting documentation, the impact of the error cannot be quantified.

7.18. The cases of procedural weakness mainly concern observations related to problems in the audit certification of cost statements (see paragraphs 7.31 to 7.33) and delays in payments by the Commission to the beneficiaries (see also **Annex 7.2**).

7.19. The errors occur in the context of a complex legal framework with a large number of eligibility criteria. A key contractual obligation for beneficiaries is the requirement to claim for reimbursement only the actual, eligible costs necessary for the implementation of the project. Failure to do so is a common factor in most of the errors found by the Court.

THE COMMISSION'S REPLIES

7.15 and 7.16. *The Commission's own audits confirm the persistence of a material level of error, mainly related to the overstatement of eligible costs by beneficiaries, as reported in detail in the Annual Activity Reports of the Research Directorates General.*

In order to address this problem the Commission has significantly reinforced its ex-post controls, in the framework of its common audit strategy (see also reply to paragraph 7.11).

7.18. *The Commission concurs with the Court concerning weaknesses detected in audit certificates. The Commission has launched a series of corrective actions (see replies to paragraphs 7.32 and 7.33).*

Audit certificates have however already shown a preventive effect, making a major contribution to the reduction of the error rate for FP6 compared to FP5, when audit certificates were not requested.

All Research DGs have increased the percentage of payments made on time. The issue is monitored closely and receives the highest attention to ensure further improvement.

7.19. *The Commission concurs with the Court over the complexity of the applicable legal framework and eligibility criteria. This complexity is also the main source of errors found by the Commission's own controls.*

THE COURT'S OBSERVATIONS

7.20. The Court's sample of payments included several major beneficiaries, each of which participates in a large number of EU projects. Such beneficiaries generally have complex accounting and administrative systems. In view of this, the rules allow a certain flexibility, such as the use of average rates for the calculation of personnel costs attributable to a project, provided this does not lead to figures which are significantly higher than the actual costs.

7.21. As these beneficiaries may apply the same average costing methodology to all their cost statements, evidence of errors at these beneficiaries implies a risk that significant amounts of ineligible costs have been unduly reimbursed by the Commission.

7.22. For example, for one large beneficiary, (accounting for five transactions in the Court's sample), the Court found that the methodology applied for the calculation of personnel and indirect costs led to the overstatement of eligible costs in the order of 10 %. In the case of another large beneficiary for which the Court audited two projects, the average costing methodology used to draw up the cost declarations led to the overstatement of eligible costs, in the order of 5-6 %.

Sanctions

7.23. An extended system of sanctions was one of the main corrective measures introduced at the start of FP6 in 2002⁽⁸⁾. The Commission has not applied any sanctions during the course of FP6. In effect, beneficiaries may submit cost statements in the knowledge that, in practice, the maximum risk they face when overstating expenditure is the repayment of the part of the funds overclaimed, with no interest charges or additional financial penalty.

⁽⁸⁾ In addition to the recovery of funds, the Commission is entitled to claim compensation (liquidated damages) from a beneficiary who is found to have overstated eligible costs and consequently received an unjustified contribution from the EU. Any beneficiary found to be persistently in breach of its contractual obligations may also be liable to flat-rate financial penalties.

THE COMMISSION'S REPLIES

7.20 and 7.21. *Beneficiaries may use average rates for personnel costs if this is in accordance with their usual accounting practices.*

To effectively address the risks highlighted by the Court in paragraph 7.21, the common audit strategy for FP6 covers all of the 200 biggest participants of FP6, who together receive 40 % of the total FP6 budget.

In addition, extrapolation to non-audited contracts should limit the risk of having significant amounts of ineligible costs unduly paid not recuperated by the Commission.

In those cases where the beneficiaries use average rates, the costs declared may, by their nature, deviate from actual costs. The Commission must examine both upwards and downwards deviations over a sufficiently large sample to obtain a fair assessment of the accuracy of average rates. This issue of transaction testing in average cost systems is being discussed between the Commission and the Court.

For FP7 the Commission has initiated a system of optional ex-ante certification of a beneficiary's average cost calculation methodology, which will concern mainly big beneficiaries. The practical implementation measures of this ex-ante certification system are currently being finalised.

7.22. *In the case of the second beneficiary mentioned by the Court these problems had been separately detected by the Commission's control system. Both cases are now being closely followed up.*

7.23. *The Commission distinguishes different types of sanctions:*

The main contractual sanction, which already existed in previous Framework Programmes, is the termination of contracts in cases of breach of the contractual obligations.

The Commission introduced under FP6 the possibility to apply liquidated damages. The pursuit of liquidated damages is part of the audit strategy which foresees their application in all cases where follow-up audits would reveal that contractors had failed to correct errors following previous audits. The implementation of the FP6 audit strategy started in 2007 and the first follow-up audits are being organised in the course of 2008. Depending on the results, liquidated damages will be applied accordingly.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Assessment of supervisory and control systems

7.24. The Commission implements various controls at each stage of the project cycle, in order to mitigate the risk of irregular payments (**Graph 7.2**):

- (a) controls over selection procedures which ensure that grants are awarded to eligible beneficiaries, based on the merit of the proposals; and
- (b) checks on payments to beneficiaries designed to minimise the risk of making undue payments.

7.25. The Court assessed the desk reviews of cost statements before reimbursement of expenditure by DG Energy and Transport (DG TREN) and the Commission's *ex-post* audits of reimbursed expenditure. The Court also assessed the reliability of the audit certification system in providing assurance on the legality and regularity of expenditure. A summary of the results may be found in **Annex 7.1**.

Desk reviews of cost statements before reimbursement of expenditure

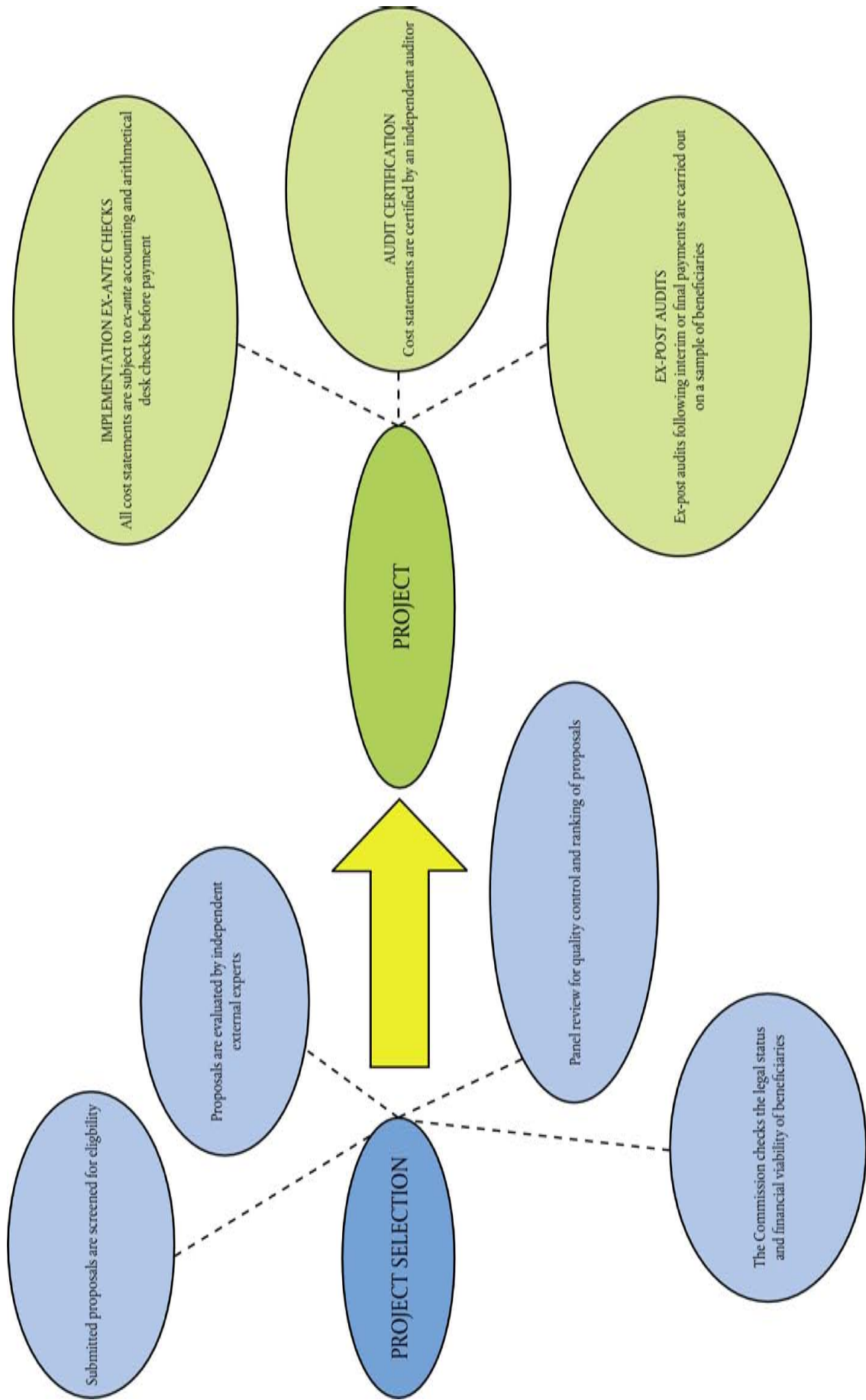
7.26. The Commission makes accounting and arithmetical checks to ensure that cost statements and audit certificates have been submitted in accordance with the grant agreement. In some cases, the Commission may extend the checks to include verification of individual cost items based on supplementary information, such as invoices or payslips, requested from the beneficiary.

7.27. The Court examined guidelines and procedures, and the reporting and monitoring arrangements for the checks in DG TREN. The Court tested the operation of the checks for the 15 DG TREN reimbursements ⁽⁹⁾ included in its substantive testing sample.

7.26. *The inherent complexity of the funding mechanisms provided by the applicable regulatory framework limits the scope of the desk reviews that can reasonably be made before reimbursement of expenditure. Therefore the Commission has significantly reinforced its ex-post controls and put in place a common audit strategy (see also reply to paragraph 7.11).*

⁽⁹⁾ 8 research, 7 TEN.

Graph 7.2 — Research Framework Programmes — key controls



THE COURT'S OBSERVATIONS

7.28. DG TREN has extensive guidelines covering issues such as the sampling approach and the methodology for extended checks. The DG also has detailed written procedures and makes use of standard checklists.

7.29. The reporting and monitoring arrangements for desk reviews in DG TREN remain as observed by the Court in 2006. They are restricted to the production of aggregate information on costs accepted or rejected, with no detailed information about the types and rates of errors which would contribute to a more focused approach.

7.30. The Court found one case (a reimbursement to a research beneficiary) where the checks failed to operate satisfactorily. The beneficiary's cost statement used budgeted rates for personnel costs rather than actual figures, leading to an overstatement of 16 %. This could have been detected through plausibility checks before the authorisation of the payment.

Audit certification of cost statements

7.31. For the 62 transactions audited at the beneficiary where a certificate had been provided, the Court compared the results of its own testing with the certificate.

7.32. In 32 (52 %) of cases, the certifying auditor had issued an unqualified opinion, whereas the Court found serious errors in the cost statements. This confirms the previous finding of the Court that this control does not always provide sufficient assurance of the legality and regularity of the expenditure.

7.33. The scope for varied interpretation of the complex funding rules of FP6 creates uncertainty among beneficiaries and certifying auditors on eligibility issues (particularly for personnel and indirect costs). This, together with the lack of a mandatory model audit certificate for FP6 continue to reduce the effectiveness of this key element of the supervisory and control systems. The measures taken by the Commission to improve the quality of audit certification for FP7, such as a compulsory set of procedures and a mandatory report, are in the early stages of implementation.

THE COMMISSION'S REPLIES

7.29. *The current control strategy has significantly reduced the reliance on ex-ante desk reviews. The control systems have been significantly strengthened with the introduction of audit certificates as from FP6 as well as the intensification of ex-post controls with the introduction of the FP6 audit strategy. The thorough analysis of the results of ex-post audits yields adequate information on the types of error and error rates. This is reported by all Research DGs in their respective Annual Activity Reports.*

7.30. *The Commission will correct the error by issuing a recovery order.*

7.32 and 7.33. *The Commission agrees that the reliability of FP6 audit certification is not fully satisfactory, considering the remaining level of errors noted in audits. Nevertheless, the overall level of errors in FP6 is lower than the errors noted in uncertified cost claims related to FP5. This indicates that audit certificates do contribute to improving the accuracy of cost claims.*

As regards FP6, there is no compulsory certificate model. Nevertheless the proposed model has been followed in most of the audit certificates submitted.

For FP7 the Commission has further improved the reliability of audit certificates by using 'agreed upon procedures', setting out in detail the audit work to be performed by the certifying auditors and encouraging optional certification of the cost methodology.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

The Commission's ex-post financial audits

7.34. In 2007, the coverage of expenditure by *ex-post* audits has increased (**Table 7.2**), responding to previous criticisms of the Court. However, efforts are still needed to reduce the number of open audit files and recover outstanding amounts overclaimed without excessive delays.

7.35. Shortcomings remain in the sharing of audit results between the research DGs, which continue to maintain local IT tools with no automatic input to the Commission's central audit tracking facility.

7.36. In 2007, the research DGs began to implement a common *ex-post* audit strategy for FP6, designed to increase assurance on the legality and regularity of the expenditure.

7.37. The strategy includes several initiatives which are likely to contribute to more effective operation of this control. These include the use of common risk criteria and sample selection methods, focusing on large beneficiaries. The strategy also incorporates enhanced quality control procedures, the introduction of a working group for the sharing of audit results, the development of a common audit manual, joint audit teams and monthly coordination meetings to discuss cases and adopt common positions.

7.34. *The Research DGs have significantly increased their audit efforts in 2007 and have met their annual targets.*

Following an increased audit effort in 2007, attention is now turned towards the correction of the detected errors. The Research DGs are actively striving to improve the monitoring tools and are issuing more precise administrative and financial guidelines. These are expected to improve the efficiency and completeness of the recovery process (including extrapolation and follow-up of the Court's findings).

7.35. *Substantial efforts are being made to share information regarding audit results in an effective manner. A common repository of audit results for sharing information amongst the Research DGs has been operational since May 2008.*

Data on FP5 and FP6 audits have now been transferred to the Commission's central audit tracking facility, and work is in progress to ensure the automatic transfer of new audit data from all local IT tools used by the Research DGs.

Table 7.2 — Ex-post financial audits on Research Framework Programmes completed 2005 to 2007

Directorate-General	Number of completed audits			Number of audited participations			Number of open contracts			Value of audited participations (million euro)			Value of open contracts (million euro)			Adjustments of ineligible costs in favour of the Commission as a result of the audits						value of audited participations/value of open contracts (%)		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005		2006		2007		2005	2006	2007
																Value (mio euro)	value audited contracts (%)	Value (mio euro)	value audited contracts (%)	Value (mio euro)	value audited contracts (%)			
Energy and Transport ⁽¹⁾	16	69	126	20	100	188	1 099	1 166	294	21,49	66,48	73,08	899,46	929,55	1 063,30	0,85	3,9	5,47	8,2	3,70	5,1	2,4	7,2	6,9
Information Society and Media ⁽²⁾	30	80	143	72	192	339	1 520	1 415	1 281	32,61	79,45	167,67	1 809,00	1 889,00	2 022,00	2,57	7,9	3,59	4,5	6,86	4,1	1,8	4,2	8,3
Enterprise and Industry ⁽³⁾	1	44	108	8	69	127	1 672	2 369	224	22,28	28,66	29,67	305,75	1 179,00	332,11	1,38	6,2	0,64	2,2	0,78	2,6	7,3	2,4	8,9
Research ⁽²⁾	23	151	305	35	198	565	8 906	12 070	9 441	38,25	58,68	293,40	5 032,43	6 663,85	4 713,16	0,72	1,9	3,47	5,9	4,81	1,6	0,8	0,9	6,2
Total	70	344	682	135	559	1 219	13 197	17 020	11 240	114,63	233,26	563,82	8 046,64	10 661,41	8 130,57	5,52	4,8	13,18	5,6	16,15	2,9	1,4	2,2	6,9

⁽¹⁾ Excluding Trans-European Network (Transport) projects. For 2005 and 2006 the figures include all programmes (research and non-research) audited by the Directorate-General.

⁽²⁾ The value of audited participations includes all costs (EU and participant).

⁽³⁾ For 2005 and 2006 the figures include all programmes (research and non-research) audited by the Directorate-General.

Source: Data provided by the Commission.

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7.38. In addition, the strategy aims to reinforce the audit certification process by continuing support to beneficiaries and certifying auditors and by the development of *ex-ante* certification of costing methodologies in FP7.

7.39. Although the new strategy represents a sound basis for addressing the problems identified by the Court, potential benefits depend on its full and effective implementation from 2008 onwards.

Overall conclusions and recommendations

7.40. Based on its audit work, the Court concludes that payments in 2007 for the policy group Research, Energy and Transport are affected by a material level of error of legality and/or regularity.

7.41. The Court's assessment of the supervisory and control systems for the policy group Research, Energy and Transport is that they are partially effective.

7.42. The Court reiterates its recommendation to simplify and clarify the rules for the calculation and reporting of costs by beneficiaries, where possible making more extensive use of lump sum financing and introducing a results-based, rather than input-based, financing system.

7.43. Within the current framework of a funding system based on the reimbursement of costs claimed by beneficiaries, the Commission should:

- (a) address the persistent errors in payments, making effective use of the sanction mechanisms available under FP6 rules (paragraphs 7.14 to 7.23);
- (b) ensure that desk checks before payments to beneficiaries are rigorously applied and enhance its analysis of errors found (paragraphs 7.26 to 7.30);

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7.39. *The implementation of the common audit strategy for FP6 is fully on track. The first results were already visible in 2007 (see also replies to paragraphs 7.15, 7.16, 7.20, 7.21, 7.26 and 7.29).*

7.40 and 7.41. *The control strategy of the Commission aims to detect and correct errors, so that, when fully implemented over a period of four years, it will ensure that the residual error rate (errors that remain uncorrected) is below the materiality threshold, as described in detail in the Annual Activity Reports of the Research DGs.*

7.42. *The Commission agrees that further simplification is needed with regard to cost eligibility issues, particularly for personnel and indirect costs. It draws attention to the legal limitations of FP7 and to the difficulties to define lump sums and flat rates which are representative.*

Furthermore the ex-ante certification of cost calculation methodology introduced in FP7 is a major step towards simplification. The Commission refers to the issues discussed in its reply to paragraphs 7.20 and 7.21.

As regards the development of alternative funding mechanisms for the future (such as lump sums and results-based financing), the Commission is open to discussions with the Court and other stakeholders.

7.43.

- (a) *The FP6 audit strategy is designed to address persistent errors in payments. Sanctions, and in particular liquidated damages, are part of the audit strategy implemented since 2007.*
- (b) *With the introduction of audit certificates in FP6, ex-ante verification is significantly strengthened compared to previous framework programmes.*

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- (c) continue to provide support to beneficiaries and certifying auditors for the audit certification process and ensure the effective implementation of the measures introduced to improve the certification of cost statements for FP7 (paragraphs 7.31 to 7.33);
- (d) pursue its common *ex-post* audit strategy for FP6, in particular through the development of common management information systems and the timely and effective implementation of audit results (paragraphs 7.34 to 7.39).

FOLLOW-UP OF PREVIOUS OBSERVATIONS

Follow-up of key Statement of Assurance observations

7.44. A summary of the results of the Court's follow-up of key observations in recent Statements of Assurance may be found in **Annex 7.2**.

Follow-up of Special Report No 6/2005 on the trans-European network for transport (TEN-T)

7.45. Special Report No 6/2005 on the trans-European network for transport (TEN-T) ⁽¹⁰⁾ identified weaknesses, notably in

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On the spot verification of cost statements by means of audits remains a corner-stone of the assurance strategy, and provides substantive information on the errors made. The Commission has therefore stepped up its ex-post controls with the introduction of the FP6 audit strategy. The strategy includes a significant increase in the audit effort and measures to correct the errors found. These measures are an effective alternative to those recommended by the Court.

- (c) *A number of actions have been taken to improve the quality of audit certificates for FP6, such as the issuing of guidance notes for the beneficiaries and certifying auditors, the creation of a task force for the handling of audit certificates, and by certifying auditors' participation in workshops and training courses.*

For FP7 the Commission has improved the reliability of audit certificates by using 'agreed-upon procedures', setting out in detail the audit work to be performed by the certifying auditors.

The Commission is also encouraging the optional certification of the cost methodology on the basis of implementing measures, which are currently being finalised.

- (d) *Efforts will be pursued to implement audit results effectively and in a timely manner. Use will be made of the ABAC facilities to track audits, as well as recovery orders and compensations.*

7.44. *See the Commission's replies in Annex 7.2.*

⁽¹⁰⁾ OJ C 94, 21.4.2006.

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the targeting of the funding and in the selection and monitoring of projects. The Court recommended the Commission to:

- (a) concentrate funding on project sections with highest European added value by giving priority to cross-border projects and increasing funding rates;
- (b) apply a more efficient, transparent and strict evaluation procedure for the selection of projects for funding;
- (c) perform more rigorous project monitoring.

7.46. The action taken by the Commission has partly addressed the Court's recommendations.

7.47. The maximum rate of financial aid for cross-border projects has increased to 30 % under the new regulation and the minimum funding threshold has been increased from 1 million to 1,5 million euro.

7.48. The evaluation procedure for the selection of projects has been improved by increasing the use of external experts and introducing a guide for applicants.

7.49. Monitoring has been enhanced by the introduction of systematic on-site inspections and of a single database of projects. The Commission has clarified the respective definitions of 'studies' and 'works' as suggested by the Court, but has not harmonised the structure for the description of works, nor standardised the technical and financial monitoring.

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7.49. *When preparing together the new model financial decision for the new programming period 2007-2013, the Commission and the TEN-T Executive Agency paid particular attention to improving all the elements that will allow a better technical and financial monitoring of the actions funded under the TEN-T programme. As a result, modifications were introduced to the model financial decision itself and a more robust monitoring system was devised, based on a new detailed strategic action plan for the implementation of the project that is to be submitted by the beneficiary at the latest six months after the notification of the decision. The introduction of this new requirement, and a streamlined yearly reporting system, are expected to improve the monitoring of the projects, and to support the beneficiaries during the implementation phase by detecting problems at an early stage.*

ANNEX 7.1

Assessment of the supervisory and control systems

System concerned	Key internal control			Overall assessment
	Desk checks before payment	Audit certification	Ex-post financial audits	
Sixth Framework Programme (FP6)				

Legend

	Effective
	Partially effective
	Not effective

Result of transaction testing

Sample estimate of the proportion of transactions affected by an error	48 %
Error rate	Between 2 % and 5 %

Follow-up of key Statement of Assurance observations

Court observation	Action taken	Court analysis	Commission reply
1. <i>Statement of Assurance 2005: a material level of error in costs declared by beneficiaries</i>			
<p>In 2005, the Court detected a material level of error in 17 of the 22 underlying transactions audited at the beneficiaries. The most frequent types of errors were: lack of supporting evidence, in particular for working time charged, or double charging of costs; use of average rates for personnel costs which deviate significantly from actual costs; unjustified allocation of indirect costs to the action; claims of costs which did not meet the eligibility criteria.</p> <p>(Annual Report concerning the financial year 2005, paragraphs 7.6 to 7.8).</p>	<p>In three cases, the Commission did not agree with the Court's findings and has taken no corrective action.</p> <p>In 10 cases, the Commission has made financial corrections, either by issuing a recovery order or by adjusting payments to the beneficiaries in subsequent periods.</p> <p>In four cases, the Commission has initiated corrective action which remains to be completed.</p>	<p>Although the Commission has taken corrective action for the majority of the Court's findings, in several cases the financial corrections have taken a considerable time (up to 20 months), or are not completed. Delays in the correction of undue payments are detrimental to the sound financial management of the expenditure.</p>	<p><i>On the one hand, the Commission agrees that financial corrections made through compensation in the following payment may result in some delays. The Commission considers however that it is an appropriate system for ongoing projects.</i></p> <p><i>On the other hand the Commission continues to improve the follow-up of its audits in order to limit/avoid unjustified delays.</i></p>
2. <i>Weaknesses in the audit certification system for FP6</i>			
<p>Late issue of guidelines by the Commission, together with the complexity of the financial provisions of FP6 have adversely affected the audit certification system. Improved guidelines are needed to address uncertainties on eligibility issues and on the independence of the certifying auditors.</p> <p>The audits carried out by the Court at beneficiaries have consistently detected significant amounts of ineligible costs included in cost statements for which the certifying auditor has issued an unqualified opinion. The problems most commonly relate to ineligible personnel expenditure and the use of costing systems which are not in line with contractual provisions.</p> <p>(Annual Report concerning the financial year 2004, paragraph 6.11; Annual Report concerning the financial year 2005, paragraphs 7.15 to 7.17; Annual Report concerning the financial year 2006, paragraphs 7.14 to 7.17).</p>	<p>The Commission has improved support to certifying auditors and beneficiaries, and to its own operational departments.</p> <p>The <i>ex-post</i> audit strategy for FP6 is intended to contribute to the assessment of the effectiveness of the system of audit certification. Issues related to audit certificates are discussed regularly by the Research DGs in meetings of the Coordination Group for external audit in the Research family.</p> <p>For FP7, the Commission has introduced further measures to improve the quality of audit certificates: 'agreed upon procedures', compulsory certification of the calculation methodology for average personnel costs and optional certification of personnel cost and indirect cost methodologies.</p>	<p>The Court continues to find that, in most cases for which it has identified significant errors in cost statements, the certifying auditor has given an unqualified opinion. It remains the case for FP6 that audit certificates do not yet function as a reliable control.</p>	<p><i>The Commission agrees with the Court that the reliability of FP6 audit certification is not fully satisfactory, considering the remaining level of errors found in audits. Nevertheless, the overall level of errors in FP6 is lower than the errors noted in uncertified cost claims related to FP5. This indicates that audit certificates contribute to the improvement of the accuracy of cost claims.</i></p> <p><i>Furthermore for FP7 the Commission has improved the reliability of audit certificates by using 'agreed upon procedures', setting out in detail the audit work to be performed by the certifying auditors.</i></p>

Court observation	Action taken	Court analysis	Commission reply
3. Persistence of delays in payments by the Commission			
<p>In a significant proportion of cases, the Commission has incurred undue delays in making payments to beneficiaries, thus failing to comply with the time limits for expenditure operations set out in the Financial Regulation.</p> <p>In 2005, 11 out of 69 payments audited by the Court were made late (i.e. 16 %). For 2006, the Court identified late payments in 21 out of 113 cases (i.e. 18,6 %).</p> <p>In 2007, the Court found late payments in 30 out of 180 cases audited (i.e. 17 %).</p> <p>(Annual Report concerning the financial year 2003, paragraph 6.22; Annual Report concerning the financial year 2004, paragraph 6.27; Annual Report concerning the financial year 2005, paragraph 7.10; Annual Report concerning the financial year 2006, paragraph 7.29 and Annex 7.1).</p>	<p>The Commission has improved the monitoring of delays, which are the subject of regular management meetings.</p> <p>The Commission has analysed the reasons for delays. Training sessions have been organised and additional instructions on the payment process have been issued to financial officers.</p>	<p>Although steps have been taken to address the problem, the Commission has made little discernible progress in reducing payment delays during the course of FP6.</p> <p>As also pointed out by the Commission's internal audit services, the persistence of delays increases the risks to the legality and regularity of expenditure. Apart from the financial risk (beneficiaries may demand interest) and the operational risks (evaluation experts may be unwilling to participate in future evaluations and projects may face cashflow difficulties), the Commission also exposes itself to unnecessary reputation risk.</p>	<p><i>All Research DGs have increased the percentage of payments made on time. The issue is monitored closely and receives the highest attention to ensure further improvement.</i></p>

CHAPTER 8

External aid, Development and Enlargement

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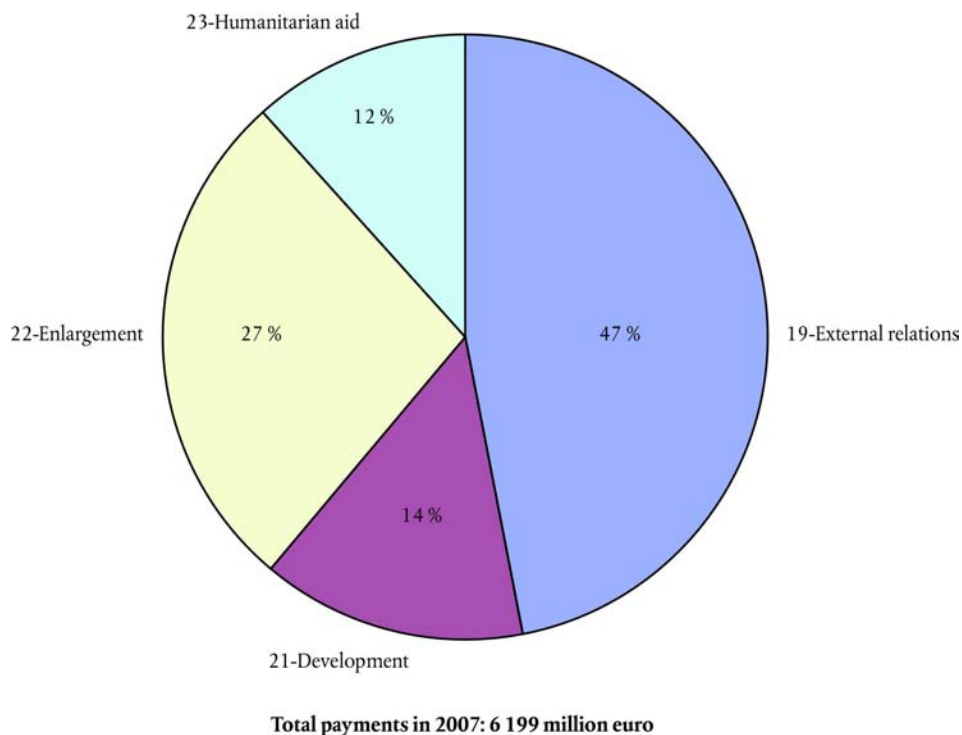
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INTRODUCTION

Specific characteristics of External aid, Development and Enlargement

8.1. This chapter covers the Court's findings on policy group External aid, Development and Enlargement, which comprises the following policy areas: 19-External relations; 21-Development and Relations with African, Caribbean and Pacific (ACP) States ⁽¹⁾; 22-Enlargement; and 23-Humanitarian aid. In 2007, commitments totalled 6 090 million euro (7 153 million in 2006) and payments totalled 6 199 million euro (6 292 million euro in 2006). The distribution of payments by policy area is given in **Graph 8.1**. More detailed information on spending for the year is provided in **Annex I** of this report.

Graph 8.1 — External aid, development and enlargement — breakdown of payments by policy area



Source: 2007 annual accounts.

⁽¹⁾ Aid provided through the European Development Funds is reported separately as it is not financed from the General Budget.

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8.2. External relations and Development expenditure, implemented mainly by the EuropeAid Co-operation Office (EuropeAid), includes:

- (a) financial and technical assistance to, and economic cooperation with, countries in Asia and Latin America;
- (b) European neighbourhood policy including the strategic partnership with Russia;
- (c) thematic programmes including food security, non-state actors and local authorities, environment, health and education, democracy and human rights.

8.3. The majority of the expenditure is subject to direct centralised management by Commission services either at headquarters or, for approximately 80 % of the spending, at the Commission's Delegations in the third countries concerned. Joint management applies to aid delivered through international organisations.

8.4. A large proportion of the payments are advances/prefinancing made to the organisations implementing development projects, including government institutions, NGOs, and international organisations. The projects supported are dispersed through more than 150 countries, and the implementing organisations vary greatly both in size and competence. Within each of the projects there are a large number of individual payments, which are subject to complex rules, in particular concerning tendering and the origin of supplies.

8.5. The Directorate-General for Enlargement manages expenditure on transition and institution-building assistance under the instrument for pre-accession assistance, the Phare programme, CARDS ⁽²⁾, and cooperation with Turkey. The payments are in general made either on the basis of a decentralised implementation system (DIS) or the extended decentralised implementation system (EDIS). In the case of DIS, *ex-ante* controls of contract award decisions are carried out by the Commission Delegation whereas under EDIS the *ex-ante* control is waived.

⁽²⁾ Phare was the main financial instrument of the pre-accession strategy for Central and Eastern European countries. The CARDS programme is Community Assistance for Reconstruction, Development and Stability in the Balkans.

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8.4. *Given the multi-annual nature of many projects and control systems, errors detected during the course of a project and any associated undue payments can be remedied in a later year than the one under examination. Indeed, the control system is shaped to ensure that controls on payment claims by the beneficiaries are carried out at key stages of the project implementation, thus allowing errors on advance payments/pre-financing to be detected and remedied by subsequent payments in a later year than the one under examination.*

Final payments are made upon completion of the project and approval by the Commission of the final project reports.

8.5. *Two other modes are used for potential candidates. In Albania, and Bosnia and Herzegovina, assistance is managed by the EC Delegations (centralised direct management in deconcentrated mode). In Montenegro, the former Yugoslav Republic of Macedonia, Serbia and Kosovo, the European Agency for Reconstruction manages the assistance in centralised indirect mode.*

The centralised management is used for multi-beneficiary programmes and for assistance to the Turkish Cypriot Community.

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8.6. Humanitarian aid, including food aid, is implemented by the Directorate-General for Humanitarian Aid (ECHO). Expenditure is managed at headquarters level. Approximately one half of the appropriations committed are related to NGOs (direct centralised management) and one half to UN or other international organisations (joint management).

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Audit scope

8.7. The objective of the audit was to provide a conclusion as to the legality and regularity of the underlying transactions in external aid, development and enlargement. The audit was based on two main components:

- (a) substantive testing of underlying transactions made by the Commission or its Delegations in 2007 by means of a representative statistical sample of 145 items. The sample consisted of payments to implementing organisations, budget support payments and payments to trust funds, and other payments made directly by the Commission/Delegation on the basis of e.g. works, service or supply contracts. Where necessary the implementing organisations were visited on the spot in order to verify underlying payments declared in financial or audit reports;
- (b) an evaluation of the Commission's supervisory and control systems at Headquarters as well as in Delegations, including:
 - (i) *ex-ante* checks on contracts and payments;
 - (ii) monitoring of implementing organisations;
 - (iii) external audits;
 - (iv) internal audit.

8.8. In the context of the audit, eight countries were visited on the spot in order to undertake detailed audit of the transactions: Indonesia, Nicaragua, Costa Rica, Egypt and the Philippines for External relations expenditure and Bulgaria, Turkey and Croatia for Enlargement.

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Legality and Regularity of underlying transactions

8.9. The substantive testing for the policy group as a whole revealed a material level of error of legality and/or regularity. The estimated error rate and proportion of transactions affected by errors — mostly at the level of implementing organisations — are shown in **Annex 8.1**. The following types of errors were noted:

- (a) errors of eligibility, resulting from, for example, contracting procedures which were not applied properly, expenditure outside the specified implementation period or cost categories of the project, or payments made by the beneficiary country without a legal basis or before the respective services had been provided;

- (b) errors of occurrence: for some payments the supporting evidence (e.g. invoices, receipts and bank statements) necessary to validate the payments was missing.

8.10. Furthermore, for three payments to United Nations organisations some of the documents needed could not be provided in good time by the organisations concerned.

Assessment of supervisory and control systems**Ex-ante checks**

8.11. Although some specific errors were found, the Commission's system of *ex-ante* checks on payments and contracts provided a generally effective check on transactions deriving directly from the work of the Commission's own services.

8.9. *These errors mostly concern expenditure made by implementing organisations on advances/prefinancing payments. The mandatory financial audits before final payments foreseen under the Commission's control system would allow the Commission to detect and correct the errors.*

- (a) *In one example the Commission's appreciation differs from the Court's finding.*

The errors found concern contracts concluded by the beneficiary countries under a scheme for which the beneficiary country is entitled to receiving advances payments from the Commission (pre-financing). The Commission carefully checks the eligibility of expenditure once it receives the final declaration and the supporting documents from countries benefitting from pre-accession aid; it withholds or withdraws final payment for expenditure which is not in conformity with the rules.

8.10. *The Commission has provided all information in its possession and fully supports the Court's request for obtaining from UN organisations further supporting evidence.*

As soon as the Commission was informed by the Court of difficulties encountered in this respect, it approached its counterparts at the UN in order to find a solution and to ensure that the Court received the information requested.

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8.12. However, in Bulgaria it was found that in spite of EDIS accreditation having been given (thus waiving the Delegation's *ex-ante* control) the systems in question contain significant weaknesses. In two implementing agencies that had received EDIS accreditation in June 2007 there were weaknesses concerning respect of the applicable tendering and contract award procedures, as well as the fulfilment of contractual implementation conditions. This has been confirmed by the Commission services and has given rise to a reservation in DG Enlargement's Director General's Annual Declaration.

8.13. Regarding budget support, seven payments were examined together with the supervisory and control systems operated in the Delegations concerned.

8.14. Budget support can be granted if the partner country's management of public spending is sufficiently transparent, reliable and effective, and where it has put in place properly formulated sectoral or macroeconomic policies approved by its principal donors, including where relevant the international financial institutions ⁽³⁾. On that basis the Commission developed specific guidelines establishing the conditions for disbursement of funds, the payment of successive tranches being conditional on satisfactory progress towards achieving the objectives ⁽⁴⁾. However, the performance indicators used to provide the assessments and to measure the progress achieved were not in all the cases examined time-bound, clear and unambiguous, and achievable.

8.15. In the case of two of the payments, more than half of the indicators (in one case, six out of nine) were not time-bound, thereby making it impossible to draw useful conclusions from the non-fulfilment of the condition at a particular date. In addition more than 40 % of the indicators were not measurable or not specific, for example the percentage of forest cover achieved with no specification of the measurement criteria, and improvement of government staff performance with no explanation of what should be assessed. In one case more than 70 % of the indicators were assessed with documentation provided in Arabic, even though English was specifically required by the Financing Agreement, reducing significantly the number of actors in a position fully to understand the information.

⁽³⁾ Regulation (EC) No 1638/2006 of the European Parliament and of the Council of 24 October 2006 laying down general provisions establishing a European Neighbourhood and Partnership Instrument (OJ L 310, 9.11.2006, p. 1) (Article 15(2)(e)), and Regulation (EC) No 1905/2006 of the European Parliament and of the Council of 18 December 2006 establishing a financing instrument for development cooperation (OJ L 378, 27.12.2006, p. 41) (Article 25(1)(b)).

⁽⁴⁾ Guidelines on the Programming, Design & Management of General Budget Support, January 2007.

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8.12. *The payments to two implementing agencies were suspended in February 2008. Unless adequate measures are taken very quickly, the Commission will withdraw their accreditation so that they will no longer be entitled to manage pre- and post-accession funds.*

The Commission will continue to closely monitor the beneficiary countries systems. An action plan has been set up to ensure that improvements take place. Some progress has already been made, but the national authorities need to take further action.

8.14. *As in these cases, the tranches to be released were denominated as floating, the disbursement is effected when the condition(s) is/are met. Performance indicators, and conditions at large, could therefore not be time bound. This modality is in use by different donors. For instance, in the case of HIPC, the conditions are floating and the different stages are not time bound. The Commission shares the general comment of the Court that in specific cases a time-frame is required in order to provide a more predictable fulfilment of the condition. The Commission considers that in all cases it seeks to be clear and unambiguous and to ensure that performance indicators are achievable.*

8.15. *As previously stated, time-boundness is not required as such. The Commission can agree that there is always room for improvement and that some indicators and conditions may be more clearly defined and geared towards a more results oriented approach. Sectoral reforms should, however, be seen as a process, and therefore, previous steps targeting preparations phases are, in some cases, necessary in order to accompany the whole process.*

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8.16. The Commission's General Budget Support Guidelines in practice leave room for interpretation, and even if according to the performance measures programme outcomes did not reach 100 % the beneficiary countries may still receive 100 % of the funds contracted.

Monitoring of implementing organisations

8.17. Errors at the level of implementing organisations are frequently due to weaknesses in their financial procedures. As regards the External relations and Development policy area, the Court detected weaknesses in five out of the nine implementing organisations visited.

8.18. The main weaknesses detected were inadequate procedures concerning supporting documents and filing, and accounting systems that are not adequate to ensure that the expenditure is correctly reported, even taking the often small size of the organisations into account. In addition inadequate procedures for recording expenditure were noted, which led to the systematic entering of advances as actual expenditure in the accounting system and inconsistent use of exchange rates. The Court considers that there is scope for preventing such weaknesses by means of enhanced targeting of monitoring and support by Delegations.

8.19. In the cases where the action was carried out by implementing organisations in cooperation with their local partners, the Court also noted in three instances that the systems in place did not ensure that the provisions in the contract between the implementing organisation and the Commission were known and applied by the local partners.

8.20. A major part of EuropeAid and DG ECHO expenditure (payments of 820 million euro in 2007) is channelled through United Nations organisations. The Financial and Administrative Framework Agreement between the European Community and the United Nations (FAFA), signed on 29 April 2003, specifies the conditions for verification of the resulting expenditure.

THE COMMISSION'S REPLIES

8.16. *While seeking the most precise conditions for payments, there must be a certain degree of judgement as far as the indicators are evaluated. This is in particular due to some external effects for which governments cannot be made responsible. However, in any case a rigorous assessment needs to be carried out.*

8.17-8.20. *Implementing organisations are not part of the Commission Internal Control System but are linked by a contractual relation to implement specific actions. The Commission, as a priority, monitors compliance of the terms of the contract, including, where necessary, key aspects of the internal control systems of the implementing organisations. The fact that a weakness is identified at implementing organisation level implies neither a weakness of the Commission control system nor that this weakness will go undetected by the Commission.*

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8.21. In 2007 the Commission initiated or carried out 57 verification missions under FAFA, compared with only 22 between 2004 and 2006. The results of these verifications are an important component in the Commission's assurance as to the legality and regularity of the underlying transactions. However, only four of the missions (covering seven projects) had resulted in a final report at the date of the Court's audit. The Court is therefore unable to assess the total contribution to the Commission's supervision and control.

8.22. Concerning the Enlargement policy area, weaknesses were noted at an implementing agency in Turkey, namely a lack of adequate segregation of duties and staffing issues. In this case the EC Delegation's *ex-ante* control of tendering and awarding of contracts under decentralised management (DIS) was sufficient to ensure the legality and regularity of the underlying transactions.

External audits of project claims

8.23. EuropeAid makes use of a system of audits to gain assurance that claims made by projects are eligible. The first layer of assurance is provided by audits at project level which support the requests for further financing. Audit reports are required in most cases before payments are made to project implementing organisations. The quality of these reports and of the audit work underlying them is therefore of major importance in approving related payments.

8.24. Concerning these project audits improvements were noted in 2007. However, the quality of such audits is still not always sufficient. The main weaknesses found were:

- in three out of the 11 reports selected for review on the spot at Delegations, the Court detected ineligible expenditure, non-compliance with tendering procedures, and in two cases weaknesses in the internal control system which had not been detected by the external auditors;

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8.22. *The verification missions follow a cycle that does not always fit the annual calendar, and most of the missions were performed in the second part of 2007.*

The complex and complementing controls, of which verification missions are but a part, form the basis of assurance of the Directors-general in the Annual Activity Report. Indeed other sources of information are also available, such as the four pillar review (completed for more than 97 % of contributions made to FAFA signatories), respect of the reporting requirements and checks made by the Commission services.

8.23. *At the request of the Commission, the Turkish authorities took actions which averted the considered suspension of DIS including adopting legislation designed to strengthen the CFCU's role. As a result, the segregation of duties has meanwhile been implemented and staffing levels increased substantially. Constant monitoring and further follow-up remain key priorities.*

8.24. *External audits are one of the components of EuropeAid's internal control system as part of a set of checks on the legality and regularity of operations.*

The Commission welcomes the Court's appreciation of the improvements observed.

These audit reports are linked to contracts signed before February 2006. As a consequence, the new terms of reference set up by EuropeAid for external audits and put into force for new contracts signed as from this date were not applicable in the present cases. The aim of these new terms of reference is precisely to prevent the occurrence of weaknesses such as the ones mentioned by the Court.

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- for two out of these three, the quality was not ensured as the selection of the auditors was not transparent;
- in another case the scope of the audit was inappropriate as only the audit report on the organisation was provided, which did not contain any information on the project in question.

For expenditure verifications launched by beneficiaries new terms of reference have been in force for contracts signed as from February 2006. However these do not affect contracts existing prior to this date and so it will be some time before the benefits are fully apparent. For audits launched by the Commission, revised terms of reference have been obligatory since October 2007.

8.25. EuropeAid commissions additional project audits, selected on a risk-analysis basis, in order to provide a further layer of assurance. However complete procedures have not yet been developed so as to draw full benefit from these audits:

- (a) the coverage of expenditure by the additional audits planned varied across the main geographical directorates from 8 % to 43 %. Technical divergences from the guidelines prevent consolidation of the data at the level of EuropeAid as a whole, and it is therefore not clear whether additional assurance is achieved to a consistent minimum level;

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Both contracts were signed in 2005 and, according to the general conditions put into force for grant contracts signed as from February 2003, an external auditor has to certify the final financial report of an action before being submitted to the Commission. This auditor is selected by the beneficiary and must be approved by the Commission. His name is mentioned in the Specific Conditions of the contract. He must be 'member of an internationally recognised supervisory body for statutory auditing'.

This contract was signed by the Commission in 2002. At that time the beneficiaries were allowed to send, together with the financial and narrative reports, an audit report on their yearly accounts only. Since 2003, rules applicable to Grant contracts have been changed and a specific audit report on the action is now required before making the final payment.

The Commission expects that the improvements introduced become more and more visible.

8.25.

- (a) *The majority of the Annual Audit Plan (AAP) audits take place during the implementation of the action and depend, to a great extent, on the pace of implementation.*

This implies that: according to the financial volume managed by a Delegation, the composition of its projects' portfolio (number and type) and the status of their implementation, audit activities may vary from Delegation to Delegation and from one year to another. Setting a target audit ratio as a percentage of the financial volume managed would not impede fluctuations in the audit activity from one year to another and would also be largely affected by the type and value of projects audited.

In EuropeAid's system, assurance is not gathered by ensuring a certain pre-determined audit coverage ratio but, simply, by ensuring that the audit coverage encompasses all relevant 'audit subject', identified in relation to the risks perceived.

THE COURT'S OBSERVATIONS

- (b) the audit plan, which originally foresaw 373 audits, was changed substantially during the year (109 audits were withdrawn and 99 added, leaving 363 audits). This degree of change shortly after approval of the plan puts the systematic and risk-based nature of the audit planning in question. The CRIS-Audit computer application that provides for monitoring of progress and results did not come into full use in 2007. The final report does not refer to planning criteria, such as target population and coverage ratio, and in consequence the results cannot be compared against those planned;
- (c) by the end of the year audit reports had been received for only 121 of the planned audits. This low level of implementation reduces the quality of the assurance that is provided by the external audit activity for the year in question;
- (d) reporting on progress and analysis of the external audit results were not fully developed in 2007. The central unit responsible for audit methodology produced a synthesis report, but its coverage was not complete. For example, audits done by local firms under contract to individual Delegations, where the quality risk may be higher than under central framework contracts, were not reviewed.

8.26. *Ex-post* controls (closure audits) are carried out by contracted external auditors on selected recently-closed programmes in the Enlargement policy area. Following a change of methodology, the number of reports was exceptionally high in 2007, and some have not received timely follow-up. DG Enlargement received 99 final audit reports in 2007, for 66 of which the follow-up had not yet been finalised at the time of the Court's audit in April 2008, and six reports that had not been finalised in 2006 remained open. In some cases it takes more than a year from the final report to receive a final reply from the beneficiary country.

THE COMMISSION'S REPLIES

- (b) *The audit plan contains a number of mandatory audits, on projects whose maturity varies considerably. Some foreseen in the year will be postponed to subsequent years and others brought forward according to project maturity.*

Since 1 January 2008 CRIS-Audit provides for the monitoring of the progress and results of audits, including the AAP 2007.

Meanwhile, the Commission regularly monitors the implementation of the AAP during the year, including through regular reports and updates from the Delegations.

- (c) *At the end of the year 2007, two-thirds of the audits of the 2007 audit plan had been commissioned and one-third of the reports received. This is in line with previous years. By the same date almost all the reports of the audits foreseen in the Annual Audit Plan 2006 had been received (171 out of 177 planned audits), confirming the normal life-cycle of an Annual Audit Plan, which -is finalised in year $n + 1$.*
- (d) *The synthesis report produced annually covers audits financed under the Audit Framework Contract (FWC). These include audits managed by EuropeAid Headquarters as well as by Delegations, and this provides a representative view of the problems identified by the auditors and possible solutions.*

8.26. *In spite of the exceptionally high number of reports, the Commission has been able to absorb the workload: the number of reports dealt with rose by 70 % when compared to 2006.*

Many of the reports could not be closed at the year end since before the Commission can adopt a final position, the auditee has to reply to the Commission's observations, and any irregularities examined. This takes an average of 3 to 4 months.

Longer processing delays have to be occasionally accepted due to the complexity of the findings and as a consequence of the need of accuracy in the application of possible financial corrections.

THE COURT'S OBSERVATIONS

8.27. DG ECHO commissions audits at its NGO implementing partners' headquarters offices, and field audits of projects on the spot. In 2007 DG ECHO significantly increased the number of field audits, although, as in 2006, the majority of audits were done at partners' headquarters where the reality of expenditure cannot be completely checked.

8.28. These headquarters audits include samples of payments from about one-third of projects. In 2007 2,6 % of the amount audited was reported as potentially ineligible although after explanations have been received from the NGOs only part of this is likely finally to be recovered. There is no provision to extrapolate the results, and the audit system thus does not provide a means to assess the scale of potentially ineligible expenditure as a whole. Concerning two NGO headquarters audited on the spot by the Court, the audit reports commissioned by DG ECHO had failed to draw attention to weaknesses in tender procedures and to ineligible expenditure.

Internal audit

8.29. The Internal Audit Capability (IAC) serving both EuropeAid and DG ECHO expects to provide an annual overall assessment of the state of internal control in EuropeAid in 2010, after completion of a multiannual audit plan, based on an IAC internal risk analysis, that covers the period 2007-2009. The internal IAC risk analysis is not completely in line with EuropeAid's own risk analysis, and audits are not planned during the period 2007-2009 for certain of the areas identified as high risk.

THE COMMISSION'S REPLIES

8.27. As indicated in the Commission's reply to the Court's 2006 annual report, the audits have to be seen in the context of an overall control strategy (see paragraph 8.18 of the Commission's replies to the Court's 2006 Annual Report). The Commission puts emphasis on monitoring operations through close follow-up performed by both experts in the field and the Commission staff at headquarters. Furthermore, the Commission analyses in detail the information provided by partners in the various reports.

The information resulting from the checks described above are used by the external auditors in headquarters audits, and this enables them to assess the reality and legality of project expenditure.

8.28. Through various control procedures, such as the assessment of the partner before the signature of an FPA, the annual evaluation performed by DG ECHO of its partners, and the assessment — during HQ audits — of the control systems put in place, DG ECHO verifies whether its partners have established systems of control. These procedures offer equivalent guarantees for payments in accordance with Article 117 of the Financial Regulation and article 180 of its IR which allow the authorising officer responsible to waive, depending on his risk assessment, the obligation to provide a certificate on the financial statements and underlying accounts in certain circumstances.

8.29. The IAC risk analysis is made independently of EuropeAid's own risk analysis. However, the latter is considered as an element when the IAC risk register is drawn up. While the IAC risk register might consider an area to be high risk, that area might not appear in the audit plan for a particular year because the business process is not yet within the working practice of the DG or the management cycle for certain programmes. In addition, since the IAC's audit plan is coordinated with the IAS for the 2007-2009 period, some auditable items will be found on the audit plan for the IAS rather than for the IAC.

THE COURT'S OBSERVATIONS

8.30. Very little resource (one professional audit staff member) was allocated to audit of DG ECHO in 2007, and no comprehensive audit plan was approved or implemented. At the end of 2007 a new separate IAC was established to carry out the internal audit work for DG ECHO.

Overall conclusions and recommendations

Conclusions

8.31. Based on its audit work the Court concludes that transactions underlying the expenditure in the policy group External aid, Development and Enlargement are affected by a material level of error of legality and/or regularity (see paragraph 8.9).

8.32. The Court's assessment of the supervisory and control systems for External relations, Development, Enlargement and Humanitarian aid is that they are partially effective (see **Annex 8.1** and paragraphs 8.11 to 8.30).

Recommendations

8.33. In order to mitigate these weaknesses, the Court recommends that:

- (a) EuropeAid should give more training and support to project finance staff, and increase the active monitoring of their work by Delegation finance and contracts sections;
- (b) EuropeAid should ensure that plans for risk-based audits are realistic and are implemented promptly, and should also collect and analyse the results of the whole programme of audits both to control quality and in order to make best use of lessons learned;

THE COMMISSION'S REPLIES

8.30. *The Commission allocated two staff to support the internal audit effort directed for DG ECHO. The IAC's audit plan was risk based and took into consideration the considerable audit work on humanitarian activities undertaken by both the Internal Audit Service and the Court of Auditors. The residual risk to be covered showed that the IAC's 2007 work plan to be appropriated.*

8.31. *These errors mostly concern expenditure on advances/prefinancing payments made by implementing organisations. The mandatory financial audits before final payments foreseen under the Commission's control system would allow the Commission to detect and correct the errors.*

The Commission carefully checks the eligibility of expenditure once it receives the final declaration and the supporting documents from countries benefitting from pre-accession aid; it withholds or withdraws final payment for expenditure which is not in conformity with the rules.

8.33.

- (a) *During the life of an operation, the Commission's services monitor its implementation, through dialogue with local authorities, technical meetings with beneficiaries, and missions on the ground. A results-oriented monitoring (ROM) carried out annually by independent experts, complements these activities and monitors the progress, outcome impact and potential problems of on-going projects. Additional project audits, both operational and financial, may also be carried out following a risk assessment.*
- (b) *The methodology for the AAP is fine-tuned each year, with a view to making the identification of risk-based audits as realistic as possible. The implementation of the AAP will be monitored closely throughout 2008, and the use of the results of the audits will be optimised*

THE COURT'S OBSERVATIONS

- (c) the Commission's management of budget support programmes should be based on measurable, achievable, timed and relevant indicators and require reliable and corroborative evidence to assess them as well as providing a clear link between funding and performance;
- (d) further steps should be taken urgently to correct the weaknesses in the management of EU funds in Bulgaria, and the necessary monitoring maintained in Turkey;
- (e) the delays in obtaining final replies on closure audits should be reduced;
- (f) DG ECHO should enhance its audit strategy by ensuring a better coverage of operations at implementing organisation level and more specifically at field level for all types of partners.

THE COMMISSION'S REPLIES

- (c) *Community funds under budget support operations are provided against performance. In this context, the Commission seeks to utilise indicators that are measurable, achievable and relevant over time or at a specific point in time. In many cases assessments of performance based on reliable evidence are carried out by the donor community in line with the Paris Declaration. Within this framework the Commission is making considerable efforts to introduce more output and outcome oriented performance indicators.*
- (d) *Concerning Bulgaria, the Commission will continue to closely monitor the management systems. An action plan has been set up to ensure that improvements take place. The national authorities need to take urgent action to redress the situation; the proposed measures will be closely monitored and audited to verify that they lead to the desired improvements.*

Concerning Turkey, further to a request from the Commission, the national authorities took action. The segregation of functions has meanwhile been implemented and staffing levels increased substantially. Constant monitoring and further follow-up remain key priorities.

- (e) *In spite of the exceptionally high number of reports received in 2007, the Commission has been able to absorb the workload: the number of reports dealt with rose by 70 % when compared to 2006.*

Many of the reports could not be closed at the year end since before the Commission can adopt a final position, the auditee has to reply to the Commission's observations, and any irregularities need to be examined. This takes an average of 3 to 4 months. Longer processing delays have to be occasionally accepted due to the complexity of the findings and as a consequence of the need of accuracy in the application of possible financial corrections.

- (f) *The Commission will give consideration to the Court's recommendation and has already increased the number of field audits in 2007.*

Any increase in audit coverage above the current optimum would give rise to increased costs to the detriment of policy implementation. This in turn could lead to further discontent among Commission partners who are called to implement humanitarian aid on the ground.

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FOLLOW-UP OF PREVIOUS OBSERVATIONS

Follow-up of key Statement of Assurance observations

8.34. A summary of the results of the Court's follow-up of key observations in recent Statements of Assurance may be found in **Annex 8.2**.

Follow-up review of Special Report No 2/2006 on the performance of projects financed under TACIS in the Russian Federation**Introduction**

8.35. In April 2006 the Court published Special Report No 2/2006 concerning the performance of TACIS Projects in the Russian Federation ⁽⁵⁾. The main conclusion was that too many projects had not achieved their objectives partly due to shortcomings in Commission's management:

- (a) lack of dialogue with the Russian authorities and beneficiaries to establish real needs;
- (b) project objectives were imprecise and not measurable, and underlying assumptions unrealistic (including time aspect);
- (c) co-financing to strengthen ownership was practically not used;
- (d) the aspects of project evaluation, dissemination of project results and sustainability were not given sufficient consideration.

8.36. The Court's recommendations accordingly aimed at improving the Commission's management regarding these aspects. The European Parliament ⁽⁶⁾ and the European Council ⁽⁷⁾ also asked for a deeper dialogue between the Commission and the relevant Russian authorities to identify the national needs, priorities and direction accurately. The discharge authority also called for a financing of only those projects which had clear and mutually shared objectives and furthermore recommended more co-financing, a more realistic appraisal of sustainability and to ensure that evaluations were carried out and project results were disseminated.

⁽⁵⁾ OJ C 119, 19.5.2006.

⁽⁶⁾ Working document No PE 374.332 of the Committee on Budgetary Control.

⁽⁷⁾ Draft Council Conclusions of 6 July 2006 No 196/06 Rev 1.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

8.37. In its replies to the Special Report the Commission recognised that the weaknesses reported by the Court were, to a large extent, valid but emphasised that it had already introduced improvements to the management of its external assistance programmes. The Commission claimed that most of the shortcomings had been resolved as a result of the reform of the EC external assistance, which has taken place over the period 2002 to 2005, in particular the devolution of responsibilities to Delegations.

8.38. The objective of this limited follow-up review, conducted in the second half of 2007, was to examine how far the main recommendations had really been addressed by the Commission. For this purpose relevant documentation was analysed and interviews held with the Commission services. Furthermore a representative statistical sample of 10 TACIS projects (out of 13) with a total value of 27,3 million euro, finalised between December 2006 and June 2007, was reviewed on the spot.

The Court's observations

More productive dialogue

8.39. The devolution of management responsibilities from Commission headquarters to its Delegation in Moscow has indeed had a positive impact on the quality of the project identification and preparation processes. There are signs that the dialogue with the Russian authorities has improved ensuring a greater involvement of the partner country. A higher number of beneficiaries have been involved in the deliberations between the Commission and the Russian central governmental authorities concerning the identification of needs and prioritisation of topics. As a result programming, project identification and preparation have improved overall, and have taken into account more effectively the Russian and EU partnership priorities.

8.40. However cooperation with the Russian counterparts could be developed further. The late signature by Russia of action programmes still reduces the time available for effective project implementation. Russian regional authorities benefiting from the projects are still insufficiently involved in project preparation. This is particularly regrettable as Russian authorities at the regional level have shown more ownership and have made more human resources available for project purposes than the implementing partners at the central level.

8.39. *The Commission welcomes the Court's acknowledgement of the progress made as a result of the process of devolution and of its positive impact.*

8.40. *The introduction of the Reform of External assistance (RELEX Reform), notably by means of the devolution of EC external aid management to the EC Delegations, between 2002 and 2005, ensures a better dialogue with, and greater involvement of, the partner country from the preparatory phase to the final implementation. Although the volume of financial assistance to the Russian Federation has been decreasing in the past years the key objective of most projects is to contribute to the development of laws, policies and/or practises in certain sectors in Russia. In such projects, the natural partners are the central (federal) authorities.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Improved objective setting but still long planning schedules

8.41. The new quality support review process at Commission headquarters ('QSG')⁽⁸⁾, which, since 2005, has also covered the assistance programmes for Russia, has had a positive impact on overall planning and objective setting. Project objectives were better formulated and relevant to the ongoing Russian reforms. Contractors have made use of logical frameworks when establishing and executing their action plans. In general the projects audited showed a higher success rate than was found in the initial audit.

8.42. However, due to the exhaustive programming procedures to be applied by the Commission, lengthy planning schedules have in the main persisted. For two projects reviewed the objectives had been overtaken by events or had become, at least partly, irrelevant.

8.43. The Court shares some beneficiary organisations' criticism of the EU's procedures for not being capable of responding rapidly and in an 'unbureaucratic' manner to Russian requests for assistance. This Russian demand for rapid, small-scale assistance for necessary reforms could potentially be met through a new 'Common Spaces Facility', details of which were being negotiated in 2007 to enable a rapid reaction to requests for short and medium-term assistance to facilitate joint action under the four 'common spaces'⁽⁹⁾.

Co-financing remains problematic

8.44. At the time of this follow-up the Commission and the Russian Government were jointly considering technical solutions for introducing national co-financing for all future assistance measures under the European Neighbourhood and Partnership Instrument (ENPI)⁽¹⁰⁾.

⁽⁸⁾ The 'iQSG' (inter-service Quality Support Group) was set up to improve the quality of the main strategic and programming documents such as country strategy papers and national indicative programmes. The 'oQSG' (office Quality Support Group) were established by EuropeAid to improve the quality of the preparation and formulation stages of projects, mainly through performing peer reviews of relevant documents.

⁽⁹⁾ At the St. Petersburg Summit in May 2003, the EU and Russia agreed to reinforce their cooperation by creating in the long term four 'common spaces' in the framework of the Partnership and Cooperation Agreement. These are as follows: The Common Economic Space, covering economic issues and environment; the Common Space of Freedom, Security and Justice; the Common Space of External Security; and the Common Space of Research and Education including cultural aspects.

⁽¹⁰⁾ Regulation (EC) No 1638/2006 of the European Parliament and of the Council (OJ L 310, 9.11.2006, p. 1).

8.41. *The Commission acknowledges the Court's comments on the improvement of project planning and objective setting as a result of the introduction of new quality control mechanisms.*

8.42. *The Commission acknowledges the length of programming and consultation procedures as laid down in the regulation. The Commission involves stakeholders from the beginning of the formulation process in order to significantly reduce the risk of making projects obsolete. This tendency is evidenced by the monitoring reports for Russia which have demonstrated that the relevance and quality of project design ratings have been steadily improving over the years since the introduction of the RELEX reform.*

8.43. *The Common Spaces Facility has been designed by the Commission in a way to provide rapid response to Russian requests for small scale assistance.*

8.44. *The Commission and Russia are currently exploring possibilities for creating a framework for the co-financing of projects. A large number of co-financed projects are already being undertaken; this includes the European Studies Institute and the NDEP and also grant programmes such as the IBPP and the neighbourhood programmes. As regards the future, the Russian government will contribute EUR 122 million for the ENPI cross-border cooperation programmes (which would be in addition to the funds of the Commission for the same programmes).*

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8.45. So far, apart from 'in-kind' contributions, there have been no signs of a higher financial involvement of central, regional or local players. Even the requirement for office accommodation to be provided by the beneficiaries has become rare since the earlier audit.

8.46. As in the past, without increased national co-financing of projects from the Russian Federation, it remains difficult to strengthen commitment and ownership.

Improved evaluation, however dissemination of project results and sustainability still weak

8.47. While the projects audited have not been evaluated individually by the Commission, the Court recognises an overall improved situation: since 2006 the Delegation has initiated several sectoral *ex-post* evaluations such as an impact study concerning public administration and civil service reform and also assessments of EU support in some other areas.

8.48. However, dissemination of valuable results was still not sufficiently ensured in the country. The primary project partners at the central governmental level have been particularly weak in this respect. Occasionally dissemination activities took place within the projects but very few after the projects had ended. Almost all websites created to bolster dissemination were abandoned after the projects ceased.

8.49. The Commission decided in 2007 that the external project monitors should not only supervise the projects during their lifetime but also produce *ex-post* monitoring reports. In the future this should enable the monitors to report, at least indicatively, also on sustainability aspects.

THE COMMISSION'S REPLIES

8.45. *Co-financing was not a legal Tacis requirement in the period 2000–2001 (when project identification took place for the projects reviewed by the Court in its Special report No 2/2006). The co-financing possibilities of the Russian Federation at the time of the programming were limited and the necessary mechanisms were not in place.*

The Commission is facing the task of accommodating project requirements with a law preventing foreign citizens from working on the premises of the Russian Government.

8.46. *The new financial instrument, the European Neighbourhood and Partnership Instrument (ENPI), adopted in 2006, stipulates that assistance shall normally be co-financed by the partner country to ensure commitment and the sense of ownership of the different actions being implemented.*

8.47. *The Commission has opted in these cases for sectoral evaluations to gain a fuller picture of the impact of EC assistance in such specific sectors.*

8.48. *The Commission applies strict visibility and dissemination guidelines as per the Communication and Visibility Manual for EC External Actions on all its projects.*

The responsibility for continued information availability and dissemination work after project finalisation lies with project beneficiaries.

8.49. *The Commission is examining the standard use of ex post monitoring following the assessment of its pilot phase.*

THE COURT'S OBSERVATIONS

8.50. So far, the sustainability of project results has continued to be problematic. There were no signs that the Commission had undertaken specific measures to improve this aspect at the planning stage. Shortcomings were encountered in most projects reviewed. This was, for example, due to a lack of action by the central level recipients to draw up and pass the necessary laws, regulations and rules to set up durable administrative structures. In addition, there was often a lack of local finance for follow-up activities.

Conclusions and recommendations

8.51. The Commission has, indeed, taken steps to improve the effectiveness of its aid for Russia. As a result the quality of the planning documentation is clearly better and the relevance of projects to Russian reforms and the level of achievement of immediate results have improved since the original audit. However, the remedial actions by the Commission are not yet sufficient to strengthen ownership and to ensure a better sustainability of project results.

8.52. The Court recommends that the Commission:

- (a) Ensures that, in principle, measures financed under the ENPI are co-financed and adequately resourced by the Russian recipients;
- (b) Ensures that, in principle, measures financed under the ENPI contain provisions for sustaining the projects' results and for guaranteeing the widest possible dissemination of results and best practice in Russia;
- (c) Shorten the projects' planning process to allow the maximum time for their execution and ensure the availability of rapid assistance when required in the context of the on-going Russian reforms.

THE COMMISSION'S REPLIES

8.50. *The Commission considers that the projects reviewed have mostly met their objectives. Concerning the sustainability the Commission has taken measures at the planning stage through its quality review system. The quality review carried out by the Quality Support Groups at identification and formulation stages, mechanism which the Court recognised has had a positive impact on overall project planning, is tasked also to assess demonstrated ownership and commitment of the partner government regarding the actions proposed. Thus since 2005 greater assurances of project sustainability are already included at planning stage.*

8.51. *Regarding the sense of ownership, in the case of Russia, the Commission has built upon the Common Space political dialogue as a basis for the cooperation and support initiatives emanating from the road Maps of 2005. Thus, financial cooperation after 2005 focuses on policy objectives already agreed between the two sides. The findings of the results-oriented monitoring (ROM) reports of the past five years already identify an increased quality of programming and implementation of projects in the ENPI East region. The average ROM score for Russia in 2007 was 2,94 out of 4,00, making projects in this country among the best performing in the ENPI East Region.*

8.52. *The Commission agrees with the Court's recommendations and:*

- (a) *The new European Neighbourhood and Partnership Instrument stipulates that assistance shall normally be co-financed by the partner country. As stated above, the RF government has already made a significant commitment of funds for the programmes for which there is already agreement.*

(See paragraphs 8.44, 8.45 and 8.46.)

- (b) *The Commission pays particular attention to wide dissemination of project outputs and results. The efforts taken to ensure greater ownership by project partners (consultation with stakeholders at programming and planning stage, new quality assurance mechanisms) will also warrant greater commitment to dissemination of projects' results by the partners after the projects are over.*

- (c) *Through the involvement of stakeholders at the planning stage, timing requirements for effective execution are better assessed and integrated into the overall planning parameters. The Delegation's initiative for the Common Spaces facility can provide a flexible mechanism to react more promptly to Russian requests for assistance.*

(See paragraphs 8.41, 8.42 and 8.43.)

ANNEX 8.1

Assessment of the supervisory and control systems

System concerned	Key internal controls (Commission services)				Key internal controls in national administrations	Overall assessment
	Ex-ante checks on contracts and payments	Monitoring of project implementing organisations	External audits/closure audits of project claims	Internal audit		
EuropeAid Co-operation office					N/A	
Enlargement		N/A				
DG Humanitarian Aid (ECHO)		N/A			N/A	

Legend:

	Effective
	Partially effective
	Not effective
N/A	Not applicable: does not apply or not assessed

Note: In relation to controls shown as 'Partially effective', this table should be read in conjunction with **Annex 8.2**, which indicates where progress has been made.

Result of transaction testing

Sample estimate of the proportion of transactions affected by an error	11 %
Error rate	Between 2 % and 5 %

Follow-up of key Statement of Assurance observations

Court observation	Action taken	Court analysis	Commission reply
External relations and development			
<i>Weaknesses concerning implementing organisations</i>			
<p>As in previous years the Court noted a material incidence of error in the sample of payments tested at implementing organisation level.</p> <p>(Annual Report concerning the financial year 2006, paragraphs 8.9 and 8.10)</p>	<p>Terms of reference for financial audits to be launched by beneficiaries have been revised.</p>	<p>Some of the effects of the new Terms of Reference were already noticed in 2007. However, as they only became compulsory from October 2007 onwards, the full benefits will only be seen in the future.</p>	<p><i>The Commission welcomes the Court's observation as regard the improvement in the quality of the audit reports. However, it should be pointed out that:</i></p> <ul style="list-style-type: none"> — <i>the new terms of reference for financial audits launched by beneficiaries are in force for all new contracts signed as from February 2006,</i> — <i>the new terms of reference for financial audits launched by the Commission are available since July 2007 and have been made compulsory since October 2007. However, the Commission claims that the previous version of terms of reference used up to 2007 were already of sufficient quality so as to allow the Authorising Officers to take the appropriate decisions.</i>
<i>Information on audits and their results</i>			
<p>Neither External Assistance Management Reports (EAMRs) nor the computerised management information system CRIS (Common Relex Information System) contain complete and systematic information on audits of projects and their results.</p> <p>(Annual Report concerning the financial year 2006, paragraphs 8.22 and 8.23)</p>	<p>The reporting format used by Delegations on the implementation of the Annual Audit Plan 2007 has been modified. Further improvements have been made concerning CRIS-Audit.</p>	<p>Improvements have been made. However, CRIS-Audit did not come into full use during 2007 and audits managed by project implementing organisations are still not included in the reporting.</p>	<p><i>All the audits of the Annual Audit Plan 2007, as well as the audits of the current year, have been entered in CRIS-Audit.</i></p>
Enlargement			
<i>Extended Decentralised Implementation System (EDIS)</i>			
<p>Weaknesses were noted at the level of the national administration supervisory systems in Romania and Bulgaria, confirmed by the delay in the EDIS accreditation for Phare in Bulgaria.</p> <p>(Annual Report concerning the financial year 2006, paragraph 9.19)</p>	<p>The Commission implemented close monitoring of the progress made in the national management systems.</p>	<p>Despite the actions taken in this respect in the case of Bulgaria the audit work carried out revealed that there is still room for improvement at the level of the national supervisory and control systems.</p>	<p><i>The Commission will continue to closely monitor the management systems in tight cooperation with the Bulgarian authorities. The proposed measures will be closely monitored and audited to verify that they lead to the desired improvements.</i></p>
Humanitarian aid			
<i>External audits</i>			
<p>The majority of audits are done at the partners' headquarters. As the reality of expenditure can be more effectively checked at field level, there should be more emphasis on on-the-spot audits.</p> <p>(Annual Report concerning the financial year 2006, paragraph 8.18)</p>	<p>A new Framework Contract was concluded in August 2006.</p>	<p>In spite of the new Framework Contract, in 2007 the majority of audits were done at partners' headquarters.</p>	<p><i>The Commission has doubled the number of field audits as compared to the number undertaken in 2006. A further increase of field audits is considered not to be cost-effective.</i></p>

CHAPTER 9

Education and Citizenship

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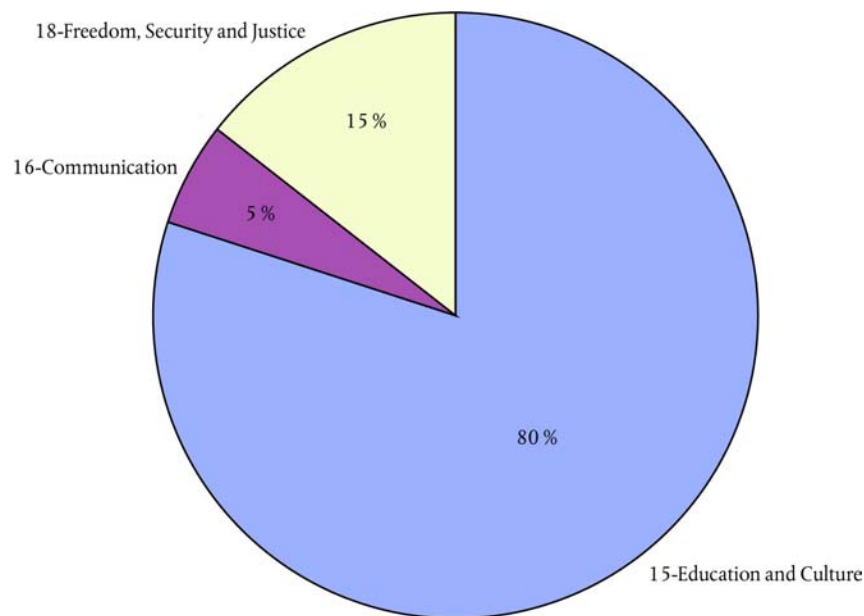
INTRODUCTION

Specific characteristics of Education and Citizenship

9.1. This chapter covers the Court's findings on policy group Education and Citizenship, which comprises the following policy areas: 15-Education and Culture, 16-Communication; and 18-Freedom, Security and Justice. In 2007, commitments totalled 1 888 million euro (1 649 million euro in 2006) and payments totalled 1 453 million euro (1 569 million euro in 2006). The distribution of payments by policy area is given in **Graph 9.1**. Budget implementation for the year 2007 was characterised by the introduction of new multiannual programmes in the context of the 2007-2013 Financial Framework ⁽¹⁾.

9.1. As far as policy areas 15 and 18 are concerned, most of the legal acts were adopted at the end of 2007 which resulted in specific constraints in terms of budget execution and launching of new financial instruments.

Graph 9.1 — Education and Citizenship — breakdown of payments (*) by policy area



Total payments in 2007: 1 453 million euro

(*) Excludes administrative expenditure.

Source: 2007 annual accounts.

⁽¹⁾ Except for expenditure under policy area 16.

THE COURT'S OBSERVATIONS

9.2. The Commission manages most of the expenditure in an indirect centralised way or through shared management, with the implementation of actions in the form of multiannual programmes delegated to National Agencies or similar management structures in Member States ⁽²⁾. The responsible entities in Member States allocate grants and contracts to projects or measures carried out by private and public beneficiaries. The grants are usually paid in instalments: an advance upon signature of the grant agreement, followed by interim and/or final payments which reimburse eligible expenditure reported by the beneficiaries in periodic cost statements.

9.3. The implementation of the programmes under the new Financial Framework was accompanied by a change in the internal control structure with an increased level of responsibility for the Member States ⁽³⁾. A National Authority thus has to give a declaration of assurance in respect of the financial management of expenditure in the Member State in question. The relationship between Commission, National Agency and National Authority has now become clearer than in previous years in each Member State.

9.4. EU support in the domains of Education and Citizenship is characterised by a multiplicity of funding schemes for various thematic areas and types of projects such as grants to actions in favour of Citizenship or for mobility in the education and training sectors. Projects are carried out not only by teaching organisations, but also by private firms and public administrations. Final beneficiaries are individuals, mostly EU citizens.

THE COMMISSION'S REPLIES

9.2. *In policy area 15 — Education and Culture, the Commission implements the budget through indirect centralised management by the national agencies (68 %) and by an executive agency (22 %), the rest being implemented directly by the Commission (7 %) and regulatory agencies (3 %).*

9.3. *The implementation of the new multiannual programme in the field of education was accompanied by the introduction of the single audit approach in line with the roadmap to the internal control framework adopted by the Commission. This has implied the development of a common control framework as well as a renewed supervisory strategy by the Commission.*

The regulatory and contractual framework defines the types of controls, minimum standards for internal control, common procedural requirements as well as classification and minimum number of checks made by the National agencies. Moreover, DG EAC has also enhanced simplification, notably on the basis of calculation of eligible expenditure (extensive use of lump sum financing).

⁽²⁾ Management of some programmes such as the European Refugee Fund and the External Borders Fund is, however, shared with Member States.

⁽³⁾ In particular in relation to the Lifelong Learning Programme (LLP) managed by the Directorate-General for Education and Culture (DG EAC).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Audit scope

9.5. The specific assessment is based on:

(a) the substantive testing of a representative statistical sample of 150 ⁽⁴⁾ payments;

(b) an assessment of the operation of supervisory and control systems for Communication policy area as well as of those laid down in the respective EU decisions for the Lifelong Learning Programme (LLP) ⁽⁵⁾, which relate to policy area Education and Culture expenditure, and for the External Borders Fund (EBF) and European Refugee Fund (ERF) II ⁽⁶⁾, which relate to policy area Freedom, Security and Justice expenditure. The following elements of the supervisory and control systems were assessed:

(i) the Commission's supervisory checks on the *ex-ante* certification or assessment of management structures carried out by Member State authorities;

(ii) the control systems in place for Education and Culture and for Communication expenditure;

(c) a follow-up of the principal observations by the Court in recent Statements of Assurance.

9.5.

(b)

(ii) *The ex-post control systems for lifelong learning (LLP) 2007-2013 could not be assessed because no final payments were made in 2007.*

⁽⁴⁾ The sample comprised 104 Education and Culture, 24 Freedom, Security and Justice and 22 Communication payments. The sample comprised 95 advances and 55 interim and final payments (of which 19 for Communication); the latter represent a significantly higher risk.

⁽⁵⁾ This programme, based on Decision No 1720/2006/EC of the European Parliament and of the Council (OJ L 327, 24.11.2006, p. 45) and Commission Decision C(2007) 1807 final, accounted for 84 % of the commitment appropriations for Education and Culture for the financial year 2007.

⁽⁶⁾ These two programmes, based on respectively Decision No 574/2007/EC of the European Parliament and of the Council (OJ L 144, 6.6.2007, p. 22), Council Decision 2004/904/EC (OJ L 381, 28.12.2004, p. 52) and Commission Decision 2006/401/EC (OJ L 162, 14.6.2006, p. 20), accounted for 42 % of the commitment appropriations for Freedom, Security and Justice for the financial year 2007.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

9.6. In line with the expected expenditure pattern for the financial year 2007, the Court's sample of payments for substantive testing included 95 advances (7), 43 of which were subject to straightforward conditions, typically the signing of a contract. For the remaining 52 advances additional conditions applied (8). An example of such additional conditions concerns the assessment by the Commission of an *ex-ante* declaration of assurance by Member States accompanied by a description of the management system for the National Agencies in charge of the management of the LLP.

Legality and regularity of underlying transactions

9.7. An important element of the legality and regularity of underlying transactions in the policy group Education and Citizenship, is the correctness of the declared cost. Overstatement of expenditure by beneficiaries may be the result of errors concerning:

- (a) eligibility: costs which are not allowed under the rules;
- (b) occurrence: costs for which there is inadequate supporting evidence; or
- (c) accuracy: incorrectly calculated costs.

9.8. The Court found a material level of error of legality and/or regularity in 21 % of the payments, of which 7 percentage points were quantifiable errors and 14 percentage points were non-quantifiable errors. Some payments were affected by more than one error. **Table 9.1** shows how many of the errors were found in different types of payment and **Table 9.2** how many in each policy area.

9.8. *Two of the errors identified at DG COMM reflect situations of which the Directorate-General's management was aware in advance. They were obliged to accept these errors in order to be able to continue the actions already undertaken. One of these two cases is an 'exception' and was the subject of a prior notification under internal standard 18.*

Table 9.1 — How many advances and interim/final payments were affected by errors and how many were free from errors?

Payments by regularity	Advances	Interim/final	Total
Payments affected by serious errors	9	16 (*)	25
Payments affected by limited errors	2	4	6
Payments free from significant errors	84	35	119
Total	95	55	150

(*) One of these payments was managed by DG Employment.

(7) The financial year 2007 saw the start-up of major new programmes under the 2007-2013 Financial Framework.

(8) These concern advance payments to National Agencies in Member States that are in charge of the management of the Lifelong Learning and Youth in Action Programmes.

Table 9.2 — How many payments affected by errors or free from errors were in each of the three policy areas?

Payments by regularity	Payments by policy area			Total
	EAC	FSJ	COMM	
Payments affected by serious errors	13	7	5	25
Payments affected by limited errors	4	0	2	6
Payments free from significant errors	87	17	15	119
Total	104	24	22	150

Legend:

EAC — Education and Culture

FSJ — Freedom, Security and Justice

COMM — Communication

9.9. Errors found included:

- (a) unjustified allocation of indirect costs to the project (eligibility);
- (b) ineligible costs (eligibility);
- (c) inadequate supporting evidence to justify the costs claimed (occurrence);
- (d) commitments made by two Directorates-General (Justice, Freedom and Security DG and Education and Culture DG) before establishment of the related financing decision (the annual work programme for five community agencies).

9.10. The errors occur in the context of a complicated legal framework with multiple (sometimes unclear) eligibility criteria. As in previous years, the Court found that beneficiaries are often unable to properly justify personnel costs. As appears from the tables above, interim and final payments are more affected by errors than advance payments (almost one out of four interim or final payments tested was affected by serious errors). This also explains why relatively more errors were found in payments authorised within the policy area Communication, where most of the sampled payments were interim or final payments.

9.11. Based on its audit work the Court concludes that payments made in the policy group Education and Citizenship are affected by a material level of error of legality and/or regularity. The error rate has been assessed by the Court as lying between 2 % and 5 % (see **Annex 9.1**).

9.10. *The errors concerning DG EAC are related to final payments of actions under the former legal framework ⁽¹⁾.*

The design of the new programmes 2007-2013 has taken into account the Court of Auditors' recommendations of previous years to simplify the rules and to make extensive use of lump sum financing. This should reduce the error rate in the future.

⁽¹⁾ *The results of the ex-post controls carried out by DG EAC, as presented in its annual activity report 2007, do not identify a material level of error.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Assessment of supervisory and control systems

9.12. The Commission has delegated an important part of the management of projects financed from its grants, to entities in Member States. Many errors of legality and regularity can only be detected (and thereby corrected) by performing on-the-spot checks. However, undertaking such checks on each project each year would result in prohibitive costs. The supervisory and control system for Education and Culture expenditure relating to the 2000-2006 programming period was largely based on *ex-post*, on-the-spot checks. *Ex-post* controls carried out in 2007 under this system, examined by the Court, did not reveal any significant weaknesses. For the Financial Framework period 2007-2013, the Commission seeks to obtain for its supervisory and control system, in particular for Education and Culture expenditure, more reliance from supervision and checks carried out by the Member States. Important elements in this process are the *ex-ante* and annual *ex-post* declarations of assurance given by the National Authorities in respect of EU expenditure managed by the Member States.

9.12. *The current DG EAC supervisory strategy is based on a range of controls, including on-the-spot checks.*

Furthermore, in recent years DG EAC carried out systems audits of all national agencies as well as a number of monitoring visits. These on-the-spot visits have allowed the Commission to have a clear picture of the functioning of national agencies in 2007, at the beginning of the LLP.

The Lifelong Learning Programme

9.13. The current system for the LLP is based, amongst other things ⁽⁹⁾, upon an *ex-ante* and annual *ex-post* declaration of assurance to be given by the National Authority in Member States in respect of the quality of the management by National Agencies and on related monitoring visits by the Commission in Member States. It provides for the Commission to accept, conditionally accept (i.e. with qualifications) or reject *ex-ante* declarations. In case of conditional acceptance, the Commission may decide to take precautionary measures applying to its contractual relationship with the National Agency.

9.13. *The Commission has taken into account the recommendations of the Court of Auditors from previous years and its own experience from the systems audits and monitoring visits when designing the new supervisory and control system and when assessing the management structures presented by the national authorities.*

9.14. In 2007 the Commission carried out an assessment of *ex-ante* declarations of assurance submitted by Member States. The completion of this assessment procedure was required before entering into a contractual relationship with the National Agencies.

⁽⁹⁾ The control system principally comprises the primary controls carried out by the National Agencies, the secondary controls carried out by the National Authorities and the Commission supervision.

THE COURT'S OBSERVATIONS

9.15. The Court audited the assessment process for *ex-ante* declarations. It concluded that the application in 2007 of the *ex-ante* declaration procedure provided little assurance for the quality of the management of the expenditure concerned in 2007 (see paragraph 9.16). However, the Court considers the design of the system — if properly applied — could provide an adequate basis for assurance in the future.

9.16. The Court noted the following weaknesses in the *ex-ante* declaration procedure:

- (a) varying approaches taken by the National Authorities to obtain a basis for the *ex-ante* declaration of assurance and differences in the degree of disclosure of the procedures carried out by these authorities. This has led to differences in the scope of reliance placed by the Commission on the declarations;
- (b) the Commission's assessment was limited to a desk review of systems and controls; therefore the effective operation of these systems and controls was not verified by the Commission;
- (c) for all Member States, the Commission approved the declarations with various qualifications to be remedied by the end of 2007. The number of qualifications relevant to the 39 Agencies was 329 and varied between 3 and 13 per Agency. Amongst these qualifications were some relating to key internal control features such as the segregation of duties, the establishment of an internal audit function and the operation of the financial systems. For these qualifications the Commission did not include a precautionary measure in its contractual relationship with the agencies concerned, as provided for in the relevant Commission Decision. There was no rigorous follow-up of corrective actions, deadlines were frequently not respected and an important number (240) of qualifications had not yet been lifted at the end of 2007;

THE COMMISSION'S REPLIES

9.15. The DG EAC supervisory system consists of: (a) monitoring visits starting in 2007, (b) review of yearly declarations of assurance including activity and financial reports due by April 2008, (c) on-the-spot checks of methods of national controls and (d) financial audits.

The system provided for in the legal basis LLP 2007-2013 represents an evolution of the 2000-2006 system taking into account the Court's recommendations. The Commission's controls in earlier years contributed with those undertaken in 2007 to DG EAC's conclusion that control systems provide reasonable assurance, though significant improvements are needed in the application of the control system at the level of checks by national authorities.

9.16.

- (a) The regulatory framework does not prevent the Commission from accepting the different control systems put in place by the Member States provided that certain objectives are met. Consequently, the Commission has not imposed a 'one size fits all' model. However, based on the first experience of declarations, the Commission has further defined the control objectives for the checks by the national authorities in guidelines provided to the Member States in February 2008.
- (b) DG EAC started on-the-spot visits in October 2007 and they continue in 2008 and following years. The first results of the on-the-spot checks indicate the effectiveness of the overall desk review carried out.
- (c) According to DG EAC classification ⁽²⁾, internal audit is a new requirement and the absence of this control is not considered crucial at the beginning of the operations for the new programmes. As regard segregation of duties and operation of financial systems, the qualifications are being followed up and will be reported on in due course (see below). DG EAC has taken a proactive approach, and when 'blocking issues' have been spotted they have been explained, discussed and solved with the national authorities before the acceptance of the national agency and the signature of the legal commitment, instead of issuing a formal report of non-acceptance.

In some cases, preventive measures have been taken, preventing the first pre-financing to be paid until the actual implementation of the remedial action agreed with the national authority.

⁽²⁾ The classification of the qualifications was based on the compliance with the Guide for National Agencies and the key elements of controls mentioned in Article 18(7) of the EC/NA agreement.

THE COURT'S OBSERVATIONS

- (d) certain criteria used by the Commission within the assessment procedure were not adequately defined, leaving uncertainty as to what is meant by completion of the assessment process and what are the precautionary measures that could be taken.

9.17. These weaknesses reduce the value of the *ex-ante* declaration procedure as an element of the supervisory and control system. In particular deficiencies in the internal control systems identified in the qualifications mentioned above under paragraph 9.16(c), represent a risk for the legality and regularity of payments made to final beneficiaries and for future payments to the National Agencies. A systematic follow-up of qualifications, in the form of monitoring visits, and a close supervision by the Commission of the annual *ex-post* declaration procedure is needed to provide assurance for the coming years that National Agencies meet the minimum requirements in respect of management and control of expenditure.

9.18. The annual *ex-post* declarations of assurance ⁽¹⁰⁾ for 2007 were to be provided by the National Authorities of the Member States by 30 April 2008 and therefore will be assessed by the Court as part of the 2008 DAS audit.

⁽¹⁰⁾ This declaration shall give assurance as to the reliability of financial systems and procedures of the National Agency and the probity of their accounts; it shall also give assurance that resources were used for the intended purpose and that control systems guarantee the legality and regularity of the underlying transactions.

THE COMMISSION'S REPLIES

Due to the very tight time schedule (adoption of the legal basis in December 2006 and by consequence adoption of the derived regulatory and contractual framework in 2007), most ex-ante declarations were assessed in the second half of 2007. Therefore, DG EAC considers that it is an achievement that more than a third of the qualifications could be closed by end 2007. Qualifications will be followed up in the exercise of the assessment of the yearly declaration of assurance.

- (d) *DG EAC considers that the monitoring of the quality of the management systems is an ongoing activity and has put in place adequate supervisory activities in order to do so. The acceptance of a national agency is formalised in a letter signed by the Director-General.*

When the Commission identifies risks in starting a programme while certain qualifications are still outstanding, it has the discretionary power to take precautionary measures, such as the blocking of the first prefinancing to national agencies.

DG EAC aims to adapt, on the basis of the results of its controls and a risk based approach, the contractual and financial management tools and procedures in order to minimise the risks identified by the Court.

9.17. *EAC is confident that the measures put in place to enhance national controls will be fully effective in the context of the yearly declaration. Moreover, a system of financial corrections is anchored in the legal instruments.*

9.18. *By the end of June 2008 DG EAC had received for LLP 85 % of the yearly reports and 50 % of the yearly declarations due, and DG EAC had started assessing them. Formal reminder letters were sent by the Director-General to the national authorities and the national agencies that did not comply with their obligations. These measures have been accompanied by the suspension of payments of the operating grant in the cases where the final reports are missing.*

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

European Refugee Fund II and External Borders Fund

9.19. The Court examined the Commission's preliminary assessment of supervisory and control systems set up by Member States for the European Refugee Fund (ERF) II which was established in 2005 and which was still in operation in the year 2007.

9.20. The assessment by the Commission is based on information sent by Member States and is still ongoing in the form of monitoring visits to Member States. Its value as an instrument to ensure that Member States supervisory and control systems are in line with the regulatory framework is reduced by:

- (a) shortcomings in the descriptions of management and control procedures provided by Member States;
- (b) the limited number of monitoring visits to Member States (10 Member States out of the 26 ⁽¹¹⁾ had been visited by the end of 2007) and the fact that most of them were not performed within the 12-month period following submission of the systems' descriptions as required by EU rules;
- (c) the fact that the follow-up procedure to monitor the progress made by the Member States in implementing the corrective measures should be more systematic.

9.20.

- (a) *The Commission has improved the format of the description of management and control systems for the Funds under the 2007-2013 financial perspective. This was accompanied by the introduction of reinforced guidelines for Member States and by the establishment of a team which will concentrate on analysing the compliance of Member States' systems.*
- (b) *An action plan ⁽³⁾ is currently being carried out in order to finalise by September 2008 those visits not carried out in 2007. Partial coverage of the on-the-spot visits must also be assessed with respect to the constraints linked to the introduction of the new 2007-2013 shared management funds and the preparation of the clearance of the accounts under the Schengen Facility, a financial instrument regarded as a major risk between 2004 and 2008. Furthermore, partial coverage of the on the spot visits is partly offset by familiarity with the systems implemented by Member States under ERF I as a result of on-the-spot visits and/or audits carried out between 2005 and 2007.*

⁽¹¹⁾ Denmark does not participate in the ERF II.

⁽³⁾ See the Annual Activity Report 2007 of DG JLS's Authorising Officer by Delegation.

THE COURT'S OBSERVATIONS

9.21. As descriptions of the Member States supervisory and control systems for the External Borders Fund (EBF) were only provided⁽¹²⁾ to the Commission in the last quarter of 2007, the Commission could not assess the Member States' systems by the end of the year 2007. As a consequence there were no transfers of funds to the responsible authorities in Member States during the financial year 2007⁽¹³⁾.

Ex-ante checks for Communication expenditure

9.22. Before reimbursing the declared expenditure for interim and final payments to projects, the Commission performs desk checks of the cost statements submitted by beneficiaries.

9.23. In the case of Communication expenditure, where most of the sampled payments were interim or final payments subject to a higher risk, the Court found that 7 out of the 12 errors it detected should have been identified by the Commission's *ex-ante* checks.

Conclusion on Supervisory and Control Systems

9.24. The Court's assessment of the supervisory checks carried out by the Commission (see paragraphs 9.12 to 9.23) for Education and Culture expenditure and ERF II is that they are partially effective. For the EBF no conclusion can be given as the descriptions of Member States' supervisory and control systems were not provided to the Commission in good time. The system for *ex-ante* checks for Communication expenditure is assessed as not being effective⁽¹⁴⁾. A summary of the results of the Court's assessment of selected supervisory and control systems may be found in **Annex 9.1**.

THE COMMISSION'S REPLIES

9.22. *Ex-ante checks are performed for all payments in the area of communication expenditure.*

9.23. *These errors will be monitored and the necessary corrective measures taken. In relation to the system as a whole, DG COMM had already entered a reservation in its Annual Activity Report because of the lack of supervision and had adopted the necessary measures to improve matters, starting with the establishment on 1 November 2007 of a monitoring unit which now incorporates the second level ex-ante control. This unit is also expanding its work in relation to ex-post controls, including on-the-spot controls.*

9.24. *The assessment of the ex-ante declaration for the LLP is the starting point of a process that will be completed by the assessment of the yearly declaration from 2008 onwards and the full implementation of the set of supervisory controls.*

The Court's assessment of non-effectiveness of the ex-ante checks for communication expenditure is based on an analysis of, mainly, interim and final payments, while 63 % of the payments selected for the policy group Education and citizenship are advance payments. This assessment should be seen in light of the fact that final payments are subject to a higher risk than advance payments which are eligible as soon as the contract is signed.

Measures have been, and will continue to be, taken in order to improve the general level of checks.

⁽¹²⁾ With the exception of Italy, Luxembourg and Malta who had not provided the required documents by December 2007.

⁽¹³⁾ The payment appropriations for 2007 amounted to 95 million euro.

⁽¹⁴⁾ A system for *ex-post* controls was only put in place in November 2007. Communication DG has created from 1 November 2007 a centralised *ex-post* control function and has started carrying out on-the-spot checks in 2008.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Overall conclusion and recommendations

9.25. Based on its audit work the Court concludes that payments underlying the policy group Education and Citizenship are affected by a material level of error of legality and/or regularity. The Court's assessment of the supervisory and control systems is that they were partially effective.

9.26. The Court recommends the Commission to take the following actions:

- (a) improve its preliminary assessment of supervisory and control systems set up by Member States for the LLP and ERF ⁽¹⁵⁾, through more monitoring visits that focus on the existence and implementation of management procedures and checks as described by Member States;
- (b) improve over time the quality of *ex-ante* checks carried out in respect of Communication expenditure through adequate check-lists to be used consistently.

9.25. *Many errors found by the Court related to payments of actions under the former framework programmes in the area of education and culture. The design of the new programmes for 2007-2013 in this area has taken into account the Court of Auditors' recommendation to simplify the rules and to make extensive use of lump sum financing. This should further reduce the error rate in the future. The lack of supervision concerning communication expenditure was known by the Commission and a reservation was introduced in the Annual Activity Report. Ex-post controls have now been introduced, including on-the-spot controls.*

9.26.

- (a) *For the Refugee Fund II, an action plan defined in the 2007 Annual Activity Report of DG JLS's Authorising Officer by Delegation is being carried out in order to finalise by September 2008 those visits not carried out in 2007.*

As regards the Lifelong Learning Programme, the implementation of this recommendation is an integral part of the multiannual supervisory strategy started in 2007. The cycle will only be completed with the analysis of the yearly declaration of assurance in 2008 and related checks.

- (b) *Check-lists are already used. In order to use them more consistently and to improve the quality of their checks before initiating a payment, more training will be provided for the authorising officers by sub-delegation, the heads of administration and the operational staff.*

FOLLOW-UP OF PREVIOUS OBSERVATIONS

9.27. The results of the Court's follow-up of key observations in recent Statements of Assurance are given in **Annex 9.2**. The observations concern the absence of a reliable management information system for late payments at DG EAC and the sharing of results of *ex-post* checks which can increase their efficiency and effectiveness.

9.27. *The Commission refers to its replies in Annex 9.2.*

⁽¹⁵⁾ In 2008 the ERF II will be followed by the ERF III.

ANNEX 9.1

Assessment of Supervisory and Control systems

System concerned	Key internal control				Overall assessment
	Assessment by the Commission of the <i>ex-ante</i> declaration of assurance	<i>Ex-post</i> declaration of assurance	<i>Ex-ante</i> checks on payments	<i>Ex-post</i> checks/audits	
Education and Culture Programmes (2000-2006)	N/A	N/A			
Lifelong Learning Programme (2007-2013)		N/A		N/A	
External Borders Fund	could not be assessed				
European Refugee Fund II		N/A		N/A	
DG COMM	N/A	N/A		N/A	

Legend:

	Effective
	Partially effective
	Not effective
N/A	Not applicable: does not apply or not assessed

Result of transaction testing

Sample estimate of the proportion of transactions affected by an error	21 %
Error rate	Between 2 % and 5 %

Follow-up key Statement of Assurance observations

Court observation	Action taken	Court analysis	Commission reply
1. Late payments by Commission			
<p>1.1. DG EAC has no reliable management information on its late payments</p> <p>(Annual Report concerning the financial year 2004, paragraph 6.27; Annual Report concerning the financial year 2005, paragraph 7.10; Annual Report concerning the financial year 2006, paragraph 7.29 and Annex 7.1)</p>	<p>Since early 2007, DG EAC has prepared a 'Financial Indicators' report which includes a section on late payments. This monthly report is sent to the Directors' board.</p>	<p>DG EAC should ensure that appropriate and timely action is taken resulting from the information contained in this report.</p>	<p><i>In addition to statistics on payment delays shown in ABAC, i.e. after the actual payment has taken place, a report of payments still to be made is presented to the Task Force Directors together with an analysis by operational units. This monthly reporting has contributed to a considerable reduction of late payments both in number and amount.</i></p>
2. Sharing of results of the ex-post checks can increase their efficiency and effectiveness.			
<p>2.1 As with the <i>ex-ante</i> desk-reviews, sharing of the results of the ex-post checks can increase their efficiency and effectiveness. The Court found out that DG EAC do not systematically disseminate results to other DGs and have not established any procedures. In November 2006 the Commission introduced an audit tracking system to enable results of audits performed by all Commission departments to be registered in a central database accessible to all Directorates-General. The Court examined the use of the tool and found that is not being used yet by DG EAC.</p> <p>(Annual Report concerning the financial year 2006, paragraphs 7.18 to 7.23)</p>	<p>As a response to the Court's observation and as part of the Action Plan towards an integrated internal control framework, the Commission decided to integrate the audit data within its financial and accounting system in order to facilitate coordination of the audits and sharing of the results between DGs. In 2007, however, DG EAC had not yet put in place the necessary procedures. In April 2008, they were still to be formalised, to include retroactive sharing of results of <i>ex-post</i> audits closed in 2007 via the ABAC system.</p>	<p>DG EAC should complete as soon as possible the sharing of the results of all <i>ex-post</i> audits closed in 2007 and ensure the consistent application of this procedure for <i>ex-post</i> audits undertaken in the future.</p>	<p><i>Staff has been trained to use the ABAC tool and has received access to it. Audit information can now be input in the system, as required at Commission level.</i></p>

CHAPTER 10

Economic and Financial Affairs

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OVERVIEW

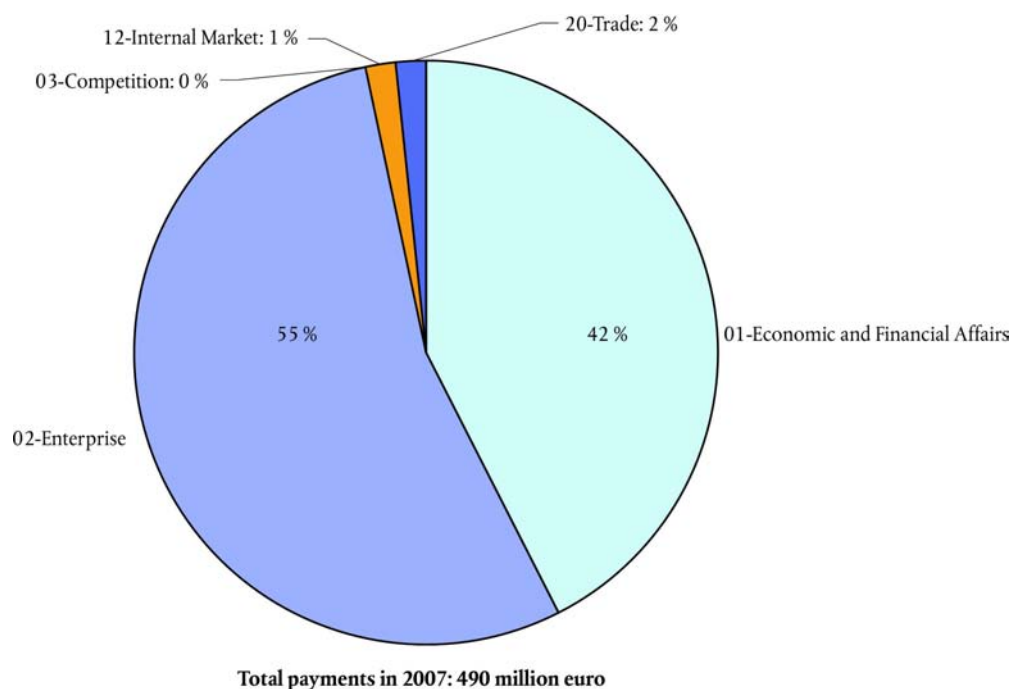
10.1. Chapter 10 consists of four parts. It firstly contains the specific assessment in the context of the Statement of Assurance (see paragraphs 10.2 to 10.34) followed by the results of the recurrent audits on the Guarantee Fund for External Actions (see paragraphs 10.36 to 10.39) and the European Coal and Steel Community in Liquidation (see paragraphs 10.40 to 10.42). The Chapter concludes with a follow-up of previous years' observations.

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Introduction

10.2. This Chapter covers the Court's findings on policy group Economic and Financial Affairs, which comprises the following policy areas: 01-Economic and Financial Affairs; 02-Enterprise; 03-Competition; 12-Internal Market; and 20-Trade. In 2007 commitments totalled 697 million euro (639 million euro in 2006) and payments totalled 490 million euro (501 million euro in 2006). The distribution of payments by policy area is given in **Graph 10.1**. More detailed information on spending for the year is provided in **Annex I** of this report.

Graph 10.1 — Economic and Financial Affairs — breakdown of payments by policy area



Source: 2007 annual accounts.

Note: Title 03 - Competition actually amounts to 0,1 %.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

10.3. The two principal areas of activities in terms of payments are policy areas Enterprise (266 million euro) and Economic and Financial Affairs (208 million euro). Budget implementation for the financial year 2007 included new multiannual programmes in the context of the 2007-2013 Financial Framework. Payments for these new programmes are, however, still limited but will gradually increase during the coming years.

Audit scope

10.4. The specific assessment is based on:

- (a) substantive testing of a representative statistical sample of one commitment transaction and 55 payment transactions made by the Commission in 2007. This included the evaluation of call for proposal and call for tender procedures;
- (b) an assessment of the following supervisory and control systems:
 - *ex-ante* desk checks for payments for procurement contracts made by the Commission;
 - *ex-ante* desk checks for payments for grants made by the Commission;
 - audit certification of project cost statements provided by independent auditors;
 - *ex-post* controls in the context of the Common sixth Framework Programme (FP6) Audit Strategy.

10.5. The representative statistical sample of 55 payment transactions included 15 advances and 40 interim, final or single payments; out of the 40, eight payment transactions were audited at the level of the beneficiary. For these interim and final payments sufficient evidence could only be gathered on the spot. The remaining payment transactions could be audited on the basis of documentation available at the level of the Commission.

Specific characteristics of the policy area

10.6. The audit covered payments made for many different policy areas or (sub-)programmes. **Table 10.1** shows all of those with payments above 20 million euro ⁽¹⁾.

⁽¹⁾ No such payments were made under policy areas Competition, Internal Market, and Trade.

Table 10.1 — Payments above 20 million euro made for main policy areas or (sub-)programmes in the policy area audited in 2007

Budg. title	Policy area or (sub-)programme	Payments 2007 (million euro)	Relative to total payments
02	Sixth Framework Programme for research and technological development	75,60	15,4 %
01	Financial instruments under the Multiannual Programme (MAP)	71,60	14,6 %
01	Financial instruments under Competitiveness and Innovation Framework Programme (CIP)	71,40	14,6 %
02	Funding of traditional Agencies	52,40	10,7 %
01	EIF capital increase	30,63	6,3 %
02	Seventh Framework Programme for research and technological development	28,01	5,7 %
01	Macroeconomic Assistance	20,21	4,1 %
02	Interoperable Delivery of pan-European eGovernment Services to public Administrations, Businesses and Citizens (IDABC)	20,16	4,1 %
Total		370,01	75,5 %

10.7. Most of the payments are grants to final beneficiaries. However, for a significant part of the payment transactions audited, the underlying expenditure is incurred after the completion of procurement procedures. Within the substantive testing sample of payment transactions, 29 of the payment transactions selected related to grants and a further eight payment transactions related to fiduciary accounts under the Multiannual Programme (MAP) and the Competitiveness and Innovation Framework Programme (CIP). Payments of contracts based on procurement represented 15 of all payment transactions audited. The participation in the capital increase of the European Investment Fund (EIF) accounted for the other three payment transactions audited.

10.8. The expenditure is mostly managed on a direct centralised basis. However, the main programmes in policy area Economic and Financial Affairs, i.e. the financial instruments under the MAP and the CIP, are run using the indirect-centralised or joint management methods, respectively. These programmes are managed by the EIF under 'Fiduciary and Management Agreements'.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

10.9. Due to the specific nature of these financial instruments, the audit of payments from the Commission to the EIF was limited to the transfer of the funds to fiduciary accounts ⁽²⁾. These fiduciary accounts are used by the EIF to execute the programmes.

Main risks to legality and regularity

10.10. Certain grants are paid on submission of cost statements by the beneficiaries ⁽³⁾. The main risk to legality and regularity of grants is that cost statements are overstated and that this is not detected by the Commission's controls.

10.10. *The risk that beneficiaries make cost overstatements largely stems from the inherent complexity of the funding mechanisms provided by the applicable regulatory framework, which are based on the reimbursement of actual costs. Resulting errors can mainly be detected by carrying out on-the-spot audits and desk controls. Therefore the Commission has adapted its internal control system to increase assurance on the legality and regularity of the expenditure on a multiannual basis through a higher number of audits and significantly increased coverage in terms of budget.*

The impact of the multiannual audit programme will gradually increase over the four-year implementation period.

10.11. This risk is considered to be high. Because of the significant number of cost statements, the Commission is not in a position to check each one on the spot at the level of the beneficiary. This mainly relates to research projects financed by policy area Enterprise under the fifth and sixth Framework Programmes. See also Chapter 7 of this Annual Report for other research expenditure.

10.12. A different risk assessment applies for other grants within the sample. Macroeconomic Assistance grants are paid to national budgets of third countries showing successful progress of their economic programmes. There is no requirement for cost statements to be presented to the Commission. In this case the risk of illegal or irregular payments is limited.

⁽²⁾ These programmes comprise financial guarantee and investment activities for small and medium enterprises (SMEs). For the execution of the programmes, funds are transferred from the General Budget to fiduciary accounts to cover possible future payments. These payments may occur at some time during the duration of the programme which can be several years after the initial funding of the fiduciary accounts and may be subject to special audits of the Court. See also Annual Report concerning the financial year 2003, paragraphs 10.5 to 10.27 (OJ C 293, 30.11.2004).

⁽³⁾ In the payment transactions audited, this related to grants under the fifth and sixth Framework Programmes and to one grant financed under the MAP.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

10.13. Similarly, the payments to fiduciary accounts for the financial instruments under MAP and CIP and the funding of agencies, in terms of legality and regularity, are not considered high risks.

10.14. Procurement contracts usually foresee payment of fixed prices on delivery of goods and on rendering of services (e.g. the main payments for IDABC). The main risks are that goods are not delivered or services not rendered as contractually agreed and that this is not detected by the Commission's controls. This risk is not deemed to be high due to the existing control measures.

10.15. Finally, the payments for the participation in the EIF capital increase are also not considered high risks in terms of legality and regularity.

Audit Findings

Legality and Regularity of underlying transactions

10.16. The Court identified legality and/or regularity errors in four of the 55 payment transactions audited. In three payment transactions, the Commission's *ex-ante* desk checks could not have identified the errors (see paragraph 10.24). These three erroneous payment transactions were financed either under the fifth or the sixth Framework Programmes for research and technological development. In all three payment transactions serious quantifiable errors as well as non-quantifiable errors were found ⁽⁴⁾. Types of errors identified in this context are consistent with the errors reported on in Chapter 7.

10.17. The errors occurred in the context of a complex legal framework with numerous (not always clear) cost eligibility criteria ⁽⁵⁾. The errors detected in the three transactions were due to:

- inadequate or missing supporting evidence to justify the cost claimed (e.g. appropriate time sheets to evidence personnel costs incurred or adequate evidence for travel costs);

10.16. *The Commission agrees that the three quantifiable errors in research Framework Programme payments are material. The Commission underlines that the Court considers all errors equal to or above 2 % 'serious'.*

The Commission is taking the necessary action to recover the amounts of funding relating to the ineligible costs.

⁽⁴⁾ An error is considered 'serious' if the amount of the error is equal to or above 2 % of the transaction value.

⁽⁵⁾ See Annual Report concerning the financial year 2006, paragraph 7.11 (OJ C 273, 15.11.2007).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

- the use of budgeted figures which does not comply with the contractual requirements to use actual cost;
- claiming costs incurred outside the eligibility period;
- claiming costs not directly related to the funded project; and
- inclusion of various ineligible costs (e.g. value added tax).

10.18. The fourth payment related to a procurement procedure for which the award decision was annulled by the Court of First Instance in March 2008 ⁽⁶⁾. This annulment has given rise to a financial risk for the European Community. This financial risk was therefore considered a non-quantifiable error.

10.19. Overall, the commitment and payment transactions audited were free from material error of legality and regularity. The Court identified errors in four out of 55 payments transactions audited. The financial impact is, however, below the materiality threshold of 2 %.

Assessment of supervisory and control systems

Financial circuits and *ex-ante* desk checks on procurement contracts

10.20. The Court assessed the financial circuits of the Directorates-General mainly involved in the implementation of the policy areas Economic and Financial Affairs, Enterprise and Internal Market ⁽⁷⁾. The consistent application of the financial circuit and adequate *ex-ante* desk checks were audited for each of the 15 payment transactions based on procurement procedures (see paragraph 10.7) as well as for the payment transactions for the EIF capital increase. Additional tests of controls were performed at the Directorate-General which is mainly in charge of policy area Internal Market as there were no transactions sampled relating to that policy area.

⁽⁶⁾ Case T-345/03.

⁽⁷⁾ The audit was confined to the two Directorates-General of the largest policy areas and to one of the small policy areas. The other two small policy areas Competition and Trade will be audited in the coming years.

THE COURT'S OBSERVATIONS

10.21. The Court found that the financial circuits and the *ex-ante* desk checks for procurement contracts are generally designed in such a way as to prevent illegal and/or irregular payments. Although in one case the *ex-ante* controls did not detect the error identified by the Court, the supervisory and control systems in respect of procurements were effective.

Ex-ante desk checks for the main grant programmes

10.22. For interim and final payments of grants based on cost statements, the Commission performs *ex-ante* desk checks of the cost statements submitted by beneficiaries before reimbursing the declared cost. For grants not based on cost statements compliance with the grant conditions are checked. The Court's assessment covered the *ex-ante* desk checks performed for each of the payment transactions involving interim or final payments of grants within the sample (23 payment transactions).

10.23. The assessment showed that adequate checklists and calculation sheets were used for grants based on cost statements ⁽⁸⁾ which assisted in identifying errors as regards accuracy and to a lesser extent eligibility and occurrence.

10.24. Especially in the case of projects financed under the Framework Programmes the *ex-ante* desk checks are inherently limited and therefore constitute a weakness in the system. Consequently, the Commission has to rely on an audit certification and/or *ex-post* controls as regards eligibility and occurrence (see paragraphs 10.11, 10.16 and 10.27 to 10.31).

THE COMMISSION'S REPLIES

10.21. *The Commission agrees that the financial circuits and the ex-ante desk checks for procurement contracts are generally designed in such a way as to prevent illegal and/or irregular payments and that the supervisory and control systems in respect of procurements were effective.*

⁽⁸⁾ This relates to audited payment transactions financed under the Multiannual Programme (1 payment transaction), the fifth Framework Programme (1 payment transaction), and the sixth Framework Programme (7 payment transactions).

THE COURT'S OBSERVATIONS

10.25. The Financial Regulation stipulates that the same cost may not be financed twice by the General Budget ⁽⁹⁾. For projects financed under the Framework Programmes which are based on cost statements, the Commission is currently not in a position to perform a coherent *ex-ante* desk check in this respect. A complete and Commission wide database with all beneficiaries which would allow better checks is not yet established.

10.26. As regards other grants and payments to fiduciary accounts in the sample ⁽¹⁰⁾, the Court found that adequate check-lists and calculation sheets exist. *Ex-ante* desk checks performed generally ensure legal and regular payments.

THE COMMISSION'S REPLIES

10.25. Applicants under the research Framework Programmes ⁽¹⁾ have to declare that the proposed project does not receive other community co-financing for the same actions. Should the declaration of the beneficiary prove to be false, the beneficiary could ⁽²⁾ be excluded from all contracts and grants financed by the Community and may also be subject to financial penalties ⁽³⁾. A beneficiary can participate in more than one project and charge different costs to each of the projects. Costs declared under other projects are in no case eligible.

While the Research DGs do share data on participants, given the setup of FP6 the Commission is not convinced that the establishment of a database for *ex-ante* checking such as that proposed by the Court would eliminate the risk of a cost being financed twice. The proposed database would require every line of every cost statement, for all Community funded projects, including those under different forms of management, to be encoded for all participants. The details would need to record, for instance, hours worked on each day on each project for each project, where this cost information is required under the contract. The information needed in the database is not included in the normal contractual reporting of the beneficiaries and would need to be requested specifically by the Commission as it is only available during on the spot audits. The cost of encoding, updating and verifying these data would be prohibitive.

For these reasons the Commission mitigates this risk with *ex-post on-the-spot* audits. The Commission has implemented a data sharing module for audits which allow the research DGs to exchange information on planned and completed audits and which helps them to co-ordinate their work, including the detection of possible duplicate charging of costs.

⁽⁹⁾ Article 111 of the Financial Regulation.

⁽¹⁰⁾ This relates to audited payment transactions financed under the Competitiveness and Innovation Framework Programme (4 payment transactions), the Multiannual Programme (5 payment transaction), and Macroeconomic Assistance (5 payment transactions).

⁽¹⁾ In application of the Financial Regulation (Article 111), which applies to all applicants for Community funding, not just research program applicants.

⁽²⁾ In accordance with Articles 94 and 96 of the Financial Regulation and in Article 134(b) of its Implementing Rules, such as 94(b) on false declarations.

⁽³⁾ Under article 134(b) of the Implementation Rules.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Audit certification of project cost statements

10.27. In general, the EU financial rules require that cost statements above a certain threshold have to be accompanied by an audit certificate. Within the policy area audited this is particularly applicable to the sixth Framework Programme. In these cases, cost statements are to be certified by an external auditor independent from the contractor or by a competent public officer in the case of certain public bodies. These audit certificates are a key control for the Commission in research projects as the *ex-ante* desk checks of the Commission are limited by nature (see paragraph 10.24).

10.28. The Court assessed in each of the projects audited at the level of the beneficiary and for which audit certificates were provided whether this control is effectively reducing the risks as regards errors of eligibility, occurrence and accuracy.

10.29. The Court found that in three projects audited at the level of the final beneficiary audit certificates were required. All of those projects were financed under the fifth or sixth Framework Programmes. In all three cases the certifying auditor issued an unqualified opinion whereas the Court detected serious quantifiable errors. In addition, the independence of the auditor was questionable in one of these cases as the person was certifying accounts partially prepared by himself.

10.30. This finding is consistent with the previous year's results ⁽¹¹⁾ and with results of the Commission's own assessment. The Commission found that in 95 contracts audited *ex-post* for policy area Enterprise, 38 cases showed errors at the level of the beneficiary although audit certificates were provided ⁽¹²⁾. This indicates that audit certificates only partially function as a reliable control.

10.29. *The Commission agrees that the three quantifiable errors in research Framework Programme payments are material.*

The Commission has informed the beneficiary about the requirements of FP6 concerning the independence of certifying auditors and invited him to ensure that his cost statements are certified by an independent auditor.

10.30. *The Commission agrees that the reliability of FP6 audit certification is not fully satisfactory, considering the remaining level of errors noted in audits. Nevertheless, the overall level of errors in FP6 is lower than the errors noted in uncertified cost claims related to FP5. This indicates that audit certificates do contribute to improving the accuracy of cost claims.*

As regards FP6, there is no compulsory certificate model. Nevertheless the proposed model has been followed in most of the audit certificates submitted.

⁽¹¹⁾ See Annual Report concerning the financial year 2006, paragraph 7.17.

⁽¹²⁾ Figures are taken from an internal Commission database on the result of *ex-post* audits finalised in 2007 for policy area Enterprise for projects financed under the sixth Framework Programme.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

For FP7 the Commission has further improved the reliability of audit certificates by using 'agreed upon procedures', setting out in detail the audit work to be performed by the certifying auditors and encouraging optional certification of the cost methodology.

Ex-post controls in the context of the Common FP6 Audit Strategy

10.31. The Court's findings concerning the projects financed under the sixth Framework Programme in policy area Enterprise are similar to the findings reported on in Chapter 7.

Overall conclusion and recommendation

10.32. Based on its audit work the Court concludes that the policy group economic and financial affairs is free from material error. However, the Court draws attention to errors set out in paragraphs 10.16 and 10.17 which, while not being material to the legality and regularity of transactions for the policy group as a whole, merit further attention.

10.33. The Court's assessment of the supervisory and control systems for policy group economic and financial affairs is that they are effective. However, the Court draws attention to weaknesses set out in paragraphs 10.24 and 10.25 as well as 10.27 to 10.31 which, while not being material to the effectiveness of the systems for the policy group as a whole, merit further attention.

10.34. In general the Commission should take appropriate action in the conduct of payments for research contracts to:

— implement simplified financial rules as regards eligible costs;

10.34.

— *The Commission agrees that further simplification is needed with regard to cost eligibility issues, particularly for personnel and indirect costs. It draws attention to the legal limitations of FP7 and to the difficulties to define lump sums and flat rates which are representative.*

Furthermore the ex-ante certification of cost calculation methodology introduced in FP7 is a major step towards simplification.

THE COURT'S OBSERVATIONS

- continue to provide support to beneficiaries and certifying auditors for the audit certification process and ensure the effective implementation of the measures introduced to improve the certification of cost statements for FP7;

- remind beneficiaries that auditors chosen shall be independent and shall not certify cost statements which were fully or partially established by themselves;

- establish a database allowing coherent checks of whether the same cost is financed twice by the General Budget.

THE COMMISSION'S REPLIES

As regards the development of alternative funding mechanisms for the future (such as lump sums and results based financing), the Commission is open to discussions with the Court and other stakeholders.

- *For FP7 the Commission has improved the reliability of audit certificates by using 'agreed upon procedures', setting out in detail the audit work to be performed by the certifying auditors.*

The Commission is also encouraging the optional certification of the cost methodology on the basis of implementing measures, which are currently being finalised.

- *The Commission accepts this recommendation.*

- *While the Research DGs do share data on participants, the Commission is not convinced that the establishment of a database for ex-ante checking such as that proposed by the Court would eliminate the risk of a cost being financed twice given the current state of the technology. The proposed database would require every line of every cost statement, for all Community funded projects, including those under different forms of management to be encoded for all participants. The details would need to record, for instance, hours worked on each day on each project for each project, where this cost information is required under the contract. The information needed in the database is not included in the normal contractual reporting of the beneficiaries and would need to be requested specifically by the Commission as it is only available during on the spot audits. The cost of encoding, updating and verifying these data would be prohibitive and the data protection implications would be serious.*

For these reasons the Commission mitigates this risk with ex-post on-the-spot audits. The Commission has implemented a data sharing module for audits which allows DGs to exchange information on planned and completed audits and which helps them to coordinate their work, including the detection of possible duplicate charging of costs.

Monitoring elements

10.35. See **Annex 10.1**.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

RESULTS OF THE AUDIT OF THE GUARANTEE FUND FOR EXTERNAL ACTIONS

10.36. The purpose of the Guarantee Fund for External Actions ⁽¹³⁾ ('the Fund'), which guarantees loans to third countries, is to reimburse the Community's creditors ⁽¹⁴⁾ in the event of a beneficiary's defaulting and to avoid direct calls on the Community budget. The administrative management of the Fund is carried out by Directorate-General for Economic and Financial Affairs (ECFIN) while the EIB is responsible for its treasury management ⁽¹⁵⁾. At 31 December 2007, the Fund's total resources were 1 152 million euro compared to 1 379 million euro at 31 December 2006. The difference is mainly due to the repayment to the General Budget of 261 million euro because of the accession of Romania and Bulgaria to the EU on 1 January 2007 ⁽¹⁶⁾.

10.37. From 1 January 2007 onwards, the provisioning of the Fund was changed from an *ex-ante* to an *ex-post* mechanism and only includes one annual payment to the Fund. In order to avoid high payments from the General Budget due to defaults on loans or guaranteed loans, a smoothing mechanism was introduced which should limit annual budget payments to the Fund to 200 million euro. No guarantee calls were made to the Fund in 2007.

10.38. The EIB applies a benchmark index to the Guarantee Fund. Although the annual performance of the Fund portfolio in 2007 amounted to 3,1 %, this is – 0,16 % below the benchmark index.

10.38. *The severe financial crisis which has perturbed markets since August 2007 has had an unavoidable impact on market values and thus performance. During the current crisis bond portfolios with a higher credit risk than their benchmarks suffered relative losses because of the widening of spreads caused by the 'flight to quality' into triple-A government bonds.*

Although the benchmark index was not achieved, the positive absolute annual performance of 3,1 % compares favourably with large privately managed global bond funds where a number experienced negative total performances.

⁽¹³⁾ Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 establishing a Guarantee Fund for external actions (OJ L 293, 12.11.1994, p. 1), as last amended by Regulation (EC, Euratom) No 89/2007 (OJ L 22, 31.1.2007, p. 1).

⁽¹⁴⁾ Principally the EIB, but also Euratom external lending and EC macro-financial assistance (MFA) loans to third countries.

⁽¹⁵⁾ Management agreement between the EIB and the European Community, as last amended on 28 April 2002 and 8 May 2002. A new supplementary agreement was signed on 25 February 2008.

⁽¹⁶⁾ As loans and guarantees for Member States are not covered by the Fund, the amount relating to the accession countries had to be repaid to the General Budget.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

10.39. The Court found that the Guarantee Fund was managed during 2007 in a satisfactory manner.

RESULTS OF THE AUDIT OF THE ECSC IN LIQUIDATION

10.40. After the expiry of the Treaty establishing the European Coal and Steel Community on 23 July 2002, the assets and liabilities of the ECSC were transferred to the European Community⁽¹⁷⁾. Their net worth, referred to as the European Coal and Steel Community in Liquidation (ECSC i.L.), is allocated to research in the coal and steel industry.

10.41. The winding-up of the financial operations of the ECSC i.L. is proceeding in compliance with the relevant legislation, including the multiannual financial guidelines.

10.42. At 31 December 2007, the total assets of the ECSC i.L. was 2 152 million euro compared to 2 174 million euro at 31 December 2006. The net profit for 2007 was 5,3 million euro compared to 23,8 million euro in 2006. This was mainly due to a loss on sales of available-for-sale bonds and other financial charges⁽¹⁸⁾. The performance of the ECSC i.L. portfolio was 2,13 % for the whole year 2007 while the benchmark, serving as reference rate for the ECSC i.L., was 2,75 %. The relative annual performance was thus – 0,62 % and therefore outside the acceptable range of – 0,44 % defined by the Commission.

10.42. *The decrease of profit (18 million euro) referred to the winding up operations (ECSC in liquidation) and is mainly due to the decrease of the total amounts of cancelled commitments linked to the operating budget (7 million euro) and the increase of other financial charges (11 million euro), linked to net present value calculations.*

The spread range is a management monitoring mechanism designed to assess the behaviour of the ECSC i.L. portfolio compared to its benchmark in normal times.

In a crisis context, such as the current 'sub-prime crisis' which began in August 2007, spreads should be expected to behave abnormally and thus fall outside ranges calculated on the basis on historical data from non-crisis times.

Although the benchmark index was not achieved, the positive absolute annual performance of 2,13 % compares favourably with the large privately managed global bond funds where a number experienced negative total performances.

FOLLOW-UP OF PREVIOUS OBSERVATIONS

10.43. See **Annex 10.2**.

⁽¹⁷⁾ Protocol on the financial consequences of the expiry of the ECSC Treaty and on the Research Fund for Coal and Steel (OJ C 80, 10.3.2001, p. 67).

⁽¹⁸⁾ Variation of net present value on new Member States' contribution of the Coal and Steel Research Fund and negative change of fair value of financial derivatives.

ANNEX 10.1

Assessment of the supervisory and control systems

System concerned	Key internal control				Overall assessment
	Adequate checklists	Ex-ante checks	Audit certification	Ex-post control	
Procurements			N/A	N/A	
Grants other than research projects			N/A	N/A	
Grants for research projects					

Legend

	Effective
	Partially effective
	Not effective
N/A	Not applicable: does not apply or not assessed

Results of transaction testing

Sample estimate of the proportion of transactions affected by an error	7,3 %
Error rate	Below 2 %

Follow-up of the Court's previous observations

Court observation	Action taken	Court analysis	Commission reply
<i>Phasing out of risk capital operations</i>			
<p>In its Annual Report, concerning the financial year 2005, paragraphs 11.6 to 11.13, the Court reported on the Phasing-out of five risk capital operations: The European Community Investment Partners (ECIP) managed by DG AIDCO, the MEDIA programmes managed by DG INFSO and three programmes managed by DG ECFIN (Venture consort, Eurotech Capital Programme and Joint Venture Programme). Main observations of the Court were as follows:</p>			
<i>ECIP Programme</i>			
<p>The Commission did not make significant progress in the closure of the programme and 1 276 of most problematic files were still open. Key financial information was missing for numerous files. Erroneous payments were not followed up and recovery orders were either not followed up or not issued. In March 2006 DG AIDCO estimated that the amount still to be recovered is 21 million euro.</p>	<p>In its reply the Commission announced that at the end of 2006 all files will be reviewed and that the Commission will be able to provide complete and reliable financial statements.</p> <p>In the meantime, new and simplified checklists for closing were implemented. As at 31.12.2007, 77 ECIP files were still pending for a global amount of 6,1 million euro, covered by 4,7 million euro of value reduction.</p>	<p>Despite the progress made in the closure of the files, the Court is still not yet able to confirm the reliability and the completeness of the financial statements linked to ECIP mainly due to uncertainties linked with the closure of the actions (pending legal actions, Financial Intermediary having lost contact with a beneficiary) and inconsistencies in the valuation, mainly due to incorrect value adjustments. No ending date for the liquidation of the ECIP programme can be given.</p>	<p><i>The liquidation of ECIP has continued during 2007 and the first part of 2008. End May 2008 there remained 30 actions to be closed compared to the more than 1 700 files open in March 2005. Since then the Commission has recovered more than 31,5 million euro. Tracing certain partners requires complex inquiries and has taken a considerable time.</i></p> <p><i>We have been prompted to revise the figures as a result of information obtained from partners during these inquiries. These figures are often called into question and we update the accounts only if an acceptable degree of confidence is attained.</i></p>
<i>MEDIA programmes</i>			
<p>The loans and subsidies granted to the audiovisual industry were subject to particularly complex conditions which require constant monitoring over a long time. Up to 2005, the MEDIA II programme was administered by a Technical Assistance Office (TAO) on behalf of the Commission. The Court found that, for financial operations before 2001, the Commission services had no detailed accounting information for the programme nor a specific auditor's certificate for the financial operations involved. For more recent transactions, documentation was often incomplete and there was inadequate follow-up, leading, in certain instances, to recovery orders not being issued in a timely manner.</p>	<p>The management of the MEDIA programme files were taken over by the new Education Audiovisual and Culture Executive Agency (EACEA) on 1 January 2006.</p> <p>The EACEA has set up specific procedures, enhanced the monitoring framework, ensured the standardisation of the files' documentation and built a database which should provide the detailed financial situation of each file.</p>	<p>The database used to manage MEDIA programmes, amounting to 35,5 million euro covered by a related value reduction of 24,85 million euro, is a major achievement. However, inaccuracies have been found in this database and improvements are still necessary.</p>	<p><i>The Commission takes note of the Court's comment about the establishment of the database. The Commission recognises that the Court's findings have led to the valuation of potential entitlements being reduced from 35,5 million euro to 35,0 million euro. The Commission intends to review these entitlements in order to determine whether their 'potential' status should not lead to any changes in the accounting principles which applied hitherto.</i></p>

Court observation	Action taken	Court analysis	Commission reply
<i>ECFIN programmes</i>			
<p>The audit of three programmes managed by DG ECFIN (Venture Consort, Eurotech Capital Programme and Joint Venture Programme) showed weaknesses in the management, follow-up and closure of the programmes.</p>	<p>In its reply, the Commission referred to the implementation of a proactive and overall strategy of closure of the remaining files and that it considers to have reasonable assurance on the accuracy and completeness of the figures related to the three programmes.</p>	<p>At the end of 2007 the Eurotech Programme was entirely closed. For Venture Consort there are two projects open for an original contribution of 0,4 million euro and for Joint Venture Programme there are four open projects for an initial investment of 1,1 million euro. The amounts are completely written down and the accounts were confirmed by the Court.</p>	<p><i>The Commission agrees with the Court's analysis for the situation at end 2007. Meanwhile, in 2008, the Commission has closed two further projects, one under Venture Consort and another under the Joint Venture Programme.</i></p>

CHAPTER 11

Administrative and other expenditure ⁽¹⁾

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⁽¹⁾ See paragraph 11.1.

THE COURT'S OBSERVATIONS

INTRODUCTION

11.1. This chapter covers the Court's findings on the administrative expenditure of the institutions, as intended in Article 1 of the Financial Regulation ⁽²⁾, included in heading 5 ('Administration') of the 'financial framework' ⁽³⁾, further administrative expenditure of the Commission not included in the above-mentioned heading 5 ⁽⁴⁾, and the operational expenditure relative to titles 24-27 and 29 of the Commission section of the general budget ⁽⁵⁾. In 2007 payments totalled 8 230 million euro. The distribution of payments among the abovementioned domains is given in **Graph 11.1** and the subdivision by institution in **Table 11.1**.

11.2. In addition, the chapter covers the Agencies and other decentralised bodies, and the European Schools.

Specific characteristics of administrative and certain operational expenditure

11.3. The appropriations relating to the administrative expenditure are managed directly by the institutions and are used to pay the salaries, allowances and pensions of persons working for the institutions, as well as rent, purchases and miscellaneous expenses.

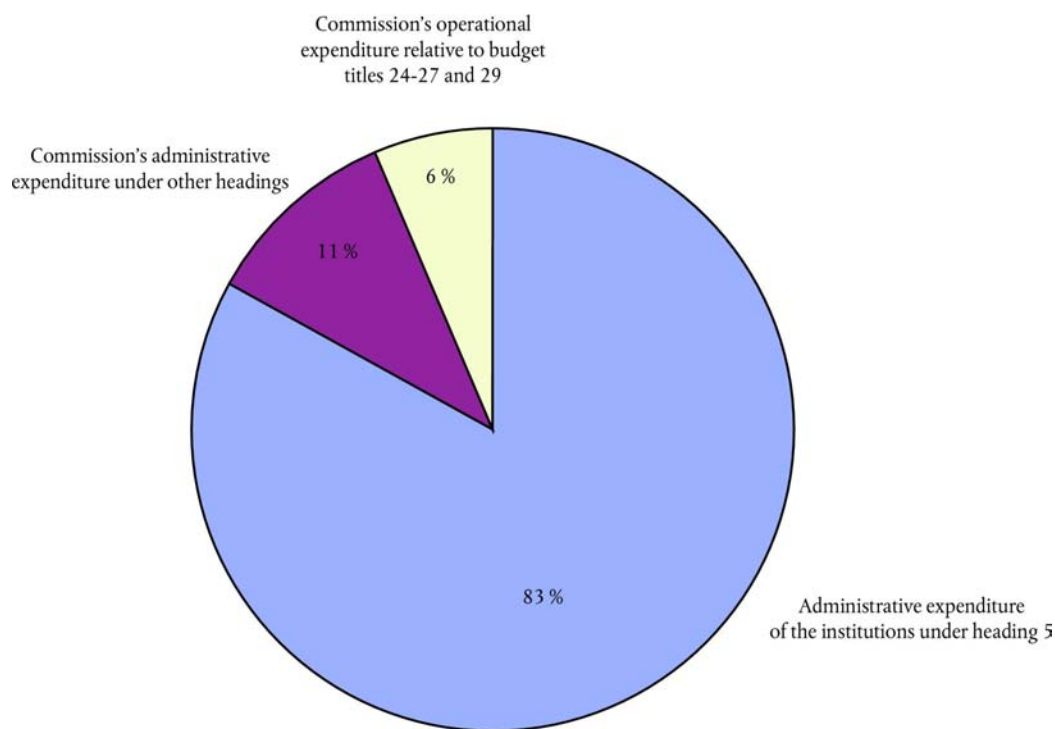
11.4. Past audits by the Court had shown that the errors found were not material. A follow-up to observations from past Annual Reports is presented in **Annex 11.2**.

⁽²⁾ European Parliament, Council, Commission, Court of Justice, Court of Auditors, European Economic and Social Committee, Committee of the Regions, European Ombudsman, European Data Protection Supervisor.

⁽³⁾ Interinstitutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management (OJ C 139, 14.6.2006).

⁽⁴⁾ Article 41(2) of the Financial Regulation requires that in the Commission section of the general budget the administrative appropriations of a title be grouped in a single chapter. This is done in chapter 01 of each title. Not all these administrative appropriations relate to the administrative expenditure included in 'heading 5', some relate to other headings of the Financial Framework.

⁽⁵⁾ Title 24 concerns 'fight against fraud', title 25 'Commission's policy coordination and legal advice', title 26 'Commission's administration', title 27 'budget' and title 29 'statistics'.

Graph 11.1 — Payments by domain

Total payments in 2007: 8 230 million euro

Source: 2007 annual accounts.

Table 11.1 — Payments in 2007

	(million euro)
European Parliament	1 329
Council	558
Commission	4 333
Court of Justice	265
Court of Auditors	107
European Economic and Social Committee	109
Committee of the Regions	68
European Ombudsman	7
European Data Protection Supervisor	4
Heading 5 of the Financial Framework	6 780
Commission's administrative expenditure under other headings ⁽¹⁾	932
Commission's operational expenditure ⁽¹⁾	518
Total	8 230

⁽¹⁾ For 2006 this expenditure was covered by other chapters of the Court's Annual Report concerning that year.

THE COURT'S OBSERVATIONS

SPECIFIC ASSESSMENT IN THE CONTEXT OF THE STATEMENT OF ASSURANCE

Audit scope

11.5. The Court examined the legality and regularity of the transactions underlying the accounts of the expenditure defined in paragraph 11.1, in order to provide a specific assessment in the context of the statement of assurance. The audit included the examination of a representative statistical sample of 56 transactions drawn from all of the abovementioned expenditure, as well as the examination of supplementary samples of transactions concerning subjects where specific risks had been identified during previous audits ⁽⁶⁾. The Court also assessed the supervisory and control systems applied by each institution to determine whether they satisfy the requirements of the Financial Regulation.

Specific observations

11.6. In 2007, all the institutions operated satisfactorily the supervisory and control systems required by the Financial Regulation and the transactions tested were free from material error of legality and regularity. However, the Court draws attention to the findings set out below, which, while not being material to the overall conclusions set out in paragraph 11.25, should be taken into consideration by the institutions concerned.

Multiplication factor applicable to salaries

11.7. Article 7 of Annex XIII to the Staff Regulations (SR), in force since 1 May 2004, provides for a progressive application of new salary scales, using a multiplication factor that reduces, with respect to the new, higher, salary scale, the monthly basic salary payable to an official recruited before 1 May 2004.

11.8. Article 5(5) SR states that 'identical conditions of recruitment and service career shall apply to all officials belonging to the same function group'. The findings set out below show that this is not the case for the application of the multiplication factor.

11.7-11.11. THE REPLY OF THE EUROPEAN PARLIAMENT

Article 7 of Annex XIII to the Staff Regulations introduced a complex mechanism, of which multiplication factors are an essential part, for ensuring the transition between the old and new salary scales applicable to the permanent and temporary staff of the European institutions. The inherent complexity of the mechanism in question was compounded by its being enshrined in a text which is singularly opaque (and even self-contradictory) and thus admits to no single unambiguous interpretation. While Parliament would have welcomed interinstitutional guidance or consensus as to the operation of this mechanism in 2005, when it had to devise rules for its own pending promotions, no such guidance or consensus was forthcoming. In applying the system as it did, Parliament was mindful of the enormous difficulties and anomalies inherent in an over-lengthy transitional period (and of the Commission's pre-reform explanatory document, which envisaged an end of the dual salary system

⁽⁶⁾ The subjects are: the application of the multiplication factor in calculating staff's pay, the employment of contract staff and payments on carried over appropriations.

THE COURT'S OBSERVATIONS

11.9. A new multiplication factor is calculated after the first promotion and, henceforth, recalculated every two years in accordance with the salary increases resulting from the salary scale. At institutions other than the Parliament, the staff do not receive the full amount of salary shown on the salary grid as long as the recalculated multiplication factor is less than 1. The Parliament applies a multiplication factor equal to 1 two years after the first promotion to everyone having, after promotion, a multiplication factor less than 1. There were 503 such cases in 2007. This procedure resulted in higher expenses as compared to the application of the procedure followed by the other institutions.

11.10. When a multiplication factor greater than 1 is calculated after a promotion, the Economic and Social Committee maintains this multiplication factor two years after the promotion, when the first advancement in step takes place, whilst the other institutions reduce the multiplication factor to 1 after the first advancement in step, and translate into seniority in step the part of the multiplication factor exceeding 1. By continuing to apply a multiplication factor higher than one, instead of converting into seniority in step the balance over 1, the Economic and Social Committee grants its staff a financial advantage which the other institutions do not grant.

by 2006). While it is now clear that other institutions have followed a different approach, Parliament considered the goal of shortening the transition to be a worthwhile objective. It has to be noticed that the two systems tend to converge relatively quickly, especially when the impact of second promotions is taken into account. In any event, an adaptation of the current practice may well give rise to considerable legal problems.

The Secretary-General, however, will appoint an administrative working group which will be charged to examine the subject in depth and to propose, if necessary, adequate adaptations.

11.10. REPLY OF THE ECONOMIC AND SOCIAL COMMITTEE

The Committee understands that some other institutions' practice is to convert a multiplication factor greater than 1, after the first advance in step, into an 'equivalent' seniority. It is however not convinced that this practice is the best reading of the Staff Regulations.

In this respect, the Committee is aware of several complaints of Commission staff, in accordance with Article 90(2) of the Staff Regulations, and of one formal appeal to the Court of Justice (F-22/07, L/Commission).

Therefore, the Committee continues to apply its current practice while waiting for the Court's ruling. In order to preserve the interests of the institution, all Committee officials concerned have been informed that its current practice is susceptible to revision. The Committee will then align its practice, if necessary retroactively, to the said ruling. In this way, provided the other European institutions do the same, Committee staff will be treated identically to all other officials of European institutions.

At the Committee, for a total of 237 promotions so far since the entry into force of the new staff Regulations (years 2004, 2005, 2006 and 2007), there were 25 cases of officials with a multiplication factor higher than one.

THE COURT'S OBSERVATIONS

11.11. The provisions of the Staff Regulations concerning the multiplication factor should be interpreted and implemented by all the institutions in the same way, so as to ensure a legal and regular application of the Staff Regulations by all institutions enabling thereby an equal treatment of their staff.

Parliament**Payments on carried over appropriations**

11.12. On 20 December 2006 the Parliament signed a contract concerning the supply of high definition broadcast cameras for the D5 building in Brussels. It was stated in the contract that the final payment of 30 % of the total price had to be made after the receipt and installation of the equipment. A final payment of 1 486 598 euro, which included the abovementioned 30 % (637 111 euro) took place on 19 December 2007. Although the equipment had been received, the document reporting the final acceptance of the goods, dated 17 December 2007, stated that the on-site installation would not occur before June 2008. The final payment (30 %) should not have been made, because it was not yet required by the contract, the corresponding amount of appropriations carried over from 2006 should have been cancelled and, for any payment due in 2008, appropriations from the 2008 budget should have been used.

11.12. THE REPLY OF THE EUROPEAN PARLIAMENT

The contract for the purchase of high-definition broadcast cameras for the D5 building in Brussels provides for the final payment of 30 % of the contract price after final receipt and installation of the equipment.

Acceptance was confirmed on 17 December 2007, but the installation was not performed because the building was not available.

The final payment was made on 19 December 2007 taking account of the following points: checks on the operation of each camera were deemed equivalent to their installation; the contractual guarantee for two years from the date of final reception was extended by six months; the supplier undertook to install the equipment as soon as the building became available.

The authorising officer considered these points to be sufficient to enable the final payment to be made using the appropriations carried over from 2006.

Follow-up to observations from past Annual Reports

11.13. The audit gave rise to remarks on actions and decisions taken as a follow-up to observations from past Annual Reports concerning the reimbursement of accommodation costs incurred on mission, the allowances for assistance to Members of the European Parliament and the additional pension scheme for Members of the European Parliament set out in **Annex 11.2**.

Council**Follow-up to observations from past Annual Reports**

11.14. The audit gave rise to remarks on actions taken as a follow-up to observations from past Annual Reports concerning payment of additional annual leave not taken set out in **Annex 11.2**.

THE COURT'S OBSERVATIONS

Commission ⁽⁷⁾**Rental expenditure (DG RELEX)**

11.15. City taxes for an amount of around 44 000 euro relating to a building rented by a Commission Delegation were paid on behalf of the lessor on the basis of an oral agreement, whereas, according to Article 88 of the Financial Regulation, contracts should be concluded in writing. A request for reimbursement was sent to the lessor, however not in the form of a 'debit note' complying with the requirements of Article 78(3) of the rules implementing the Financial Regulation (in particular, no deadline for the payment of the debt was set and the debtor was not informed that, failing payment by the deadline, recovery could be made by offsetting). Also no recovery order was established. The non-compliance with the abovementioned rules put the financial interests of the European Union at risk. Had the Delegation issued a timely and formally correct debit note, the claim could have been recovered by offsetting against the payment of the annual rent for 2008.

Payments on carried over appropriations (OIL)

11.16. In December 2007, to avoid cancelling carried over appropriations, OIL paid a fifth advance of 55 000 euro on service and maintenance charges for a building. According to the lease contract only four quarterly advances had to be paid. As the payment of a supplementary advance did not correspond to 'an obligation duly contracted' (Article 9(4) of the Financial Regulation), it should not have been made and a corresponding amount of carried over appropriations should have been cancelled.

⁽⁷⁾ The Commission departments responsible for most of the administrative expenditure are the following: Directorate-General (DG) for Personnel and Administration (ADMIN), DG for Translation (DGT), DG for Interpretation (SCIC), DG for Communication (COMM), DG for External Relations (RELEX), Office for Infrastructures and Logistics — Luxembourg (OIL), Office for Infrastructures and Logistics — Brussels (OIB), Office for the Administration and Settlement of Individual Entitlements (PMO), European Personnel Selection Office (EPSO) and Publications Office (OPOCE).

11.15. REPLY OF THE COMMISSION

The Commission accepts that the Delegation concerned did not follow adequate administrative and financial procedures. Management and supervisory systems in the delegation are now the subject of a thorough review and where necessary appropriate measures will be taken.

Regarding the payment of city charges on behalf of the owner of a rented building, the Commission agrees with the Court that the Delegation should have included a specific clause in this respect in the sublease contract.

Regarding the lack of a recovery order and the lack of a deadline for payment, the observations and comments of the Court are accepted, as adequate procedures required by the Financial Regulations and its Implementing Rules were not applied.

However, the Delegation followed the matter and recovered the total pre-paid amount (the total amount equivalent to EUR 44 000, approximately, was reimbursed to the Delegation by the owner of the rented building on 14 April 2008). Following this reimbursement, there is, in practice, no financial incidence for the Commission, in spite of the non-compliance with adequate procedures.

11.16. REPLY OF THE COMMISSION

OIL manages only administrative appropriations, which, under Article 179(1) of the Financial Regulation, are non-differentiated appropriations. In this connection, appropriations corresponding to obligations duly contracted at the close of the financial year can be carried over only to the following financial year (Article 9(4) of the Financial Regulation).

The lease for the building in question provides, as regards cost statements, for four advances and one final statement. At the end of 2007 OIL was informed that the co-owners of this building had rejected the 2006 final statement of costs established by the managing agent of the building. The amount still payable is estimated at over EUR 55 000.

So as not to doubly affect the budgetary principle of annuality, once in respect of the 2006 appropriations carried over which would have been cancelled and once in respect of the 2008 appropriations, OIL wrote asking the managing agent to recover an additional advance of EUR 55 000. At the beginning of June 2008 the final statement for 2006 had not yet been established.

THE COURT'S OBSERVATIONS

Salary payments (PMO)

11.17. *Ex-post* checks carried out by the PMO showed that, following a file processing error, in January 2007 a total amount of over 365 000 euro was paid to 118 former temporary agents, even though they no longer worked for the Commission. The error was not detected by *ex-ante* controls before the final payroll run, which illustrates a lack of sufficient control over the processes involved in running the payroll. Recoveries are still being made in 2008.

11.17. REPLY OF THE COMMISSION

At the time of the incident, most data used in the salary calculations were transmitted from Sysper (the staff data management system — since then replaced by Sysper2) to the salary calculation system NAP.

On 28 December 2006, a correction of data in Sysper was itself erroneous, leading to errors in the data transmitted. This was not detected by the ex-ante checks, because these had already taken place at that date, and was not picked up by the usual last minute control mechanisms, due to the holiday period and the reduced presence in the services.

The error was detected by mid-January 2007, but the amounts had already been paid out to the former temporary officials. For most of the cases the recovery presented no problems, and at this time (July 2008), 9 of the 118 cases are still open (including reimbursements in instalments).

The services involved have been reminded of the operating instructions concerning deadlines for last minute interventions and the period between last ex-ante controls and the final payroll run has been shortened.

Given the exceptional circumstances, the Commission is of the opinion that this does not warrant the conclusion that this incident illustrates the lack of sufficient control.

Follow-up to observations from past Annual Reports

11.18. The audit gave rise to remarks on actions taken as a follow-up to observations from past Annual Reports concerning reimbursement of accommodation costs incurred on mission and family allowances set out in **Annex 11.2**.

Court of Justice

Contract staff

11.19. The audit noted that the decision of the administrative committee of the Court of Justice relative to the recruitment and employment of contract staff does not set out any selection procedure for 'contract staff for auxiliary tasks' (Article 3b of the 'Conditions of employment of other servants of the European Communities'). Consequently, there are no formal selection procedures established by the Court of Justice for the recruitment of staff under short-term contracts to replace certain persons who are unable to perform their duties. For example, when language units at the translation service need to replace translators on maternity leave, the selection of replacement contract staff is at the discretion of the relevant head of service. Because of the absence of specific selection procedures for 'contract staff for auxiliary tasks' (including, for example, the use of selection committees) the provisions applied at the Court of Justice do not ensure that in such cases the requirements set out in

11.19. REPLY OF THE COURT OF JUSTICE

As a general rule, the Court of Justice only recruits 'Article 3b' contract staff either to replace officials or temporary agents who are absent on maternity or sick leave or, in exceptional circumstances, to bring in additional staff to help deal with an unusually heavy workload in a particular area. Such recruitments are usually for brief periods. In addition, most of these needs are for specialised staff (for instance, lawyer linguists), not readily available to come to Luxembourg for a brief employment contract.

These two factors — the brevity of the employment contracts and the frequent paucity of qualified candidates — explain why specific selection procedures have not been formally imposed so far for the recruitment of 'Article 3b' contract staff.

THE COURT'S OBSERVATIONS

Article 82(1) of the 'Conditions of employment of other servants of the European Communities' ⁽⁸⁾ are fully complied with and any risk of the appearance of non-objective selection is avoided.

We have no knowledge of any case where it could be said that the decision to recruit could have been influenced by non-objective elements. As regards, in particular, the replacement of lawyer linguists on maternity leave in the translation units, referred to by the Court of Auditors, all recruitments of 'Article 3b' contract staff were decided upon by the Authority authorised to conclude contracts (i.e. the Registrar of the Court), on a proposal from the head of unit, the director general for translation having been consulted. Ad hoc selection procedures were often put in place. All agents recruited for these auxiliary tasks fulfilled the requirements for the job as regards legal qualifications, knowledge of languages and experience in legal translation.

Court of Auditors

11.20. The Court of Auditors is audited by an independent external audit firm ⁽⁹⁾ which issued an independent assurance report concerning the legality and regularity of the use of the Court's resources, and the control procedures in place for the period from 1 January 2007 to 31 December 2007. The report states that, in the auditors' opinion, 'nothing has come to our attention that causes us to believe that in all material respects and based on (identified) criteria, (a) the resources assigned to the Court have not been used for their intended purposes, and (b) the control procedures in place do not provide the necessary guarantees to ensure the compliance of financial operations with the applicable rules and regulations'. The report will be published in the Official Journal.

European Economic and Social Committee

11.21. Apart from the point mentioned in paragraph 11.10, the audit did not give rise to any significant observations.

Committee of the Regions

11.22. The audit did not give rise to any significant observations.

⁽⁸⁾ 'Contract staff shall be selected on the broadest possible geographical basis from among nationals of Member States and without distinction as to racial or ethnic origin, political, philosophical or religious beliefs, age or disability, gender or sexual orientation and without reference to their marital status or family situation'.

⁽⁹⁾ PricewaterhouseCoopers, Société à responsabilité limitée, Réviseur d'Entreprises.

THE COURT'S OBSERVATIONS

European Ombudsman

11.23. The audit did not give rise to any significant observations.

European Data Protection Supervisor

11.24. The audit did not give rise to any significant observations.

Overall conclusions

11.25. Based on its audit work, the Court concludes that the transactions underlying the accounts of the expenditure referred to in paragraph 11.1 are free from material error and the supervisory and control systems in place conform to those required by the Financial Regulation.

EUROPEAN UNION AGENCIES

11.26. Audits of the European Union's Agencies and other decentralised bodies are the subject of Specific Annual Reports which are published separately in the Official Journal. The Court audited 27 Agencies for the financial year 2007. Their budgets totalled 1 243,5 million euro in 2007. The principal data concerning the agencies are set out in **Table 11.2**.

11.27. The Court issued unqualified opinions on the reliability of the accounts and the legality and regularity of the underlying transactions for all Agencies ⁽¹⁰⁾ audited except for the European Police College ⁽¹¹⁾ and the European GNSS Supervisory Authority ⁽¹²⁾.

⁽¹⁰⁾ The Court's annual reports on the Agencies accounts are presented on its site (<http://www.eca.europa.eu>) and will be published in the Official Journal, except for the Euratom Supply Agency.

⁽¹¹⁾ Qualified opinion with regard to the reliability of the accounts and the legality and regularity of the underlying transactions.

⁽¹²⁾ Disclaimer of opinion with regard to the reliability of the accounts.

THE COURT'S OBSERVATIONS

EUROPEAN SCHOOLS

11.28. The Court's Specific Annual Report on the European Schools (not published in the Official Journal) is submitted to the Board of Governors and to the Directors of the European Schools. The Schools' 2007 budget of 240,7 million euro was financed mainly by a Commission grant (129,2 million euro) and by contributions from the Member States (51,9 million euro) ⁽¹³⁾. The principal data concerning the European Schools are set out in **Table 11.3**.

11.29. The Court found no material errors that might call into question the reliability of the accounts that it examined and the legality and regularity of the transactions underlying these accounts.

⁽¹³⁾ Source: General introduction to the 2008 budget of the European Schools.

Table 11.2 — EU agencies — Principal data

Agencies and other decentralised bodies of the European Union	Headquarters	First year of financial autonomy	Budget ⁽¹⁾ (million euro)		Authorised posts	
			2007	2006	2007	2006
<i>Agencies</i>						
Euratom Supply Agency	Luxembourg	1960	0,3	0,2	—	—
European Centre for the Development of Vocational Training	Thessalonica	1977	17,4	16,8	97	95
European Foundation for the Improvement of Living and Working Conditions	Dublin	1977	20,2	19,8	94	94
European Environment Agency	Copenhagen	1994	35,1	37,1	116	115
European Training Foundation	Turin	1994	25,5	27	100	105
European Monitoring Centre for Drugs and Drug Addiction	Lisbon	1995	13,8	13	82	77
European Medicines Agency	London	1994	163,1	139	441	424
Translation Centre for the Bodies of the European Union	Luxembourg	1995	46,1	40,9	200	189
Community Plant Variety Office	Angers	1995	13,4	11,2	42	41
Office for Harmonization in the Internal Market	Alicante	1995	276	211,7	647	675
European Agency for Safety and Health at Work	Bilbao	1996	14,9	14,1	42	40
European Fundamental Rights Agency ⁽²⁾	Vienna	1998	14,5	9,4	46	37
European Agency for Reconstruction	Thessalonica	2000	250	271	108	108
European Police College ⁽³⁾	Bramshill	2006	7,4	5	22,5	22
Eurojust	The Hague	2002	18,4	14,7	147	112
European Aviation Safety Agency	Cologne	2003	72	65,7	467	328
European Maritime Safety Agency	Lisbon	2003	48,2	44,7	153	132
European Food Safety Authority	Parma	2003	52,2	40,2	300	250
European Network and Information Security Agency	Heraklion	2005	8,3	6,8	44	44
European Railway Agency ⁽³⁾	Valenciennes	2006	16,6	14,4	116	95
European Centre for Disease Prevention and Control	Stockholm	2005	28,9	17,1	90	50
European Agency for the Management of Operational Cooperation at the External Borders ⁽³⁾	Warsaw	2006	42,2	19,2	49	28
European GNSS Supervisory Authority ⁽³⁾	Brussels ⁽⁴⁾	2006	7,0	7	39	30
Community Fisheries Control Agency ⁽³⁾	Vigo	2007	5	—	38	
<i>Executive Agencies</i>						
Executive Agency for Competitiveness and Innovation ⁽³⁾	Brussels	2006	6,9	5,6	35	46
Education, Audiovisual and Culture Executive Agency ⁽³⁾	Brussels	2006	36	29,2	83	75
Public Health Executive Agency ⁽³⁾	Luxembourg	2007	4,1	—	28	—
Total			1 243,5	1 080,7	3 626,5	3 212

⁽¹⁾ Payment appropriations.⁽²⁾ Formerly the European Monitoring Centre on Racism and Xenophobia.⁽³⁾ Agency having acquired its financial independence in 2006.⁽⁴⁾ Provisional seat.

Table 11.3 — European schools — Principal data

European School	Country	Budget ⁽¹⁾ ⁽²⁾ (million euro)		Grant received from the Commission ⁽²⁾ (million euro)		School Population ⁽³⁾	
		2007	2006	2007	2006	2007	2006
Office	Belgium	9,3	8,8	7,5	7,5	—	—
Luxembourg I	Luxembourg	35,1	34,1	21,1	21,5	3 376	3 285
Luxembourg II	Luxembourg	7,0	6,9	2,9	3,7	897	922
Brussels I Uccle	Belgium	30,4	27,8	21,0	19,0	3 045	2 954
Brussels II (Woluwé)	Belgium	29,3	27,6	19,2	18,0	2 893	2 919
Brussels III (Ixelles)	Belgium	26,2	25,8	16,7	17,0	2 621	2 646
Brussels IV	Belgium	2,4	—	1,8	—	172	—
Mol	Belgium	11,2	10,9	6,0	6,1	657	654
Varese	Italy	17,9	16,5	8,8	8,4	1 317	1 317
Karlsruhe	Germany	11,9	11,7	3,5	3,4	1 001	964
Munich	Germany	18,9	18,5	0,4	1,0	1 666	1 599
Frankfurt	Germany	10,3	10,7	3,8	4,7	978	937
Alicante	Spain	11,3	11,1	4,2	6,0	1 017	990
Bergen	Netherlands	9,8	10,0	4,6	5,4	554	563
Culham	United Kingdom	11,1	10,8	5,9	5,4	827	832
Total		242,1	231,1	127,4	127,1	21 021	20 582

⁽¹⁾ Total revenue and expenditure as foreseen in the budget of each European School and the Office including all modifications made to the budgets initially adopted.

⁽²⁾ Source: European Schools, *clôture des comptes 2007*.

⁽³⁾ Source: 2007 Annual report of the Secretary General to the Board of Governors of the European Schools.

N. B.: Variations in totals are due to the effects of rounding.

ANNEX 11.1

Results of transaction testing of administrative and certain operational expenditure ⁽¹⁾

Sample estimate of the proportion of transactions affected by error	7 %
Error rate	below 2 %

⁽¹⁾ This table does not include data about Agencies and European Schools.

Follow-up to observations from past Annual Reports

Court observations	Action taken	Court analysis	Reply
<p><i>Reimbursement of accommodation costs incurred on mission</i></p> <p>Annual Reports concerning the financial year 2004, paragraph 9.6, and 2005, paragraph 10.7:</p> <p>The amended Staff Regulations, which entered into force on 1 May 2004, state that accommodation costs incurred on mission are reimbursed up to a maximum fixed for each country, on production of supporting documents (Article 13 of Annex VII to the Staff Regulations). Contrary to this rule, all the institutions, except the Court of Justice, the Court of Auditors and the Ombudsman, provided in their internal rules for the payment of a flat-rate sum, ranging from 30 to 60 % of the maximum allowable amount, to staff who do not produce any evidence of having incurred accommodation costs.</p>	<p>In the meantime, the Council, the European Economic and Social Committee and the Committee of the Regions have amended their internal rules so as to ensure compliance with the Staff Regulations.</p>	<p>The Parliament and the Commission should amend their internal rules in order to ensure that accommodation costs incurred on mission are reimbursed in compliance with the Staff Regulations, which were amended following a Commission's proposal agreed upon by the Parliament.</p>	<p>The European Parliament's replies</p> <p><i>The European Parliament is in a unique situation compared to other institutions in that very large numbers of its officials have to travel between Brussels, Luxembourg and Strasbourg in the course of their normal work. Such travelling between the three working places amounts to 91 % of EP missions and 88 % of the mission expenses. As a measure of sound financial management it is therefore more practical to apply the flat-rate system for staff travelling between the three working places. For missions outside the three working places, as foreseen by the Staff Regulations, reimbursement on the basis of supporting documents applies.</i></p> <p><i>Since the Court's previous observations on Parliament's rules on missions, the institution's internal auditor has conducted an audit of the mission regime. The conclusions in his report will give rise to a number of modifications to be proposed by the Secretary-General.</i></p> <p>The Commission's replies</p> <p><i>The Commission's mission guide has been reviewed in order to take the Court's remarks into account. There were delays in adoption of this text owing to several points of disagreement with the staff representatives, which have now been resolved. The text is expected to be adopted in September 2008 at the earliest.</i></p>
<p><i>Allowances for assistance to Members of the European Parliament (MEPs)</i></p> <p>Annual Report concerning the financial year 2006, paragraphs 10.10 to 10.12:</p> <p>As the major part of the amounts paid for MEPs' assistance allowance have not been subsequently justified by appropriate supporting documents of the expenses incurred on behalf of the MEPs, the Court considers that there is not sufficient documentation to demonstrate that the MEPs have actually employed or engaged the services of one or more assistants and that the duties or services mentioned in the contracts signed by the MEPs have been really carried out. The Bureau should take action in order to obtain the documents considered essential to prove that the expenditure was justified. Should these documents not be presented within reasonable time, appropriate measures, such as suspension of payments and/or issuing of recovery orders, should be initiated for the sums not justified.</p>	<p>On 13 December 2006 the Bureau amended the rules governing the Parliamentary Assistance Allowance. According to the amended rules, which apply to allowances paid in 2006 and 2007, invoices and fee statements issued by paying agents and service providers are no longer required to be submitted by MEPs, but must be retained by them. Instead, MEPs are required to submit copies of 'statements of expenditure' and 'statements of amounts invoiced' issued by paying agents and service providers.</p> <p>The Bureau decided at its meeting of 10 December 2007 that for the period from July 2004 to the end of 2005 'statements of expenditure' and 'statements of amounts invoiced' would also suffice.</p> <p>By the end of the Court's audit for 2007, the vast majority of documents justifying the 2006 and 2007 expenditure had been submitted and regularised by the Parliament's administration. Progress had also been made in collecting documents concerning the 2004 and 2005 expenditure.</p> <p>In 2008 the internal auditor of the European Parliament finalised an audit of the parliamentary assistance allowance and reported on weaknesses in this area.</p> <p>In the resolution of 22 April 2008 on the discharge for 2006, the Parliament called on its administration to correctly and consistently apply the rules and to improve implementing procedures and communication with MEPs.</p> <p>In the same resolution, the Parliament also noted that the Bureau had entrusted the Secretary-General to make contact with the Commission and the Council with a view to establishing a new set of rules and had charged a working group to assess the operation of the existing rules and to propose amendments as necessary.</p>	<p>The Parliament should:</p>	

Court observations	Action taken	Court analysis	Reply
		<ul style="list-style-type: none"> — ensure that all MEPs concerned provide 'statements of expenditure' and 'statements of amounts invoiced' for each year; — further enhance controls over the parliamentary assistance allowance, including random checks of invoices that the MEPs have in their possession; — take action to ensure that, when sufficient documentation to demonstrate that services paid for have been provided has not been submitted, appropriate measures, such as the suspension of payments and/or issue of recovery orders, are initiated for the sums not justified; — further develop the regulatory framework applied for the parliamentary assistance allowance, in order to address its weaknesses. 	<p>The European Parliament's replies</p> <ul style="list-style-type: none"> — <i>The administration is doing everything it can to ensure that the documents regularising parliamentary assistance expenses are submitted in accordance with the rules. A letter was sent to all Members concerned in February and March 2008 to inform them of the list of assistants and the amounts to be regularised, as well as the 31 May 2008 deadline for the submission of documents relating to the 2004 and 2005 financial years.</i> <i>For the 2007 regularisation exercise, a first reminder was sent to all the Members concerned in April. At the end of June, all the Members who had not submitted documents or who had submitted incomplete documents for one or more of these years received a reminder from the administration, signed by the Secretary-General. Members who did not act on this final reminder will have payments to their assistants suspended or will have the recovery procedure provided for in Article 27(3) of the Rules governing the payment of expenses and allowances to Members initiated against them.</i> <i>The regularisation exercise relating to parliamentary assistance expenses in 2006 has been completed. In every case where documentation was absent or incomplete (0,2 % of expenditure), the recovery procedure is under way. The same approach will be adopted for years in relation to which regularisation is in progress (July to December 2004, 2005 and 2007).</i> <i>During an ex-post check by the department responsible for managing the payments at the end of 2007, it was found that in a very limited number of cases the required social security attestation was lacking. In accordance with Article 14(5)(a) of the Rules governing the payment of expenses and allowances to Members, the payments concerned were suspended in every case where full documentation had not been submitted by the deadlines communicated to the Members concerned.</i> <i>For the 2004 and 2005 regularisation exercises, the documentary evidence sent by Members as at 12 September 2008 covered respectively 99,45 % and 99,33 % of the payments made. For the 2007 exercise the corresponding percentage is 99,63 %. For the three years as a whole, at this stage in the examination of the documentary evidence by the departments concerned, the documents accepted as providing adequate justification cover some 91 % of the payments made. Some of the documents received are still being processed and some have given rise to requests for additional information. Updated data will be sent to the Court before the 15 October 2008 deadline.</i> — <i>The Bureau was informed with the principle of doing more in-depth controls based on random checks once the deadline indicated in the last reminder has expired.</i> — <i>Regarding 2006, from the beginning of 2008 the Secretary-General sent letters to a dozen Members informing them of the initiation of the recovery procedure provided for in Article 27(3) of the Rules governing the payment of expenses and allowances to Members on account of failure to comply with the rules on parliamentary assistance expenses, and ordered that payments be suspended in around 10 cases.</i> — <i>On 10 March 2008 the Bureau, on a recommendation of the Conference of Presidents, charged the Secretary-General to ensure the consistent application and implementation of the European Parliament's internal rules on the reimbursement of Parliamentary assistance expenses, entrusted the Secretary-General to make contact with the Commission and the Council with a view to establishing a new set of rules and charged a working group to assess the operation of the existing rules and to propose amendments as necessary.</i> <i>On 9 July, as part of the procedure for the adoption of the implementing provisions for the Statute for Members, the Bureau adopted new rules based on the recommendations of the working group.</i>

Court observations	Action taken	Court analysis	Reply
<p><i>Additional pension scheme for Members of the European Parliament</i></p> <p>Annual Report concerning the financial year 2006, Table 10.2:</p> <p>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 case of a deficit.</p>	<p>No rules have been established defining the liabilities and responsibilities of the European Parliament and of the members of the scheme in case of a deficit</p>	<p>Appropriate rules should be established defining the liabilities and responsibilities of the European Parliament and of the members of the scheme in the event of a deficit.</p>	<p>The European Parliament's replies</p> <p><i>Confronted with an actuarial deficit, as at the end of 2004, of 43 765 745 euro, the issues relating to the management of the voluntary additional pension scheme for Members were debated by the Bureau at its meeting of 30 November 2005. On that occasion it approved the conclusions of its working group on the pension fund, namely:</i></p> <ul style="list-style-type: none"> — that the Rules governing the payment of expenses and allowances to Members should be amended so as to increase the total contribution rate from 39 % to 45 % with effect from 1 January 2006; — that a working group should be asked to submit, on the basis of an independent actuarial study, a report on the financial situation of the Fund following the approval of the Statute for Members; — it undertook to take the necessary measures, as part of the implementation of the new Statute, to guarantee the payment of the additional pensions after the entry into force of the new Statute in 2009; — it noted that, once these measures had been adopted, it would be possible to draw up the convention governing the respective relations and responsibilities of the Fund and of Parliament as mentioned by the Court of Auditors. <p><i>As the plan of measures adopted by the Bureau on 30 November 2005 indicates, it is only 'once these measures have been adopted that it will be possible to draw up the convention governing the respective relations and responsibilities of the Fund and of Parliament as mentioned by the Court of Auditors'. In accordance with this strategy, an actuarial study commissioned by Parliament was completed at the end of 2007 and has been forwarded to the Bureau working group responsible for drafting implementing provisions for the Statute for Members. Article 77 of the draft implementing provisions concerns the situation of the pension fund.</i></p> <p><i>At the meeting of 19 May 2008, the Bureau decided to abandon the system whereby Members' contributions were being deducted from their general expenses allowance. The Secretary-General sent a communication informing members of the pension fund of the change in procedure before the summer recess.</i></p> <p><i>On 9 July 2008, the Bureau adopted the implementing provisions, making it possible to proceed with the next stage. On the basis of what has been decided in these provisions on the future of the pension fund, the negotiations on a convention governing the relations and responsibilities between the fund and Parliament will begin soon and will probably be completed at the beginning of next year.</i></p>
<p><i>Payment by the Council of additional annual leave not taken</i></p> <p>Annual Reports concerning the financial years 2004, paragraph 9.18, and 2005, Table 10.2:</p> <p>At the Council additional annual leave granted before 31 December 1997 as a compensation for overtime is paid on retirement if the official has not taken the additional leave. As staff of the A and B categories are not entitled to compensation for overtime, such payments are not in accordance with Article 56 of the Staff Regulations.</p>	<p>Even though the General Secretariat has taken action in order to gradually eliminate the stock of compensatory leave for A and B staff granted before 31 December 1997, payments were still made in 2007 to compensate for additional leave not taken.</p>	<p>The payment of additional leave not taken should be discontinued.</p>	<p>The Council's replies</p> <p><i>As indicated in the replies to the Court of Auditors' reports for the previous years, the General Secretariat of the Council is aware of the Court's position concerning the payment of stocks of unused compensation days accumulated before 31 December 1997 and fully shares the observation of the Court about the necessity to bring the ongoing regularisation process to an end as soon as possible. As the Court has observed, a compulsory system aiming at the complete liquidation of all remaining stocks by 2009 has been put into place.</i></p> <p><i>In this context, the General Secretariat recalls its opinion that the continuation of the system for the progressive liquidation of these stocks until its final phase in 2009 is an inevitable consequence of the obligation to respect acquired rights as well as the fundamental principles of European law of legitimate expectations and equal treatment.</i></p> <p><i>Furthermore, the General Secretariat recalls that it has taken measures already in 1997 in order to prevent any repetition of such a situation in the future.</i></p> <p><i>The General Secretariat has also passed a decision that will prevent any residual payments linked to compensation days upon retirement. It should also be noted that the General Secretariat intends to finish work aimed at eliminating during 2009 all non-financial compensations not being in conformity with article 56 of the Staff regulations.</i></p>

Court observations	Action taken	Court analysis	Reply
<p><i>Follow-up of family allowances by the Commission</i></p> <p>Annual Reports concerning the financial year 2005, paragraph 10.12, and 2006, table 10.2:</p> <p>Staff receiving the household allowance and having no dependent children are not regularly required to update the information. There was no evidence that 676 out of 1 605 Commission staff concerned based in Brussels had been requested to confirm or update their original declarations. Insufficient checks were also carried out concerning cases where national dependent child allowances might have been received and, if so, should have been deducted from the allowances paid according to the Staff Regulations.</p> <p>In 2006 the Commission followed up 231 of the 676 cases and planned to follow up the remainder of these cases within two years.</p>	<p>The follow-up of the different types of allowances is still mainly based on the voluntary transmission of information by the staff. In February 2008, there were still 703 cases where the most recent check had been carried out before 2005, representing more than 37 % of the total of staff based in Brussels receiving the household allowance and having no dependent children.</p>	<p>Further action needs to be taken by the Commission to verify family allowances on a regular basis.</p>	<p>The Commission's replies</p> <p><i>Priority is currently given to the verification of the right to household allowances. As of May 2008, one member of staff is dedicated to this task in order to catch up the delays incurred in the verification process. At the same time, for the same persons, household allowances received from elsewhere are also checked and if necessary, the amounts are corrected retroactively. Other persons potentially receiving allowances from elsewhere, not recently controlled will follow.</i></p>

ANNEX I

Financial information on the general budget

CONTENTS

BACKGROUND INFORMATION ON THE BUDGET

1. Origin of the budget
2. Legal basis
3. Budgetary principles laid down in the Treaties and the Financial Regulation
4. Content and structure of the budget
5. Financing of the budget (budgetary revenue)
6. Types of budget appropriation
7. Implementation of the budget
 - 7.1. Responsibility for implementation
 - 7.2. Implementation of revenue
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8. Presentation of the accounts
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BACKGROUND INFORMATION ON THE BUDGET

1. ORIGIN OF THE BUDGET

The budget comprises the expenditure of the European Community and the European Atomic Energy Community (Euratom). It also includes administrative expenditure on cooperation in the fields of 'justice and home affairs' and the common foreign and security policy, as well as all other expenditure that the Council considers should be borne by the budget for the purpose of implementing these policies.

2. LEGAL BASIS

The budget is governed by the financial provisions of the Rome Treaties ⁽¹⁾ ⁽²⁾ (Articles 268 to 280 EC and Articles 171 to 183 Euratom) and by the financial regulations ⁽³⁾.

3. BUDGETARY PRINCIPLES LAID DOWN IN THE TREATIES AND THE FINANCIAL REGULATION

All items of Community revenue and expenditure are to be included in a single budget (unity and accuracy). The budget is authorised for one financial year only (annuality). Budgetary revenue and expenditure must balance (equilibrium). The accounts are established, implemented and presented in euro (unit of account). Revenue is to be used without distinction to finance all expenditure and, like the expenditure, is to be entered in full in the budget and subsequently in the financial statements without any adjustment of one item against another (universality). The appropriations are earmarked for specific purposes by title and chapter; the chapters are further subdivided into articles and items (specification). The budgetary appropriations are to be used in accordance with the principles of economy, efficiency and effectiveness (sound financial management). The budget is established and implemented and the accounts are presented in observance of the principle of transparency (transparency). There are some minor exceptions to these general principles.

4. CONTENT AND STRUCTURE OF THE BUDGET

The budget consists of a 'Summary statement of revenue and expenditure' and sections divided into 'Statements of revenue and expenditure' for each institution. The nine sections are: (I) Parliament; (II) Council; (III) Commission; (IV) Court of Justice; (V) Court of Auditors; (VI) Economic and Social Committee; (VII) Committee of the Regions; (VIII) European Ombudsman and (IX) European Data-protection Supervisor.

Within each section, items of revenue and expenditure are classified under budget headings (titles, chapters, articles and, where applicable, items) according to their type or the use to which they are to be applied.

5. FINANCING OF THE BUDGET (BUDGETARY REVENUE)

The budget is mainly financed from the Communities' own resources: GNI-based own resources; own resources accruing from VAT; customs duties; agricultural duties and sugar and isoglucose levies ⁽⁴⁾.

Besides own resources, there are other, marginal items of revenue (see **Diagram I**).

6. TYPES OF BUDGET APPROPRIATION

To cover estimated expenditure, the following types of budget appropriation are distinguished in the budget:

- (a) differentiated appropriations (DA) are used to finance multiannual activities in certain budgetary areas. They comprise commitment appropriations (CA) and payment appropriations (PA):
 - commitment appropriations make it possible to enter into legal obligations during the financial year for activities whose implementation extends over several financial years;

⁽¹⁾ Treaty of Rome (25 March 1957): Treaty establishing the European Economic Community (EEC).

⁽²⁾ Treaty of Rome (25 March 1957): Treaty establishing the European Atomic Energy Community (Euratom).

⁽³⁾ Mainly the Financial Regulation (FINREG) of 25 June 2002 (OJ L 248, 16.9.2002).

⁽⁴⁾ Principal legal acts relating to own resources: Council Decision 2007/436/EC of 7 June 2007 (OJ L 163, 23.6.2007); Council Decision 2000/597/EC, Euratom of 29 September 2000 (OJ L 253, 7.10.2000); Council Regulation (EC, Euratom) No 1150/2000 of 22 May 2000 (OJ L 130, 31.5.2000); Council Regulation (EEC, Euratom) No 1553/89 of 29 May 1989 (OJ L 155, 7.6.1989); Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (OJ L 347, 11.12.2006); Council Directive 89/130/EEC, Euratom of 13 February 1989 on the harmonisation of the compilation of gross national product at market prices (OJ L 49, 21.2.1989); Council Regulation (EC, Euratom) No 1287/2003 of 15 July 2003 on the harmonisation of gross national income at market prices (OJ L 181, 19.7.2003).

— payment appropriations make it possible to cover expenditure arising from commitments entered into during current and preceding financial years;

(b) non-differentiated appropriations (NDA) make it possible to ensure the commitment and payment of expenditure relating to annual activities during each financial year.

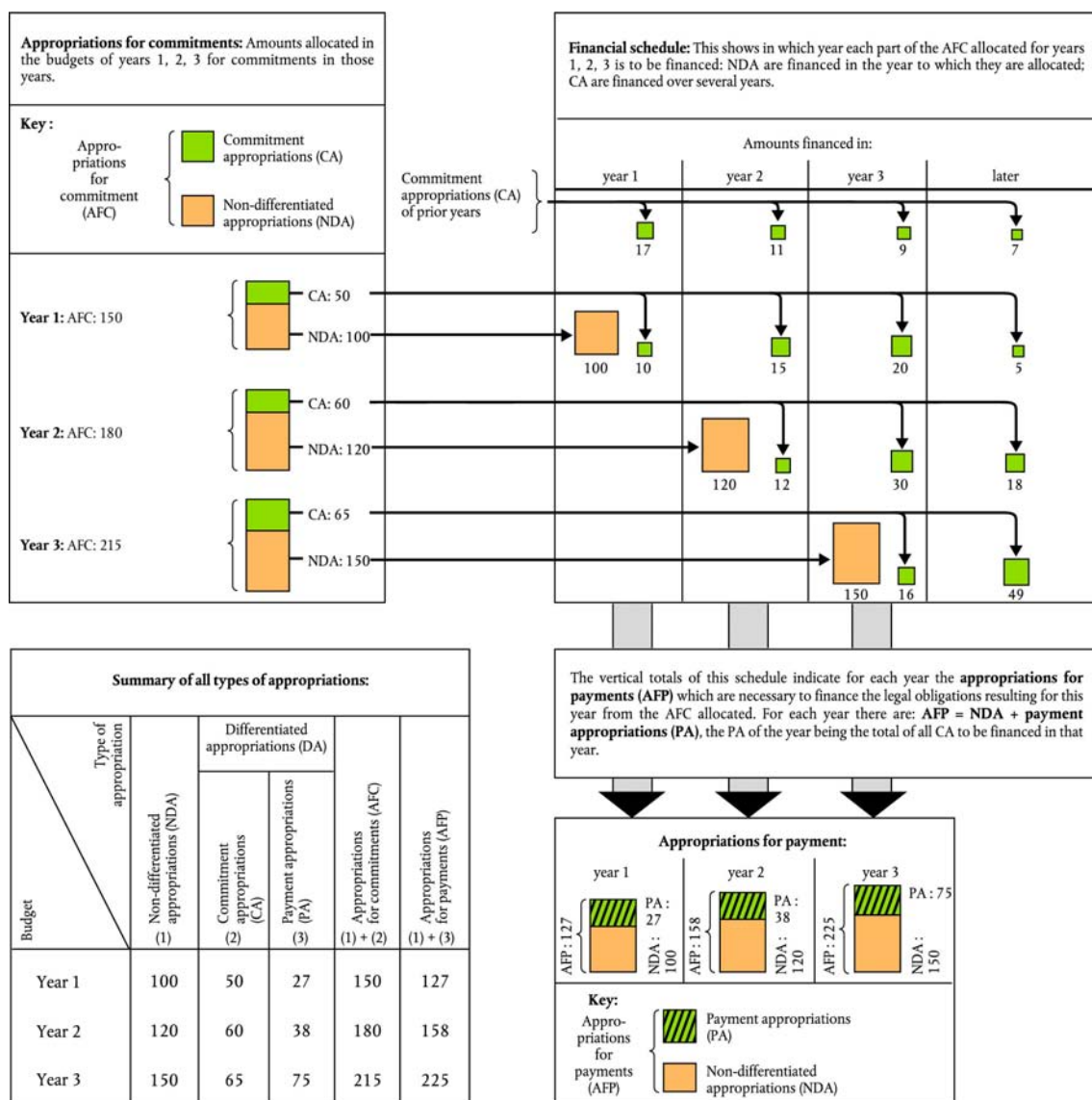
It is thus important to establish the following two totals for each financial year:

(a) the total of appropriations for commitments (AFC) ⁽⁵⁾ = non-differentiated appropriations (NDA) + commitment appropriations (CA) ⁽⁵⁾;

(b) the total of appropriations for payments (AFP) ⁽⁵⁾ = non-differentiated appropriations (NDA) + payment appropriations (PA) ⁽⁵⁾.

Revenue raised in the budget is intended to cover the total appropriations for payments. Commitment appropriations do not need to be covered by revenue.

The following simplified presentation (with illustrative amounts) shows the impact of these types of appropriations in each budget year.



⁽⁵⁾ It is important to note the differences between 'appropriations for commitments' and 'commitment appropriations' and between 'appropriations for payments' and 'payment appropriations'. The two terms 'commitment appropriations' and 'payment appropriations' are used exclusively in the context of differentiated appropriations.

7. IMPLEMENTATION OF THE BUDGET

7.1. Responsibility for implementation

The Commission implements the budget on its own responsibility in accordance with the Financial Regulation and within the limits of the allotted appropriations; it also confers upon the other institutions the requisite powers for the implementation of the sections of the budget relating to them ⁽⁶⁾. The Financial Regulation lays down the implementation procedures and, in particular, the responsibilities of the authorising officers, accounting officers, administrators of imprest accounts and internal auditors of the institutions. In the two largest areas of expenditure (EAGF and Structural Funds) the management of Community funds is shared with the Member States.

7.2. Implementation of revenue

The estimated revenue is entered in the budget subject to changes deriving from amending budgets.

The budgetary implementation of revenue consists of establishing the entitlements and recovering the revenue due to the Communities (own resources and other revenue). It is governed by certain special provisions ⁽⁷⁾. The actual revenue of a financial year is defined as the total of sums collected against entitlements established during the current financial year and sums collected against entitlements still to be recovered from previous financial years.

7.3. Implementation of expenditure

The estimated expenditure is entered in the budget.

The budgetary implementation of expenditure, i.e. the evolution and utilisation of appropriations, may be summarised as follows:

(a) appropriations for commitments:

- (i) *evolution of appropriations*: the total appropriations for commitments available in a financial year are made up as follows: initial budget (NDA and CA) + amending budgets + assigned revenue + transfers + commitment appropriations carried over from the preceding financial year + non-automatic carry-overs from the preceding financial year not yet committed + released commitment appropriations from preceding financial years which have been made available again;
- (ii) *utilisation of appropriations*: the final appropriations for commitments are available in the financial year for use in the form of commitments entered into (appropriations for commitments utilised = amount of commitments entered into);
- (iii) *carry-overs of appropriations from one financial year to the next financial year*: appropriations belonging to the financial year which have not been utilised may be carried over to the next financial year following a decision by the institution concerned. Appropriations available as assigned revenue are automatically carried over;
- (iv) *cancellation of appropriations*: the balance is cancelled;

(b) appropriations for payments:

- (i) *evolution of appropriations*: the total appropriations for payments available in a financial year are made up as follows: initial budget (NDA and PA) + amending budgets + assigned revenue + transfers + appropriations carried over from the previous financial year in the form of automatic carry-overs or non-automatic carry-overs;
- (ii) *utilisation of appropriations of the financial year*: the appropriations for payments of the financial year are available in the financial year for use as payments. They do not include appropriations carried over from the previous financial year (utilised appropriations for payments = amount of payments made against the appropriations of the financial year);
- (iii) *carry-overs of appropriations from one financial year to the next financial year*: unutilised appropriations of the financial year may be carried over to the next financial year following a decision by the institution concerned. Appropriations available as assigned revenue are automatically carried over;

⁽⁶⁾ See Articles 274 of the EC Treaty, 179 of the Euratom Treaty and 50 of the FINREG.

⁽⁷⁾ See Articles 69 to 74 of the FINREG and Regulation (EC, Euratom) No 1150/2000.

- (iv) *cancellation of appropriations*: the balance is cancelled;
- (v) *total payments during the financial year*: payments against appropriations for payments of the financial year + payments against appropriations for payments carried over from the preceding financial year;
- (vi) *actual expenditure charged to a financial year*: expenditure in the consolidated statements on budgetary implementation (see paragraph 7.4) = payments against appropriations for payments of the financial year + appropriations for payments of the financial year carried over to the following financial year.

7.4. *The consolidated statements on budgetary implementation and determination of the balance of the financial year*

The consolidated statements on budgetary implementation are drawn up after the closure of each financial year. They determine the balance of the year, which is entered in the budget of the next financial year through an amending budget.

8. PRESENTATION OF THE ACCOUNTS

The accounts for a given financial year are forwarded to the Parliament, the Council and the Court of Auditors; these accounts comprise financial statements and statements on budgetary implementation, together with a report on the budgetary and financial management. The provisional accounts are forwarded not later than 31st of March of the following year; the final accounts are due on 31 July of that year.

The 2007 annual accounts of the European Communities are the third set of accounts to be prepared under the accrual-accounting based rules brought in by the European Communities in 2005. 2007 also saw the updating of the Financial Regulation applicable to the general budget of the European Communities and the new version came into force on 1 May 2007.

It should be noted, that in the consolidated accounts 2007:

- total assets increased from 67 332 million euro in 2006 to 75 720 million euro, with total liabilities increasing from 131 550 million euro to 131 646 million euro. The difference between assets and liabilities will be financed in the short-term from budgetary funds already voted, or guaranteed by the Member States in the longer-term;
- the economic outturn for the year has increased from a surplus of 197 million euro in 2006 to a surplus of 10 120 million euro in 2007.

9. EXTERNAL AUDIT

Since 1977 the external audit of the budget has been carried out by the Court of Auditors of the European Communities ⁽⁸⁾. The Court of Auditors examines the accounts of all revenue and expenditure of the budget. It must provide the European Parliament and the Council with a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions. It also considers whether revenue has been received and expenditure incurred in a lawful and regular manner, and whether the financial management has been sound. The audits may be carried out before the closure of the financial year in question and are performed on the basis of records and, where necessary, on the spot in the institutions of the Communities, in the Member States and in third countries. The Court of Auditors draws up an annual report for each financial year and may also, at any time, submit its observations on specific questions and deliver opinions at the request of any of the institutions of the Communities.

10. DISCHARGE AND FOLLOW-UP

Since 1977 the following provisions have been applicable ⁽⁹⁾: Parliament, on the recommendation of the Council, gives, before 30 April of the second year following the financial year in question, discharge to the Commission in respect of its implementation of the budget. To this end, the Council and Parliament in turn examine the accounts presented by the Commission and the annual report and special reports of the Court of Auditors. The institutions must take appropriate action in response to the comments appearing in the decisions giving discharge and report on the measures taken.

⁽⁸⁾ See Articles 246, 247 and 248 of the EC Treaty, 160a, 160b and 160c of the Euratom Treaty and Articles 139 to 147 of the FINREG.

⁽⁹⁾ See Articles 276 of the EC Treaty and 180b of the Euratom Treaty.

EXPLANATORY NOTES

SOURCES OF FINANCIAL DATA

The financial data contained in this Annex have been drawn from the annual accounts of the European Communities and from other financial records provided by the Commission. The geographical distribution is in accordance with the country codes in the Commission's system of accounting information (ABAC). As the Commission points out, all the figures given by Member State — for both revenue and expenditure — are the result of arithmetic that gives an incomplete view of the benefits that each State derives from the Union. They must therefore be interpreted with circumspection.

MONETARY UNIT

All the financial data are presented in millions of euro. The totals are rounded from each exact value and will not therefore necessarily represent the sum of the rounded figures.

ABBREVIATIONS AND SYMBOLS

AFC	Appropriations for commitments
AFP	Appropriations for payments
AT	Austria
BE	Belgium
BG	Bulgaria
CA	Commitment appropriations
CY	Cyprus
CZ	Czech Republic
DA	Differentiated appropriations
DE	Germany
DIA	Diagram referred to within other diagrams (e.g. DIA III)
DK	Denmark
EAEC or Euratom	European Atomic Energy Community
EC	European Community(ies)
EE	Estonia
EEC	European Economic Community
EFTA	European Free Trade Association
EL	Greece
ES	Spain
EU	European Union
EU-27	Total for the 27 Member States of the European Union
FI	Finland
FR	France
FINREG	Financial Regulation of 25 June 2002
GNI	Gross National Income
HU	Hungary

IE	Ireland
IT	Italy
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NDA	Non-differentiated appropriations
NL	Netherlands
OJ	<i>Official Journal of the European Union</i>
PA	Payment appropriations
PL	Poland
PT	Portugal
RO	Romania
S	Budgetary section
SE	Sweden
SI	Slovenia
SK	Slovakia
T	Budgetary title
UK	United Kingdom
VAT	Value-added tax
0,0	Data between zero and 0,05
—	Lack of data

*DIAGRAMS***BUDGET FOR THE FINANCIAL YEAR 2007 AND BUDGETARY IMPLEMENTATION DURING THE FINANCIAL YEAR 2007**

- DIA I Budget 2007 — Estimated revenue and final appropriations for payments
- DIA II Budget 2007 — Appropriations for commitments
- DIA III Appropriations for commitments available in 2007 and utilisation thereof
- DIA IV Appropriations for payments available in 2007 and utilisation thereof
- DIA V Own resources in 2007 by Member State
- DIA VI Payments made in 2007, in each Member State

CONSOLIDATED ACCOUNTS FOR THE FINANCIAL YEAR 2007

- DIA VII Consolidated balance sheet
- DIA VIII Consolidated economic outturn account

Diagram I

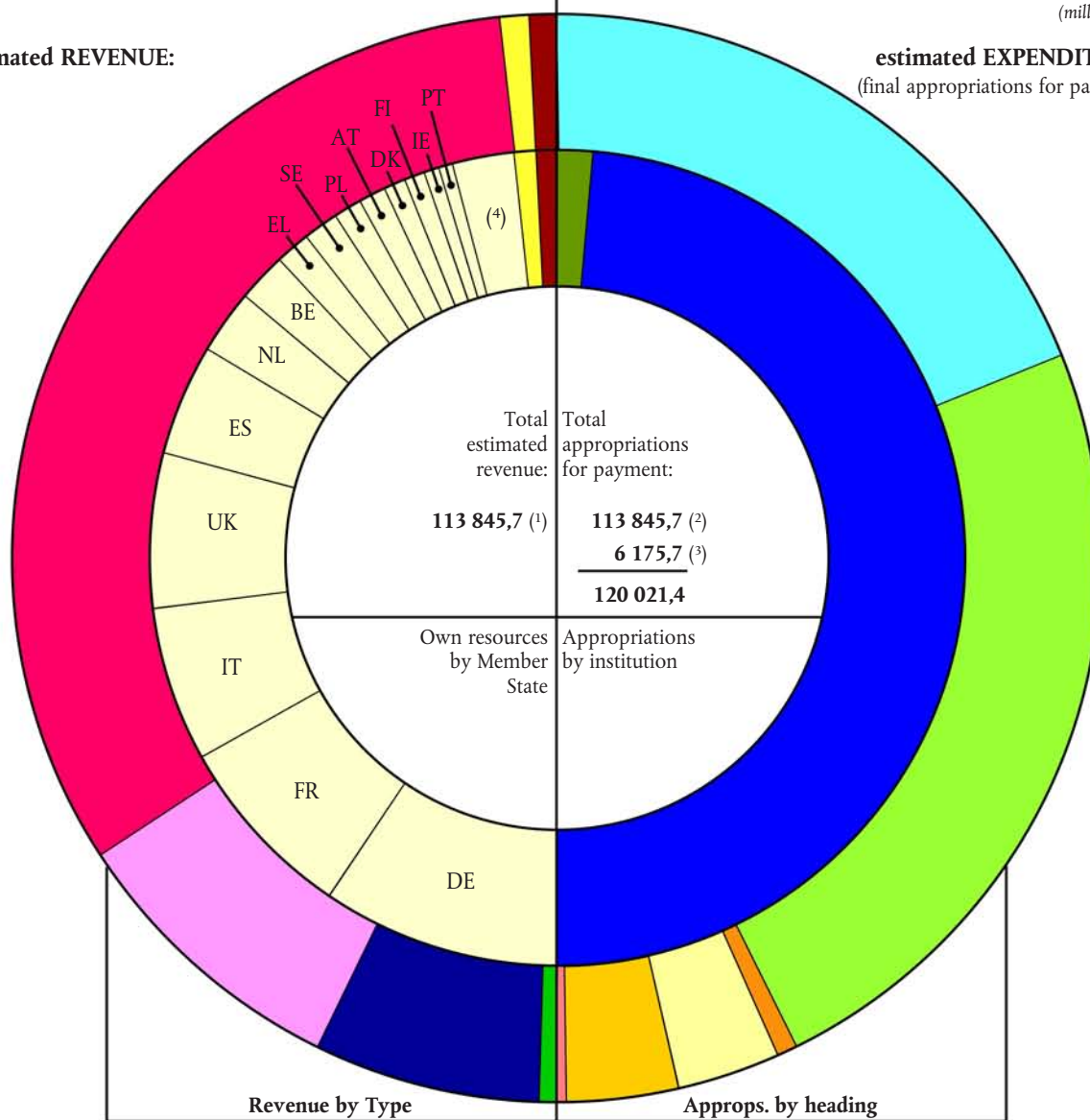
Budget 2007 — Estimated revenue and final appropriations for payments

[for revenue criteria, see 'Background information on the budget', paragraph 7.2; for expenditure criteria, see 'Background information on the general budget', paragraph 7.3 and for more detailed information, see Diagram IV, column (a)]

(million euro and %)

estimated REVENUE:

estimated EXPENDITURE:
(final appropriations for payment)



Revenue key:

Total own resources (by Member State)		
Agricultural duties	1 486,8	(1,3 %)
'Sugar' and 'isoglucose' levies	- 37,7	(0 %)
Customs duties	15 083,8	(13,2 %)
Own resources accruing from VAT	19 478,6	(17,1 %)
GNI-based own resources	74 022,0	(65 %)
Other revenue	1 703,7	(1,5 %)
Surplus available from the previous year	2 108,6	(1,9 %)

Expenditure key

Financial perspective headings:

1. Sustainable Growth	45 461,8	(37,9 %)
2. Preserv. Manage. of Natural Resources	57 019,7	(47,5 %)
3. Citizenship, freedom, security and justice	1 356,2	(1,1 %)
4. EU as a global player	7 779,5	(6,5 %)
5. Administration	7 959,5	(6,6 %)
6. Compensation	444,6	(0,4 %)
Appropriations available for other institutions	3 046,6	(2,5 %)
Appropriations available to the Commission	116 974,8	(97,5 %)
of which operating appropriations	112 061,9	(93,4 %)

(1) After amending budgets.

(4) Revenue contribution by CZ, RO, HU, SK, SI, LU, BG, LT, LV, EE, CY, MT was grouped together.

(2) After amending budgets and transfers between budget headings.

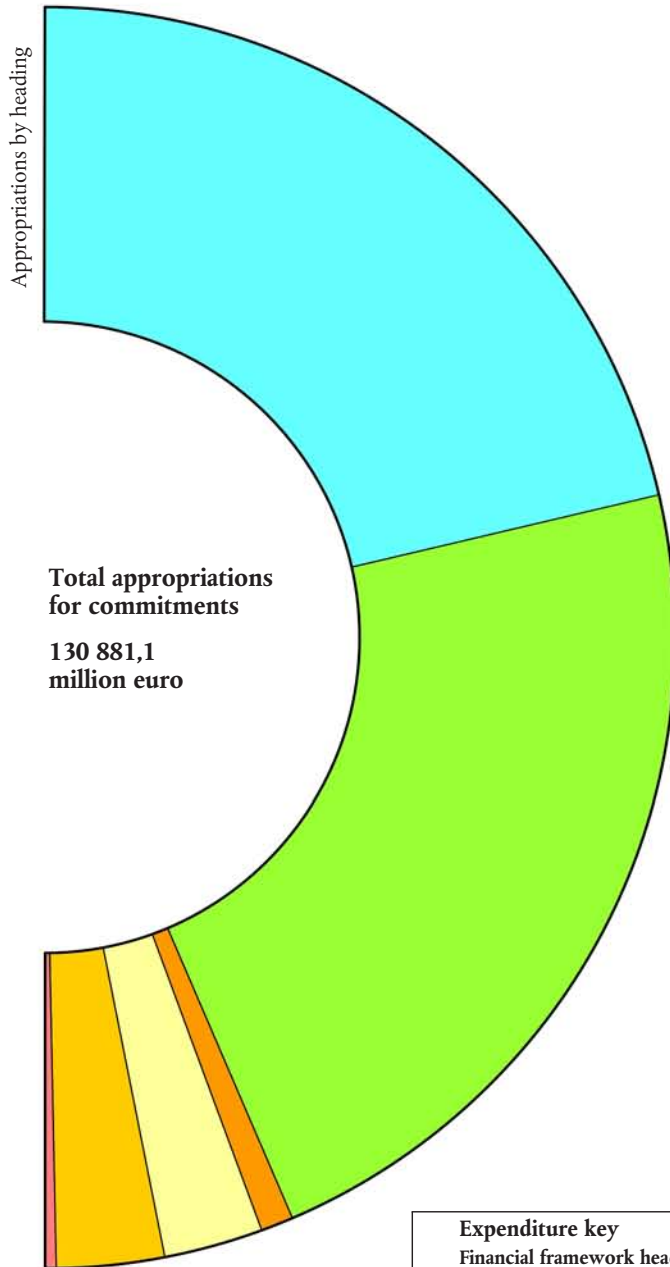
(3) Assigned revenue, appropriations made available again and carried over.

Diagram II

Budget 2007 — Appropriations for commitments

[after amending budgets; for more detailed information, see Diagram III, column (b)]

(million euro and %)



Note:
 The total appropriations for commitment are not balanced by the budgetary revenue of 2007 as the commitment appropriations also include amounts to be financed by budgetary revenue from subsequent years.

Expenditure key		
Financial framework headings:		
■	1. Sustainable Growth	56 060,3 (42,8 %)
■	2. Preserv. and Managem. of Natural Resources	58 399,1 (44,6 %)
■	3. Citizenship, freedom, security and justice	1 543,8 (1,2 %)
■	4. EU as a global player	7 142,3 (5,5 %)
■	5. Administration	7 291,0 (5,6 %)
■	6. Compensation	444,6 (0,3 %)

Diagram III

Appropriations for commitments available in 2007 and utilisation thereof

(million euro and %)

Sections (S) and titles (T) corresponding to the 2007 budgetary nomenclature and financial framework headings	Financial Framework	Final appropriations		Utilisation of appropriations					
		Amount ⁽¹⁾	Rate (%)	Commitments entered into	Utilisation Rate (%)	Carry-overs to 2008 ⁽²⁾	Rate (%)	Cancellations	Rate (%)
		(a)	(b)/(a)	(c)	(c)/(b)	(d)	(d)/(b)	(e) = (b) - (c) - (d)	(e)/(b)
<i>Budgetary nomenclature</i>									
I Parliament (S. I)		1 453,6		1 379,7	94,9	57,2	3,9	16,6	1,1
II Council (S. II)		650,2		532,4	81,9	107,8	16,6	10,0	1,5
III Commission (S. III) ⁽³⁾		128 183,3		120 326,5	93,9	4 531,8	3,5	3 325,0	2,6
III.1 Economic and financial affairs (T.01)		330,3		309,0	93,6	1,3	0,4	19,9	6,0
III.2 Enterprise (T.02)		575,0		537,5	93,5	28,0	4,9	9,6	1,7
III.3 Competition (T.03)		74,4		72,0	96,7	1,4	1,9	1,0	1,4
III.4 Employment and social affairs (T.04)		10 908,1		10 860,9	99,6	23,0	0,2	24,1	0,2
III.5 Agriculture and rural development (T.05)		57 040,8		52 026,7	91,2	3 385,7	5,9	1 628,4	2,9
III.6 Energy and transport (T.06)		1 884,6		1 835,7	97,4	37,9	2,0	11,0	0,6
III.7 Environment (T.07)		373,9		348,5	93,2	13,4	3,6	11,9	3,2
III.8 Research (T.08)		4 049,5		3 838,8	94,8	204,4	5,0	6,2	0,2
III.9 Information society and media (T.09)		1 537,0		1 491,0	97,0	42,0	2,7	4,0	0,3
III.10 Direct research (T.10)		662,8		401,7	60,6	260,9	39,4	0,2	0,0
III.11 Fisheries and maritime affairs (T.11)		958,9		706,5	73,7	5,3	0,6	247,1	25,8
III.12 Internal market (T.12)		57,3		55,3	96,5	0,9	1,5	1,1	2,0
III.13 Regional policy (T.13)		35 434,0		34 880,2	98,4	135,1	0,4	418,8	1,2
III.14 Taxation and customs union (T.14)		113,8		100,9	88,7	1,8	1,6	11,1	9,7
III.15 Education and culture (T.15)		1 440,2		1 326,7	92,1	110,8	7,7	2,7	0,2
III.16 Communication (T.16)		204,1		196,9	96,5	1,2	0,6	5,9	2,9
III.17 Health and consumer protection (T.17)		571,9		502,2	87,8	9,4	1,7	60,2	10,5
III.18 Area of freedom, security and justice (T.18)		693,2		626,0	90,3	10,6	1,5	56,7	8,2
III.19 External relations (T.19)		3 882,8		3 782,5	97,4	36,9	1,0	63,4	1,6
III.20 Trade (T.20)		73,8		71,6	97,0	0,9	1,3	1,3	1,7
III.21 Development and relations with ACP States (T.21)		1 409,9		1 304,9	92,5	97,3	6,9	7,8	0,6
III.22 Enlargement (T.22)		1 133,1		1 052,6	92,9	77,7	6,9	2,7	0,2
III.23 Humanitarian aid (T.23)		759,3		758,0	99,8	0,8	0,1	0,5	0,1
III.24 Fight against fraud (T.24)		72,6		68,8	94,7	0,0	0,0	3,8	5,3
III.25 Commission's policy coordination and legal advice (T.25)		177,6		169,4	95,4	3,5	2,0	4,7	2,7
III.26 Commission's Administration (T.26)		1 048,1		995,4	95,0	29,1	2,8	23,6	2,3
III.27 Budget (T.27)		508,8		499,1	98,1	1,8	0,3	7,9	1,5
III.28 Audit (T.28)		9,9		9,1	91,8	0,2	1,7	0,6	6,4
III.29 Statistics (T.29)		130,0		114,1	87,7	2,0	1,6	13,9	10,7
III.30 Pensions (T.30)		997,5		994,5	99,7	0,0	0,0	3,0	0,3
III.31 Language Services (T.31)		403,4		389,8	96,6	8,5	2,1	5,1	1,3
III.40 Reserves (T.40)		666,7		—	—	—	—	666,7	100,0
IV Court of Justice (S. IV)		274,7		266,0	96,8	1,6	0,6	7,1	2,6
V Court of Auditors (S. V)		121,5		109,6	90,2	0,3	0,2	11,6	9,6
VI Economic and Social Committee (S. VI)		116,3		106,6	91,6	0,6	0,5	9,1	7,8
VII Committee of the Regions (S. VII)		68,2		65,7	96,2	0,1	0,1	2,5	3,7
VIII European Ombudsman (S. VIII)		8,2		7,4	90,5	—	—	0,8	9,5
IX European Data-protection Supervisor (S. IX)		5,0		4,3	86,1	—	—	0,7	13,9
Grand total appropriations for commitments	124 455,0	130 881,1	105,2	122 798,4	93,8	4 699,4	3,6	3 383,3	2,6
<i>Financial Framework ⁽⁴⁾</i>									
1 Sustainable Growth	53 978,0	56 060,3		54 255,6	96,8	782,9	1,4	1 021,9	1,8
2 Preservation and Management of Natural Resources	55 142,0	58 399,1		53 121,7	91,0	3 353,5	5,7	1 923,9	3,3
3 Citizenship, freedom, security and justice	1 273,0	1 543,8		1 421,9	92,1	46,0	3,0	76,0	4,9
4 EU as a global player	6 578,0	7 142,3		6 636,8	92,9	273,7	3,8	231,8	3,2
5 Administration	7 039,0 ⁽⁵⁾	7 291,0		6 917,8	94,9	243,3	3,3	129,9	1,8
6 Compensation	445,0	444,6		444,6	100,0	—	—	—	—
Grand total appropriations for commitments	124 455,0	130 881,1	105,2	122 798,4	93,8	4 699,4	3,6	3 383,3	2,6
Grand total appropriations for payments	122 190,0	120 021,4	98,2	113 953,3	94,9	4 603,3	3,8	1 464,8	1,2

⁽¹⁾ Final budget appropriations after taking account of transfers between budget headings, appropriations corresponding to assigned revenue or similar and appropriations carried over from the previous financial year. As a consequence the ceiling for some financial framework headings is exceeded by the available appropriations.

⁽²⁾ Including appropriations corresponding to assigned revenue or similar.

⁽³⁾ For Section III (Commission) the titles (T) correspond to the activities/policy areas as defined by the institution for implementing activity based budgeting (ABB).

⁽⁴⁾ The ceilings of the financial framework headings comprise the adjustment foreseen in the point 48 of the Interinstitutional Agreement of 2006.

⁽⁵⁾ The Interinstitutional Agreement of 2006 states in its annex that the ceiling for this heading is presented net of staff contributions to the pension scheme, up to a maximum of 500 million euro at 2004 prices for the period 2007-2013. In 2007 this reduction amounts to 75,8 million euro.

Diagram IV

Appropriations for payments available in 2007 and utilisation thereof

(million euro and %)

Sections (S) and titles (T) corresponding to the 2007 budgetary nomenclature and financial framework headings	Final appropriations (1)	Utilisation of appropriations					
		Payments made in 2007	Utilisation rate (%)	Carry-overs to 2008	Rate (%)	Cancellations	Rate (%)
		(a)	(b)/(a)	(c)	(c)/(a)	(d) = (a) - (b) - (c)	(d)/(a)
<i>Budgetary nomenclature</i>							
I Parliament (S. I)	1 668,2	1 329,1	79,7	308,5	18,5	30,6	1,8
II Council (S. II)	741,4	557,6	75,2	163,0	22,0	20,8	2,8
III Commission (S. III) (2)	116 974,8	111 506,5	95,3	4 092,6	3,5	1 375,7	1,2
III.1 Economic and financial affairs (T.01)	328,7	262,1	79,7	6,9	2,1	59,6	18,1
III.2 Enterprise (T.02)	549,7	369,8	67,3	62,5	11,4	117,3	21,3
III.3 Competition (T.03)	81,6	70,7	86,7	8,8	10,7	2,1	2,6
III.4 Employment and social affairs (T.04)	11 664,4	11 547,4	99,0	27,9	0,2	89,0	0,8
III.5 Agriculture and rural development (T.05)	55 802,4	53 685,2	96,2	1 965,0	3,5	152,1	0,3
III.6 Energy and transport (T.06)	1 142,3	918,8	80,4	162,8	14,3	60,7	5,3
III.7 Environment (T.07)	283,9	231,8	81,6	23,0	8,1	29,1	10,3
III.8 Research (T.08)	3 311,8	2 678,5	80,9	609,4	18,4	24,0	0,7
III.9 Information society and media (T.09)	1 436,4	1 226,7	85,4	180,8	12,6	29,0	2,0
III.10 Direct research (T.10)	656,0	405,9	61,9	238,7	36,4	11,4	1,7
III.11 Fisheries and maritime affairs (T.11)	1 248,1	1 039,0	83,2	13,1	1,0	196,0	15,7
III.12 Internal market (T.12)	63,9	54,4	85,2	6,5	10,2	2,9	4,6
III.13 Regional policy (T.13)	26 693,1	26 583,0	99,6	14,2	0,1	95,8	0,4
III.14 Taxation and customs union (T.14)	122,9	84,7	68,9	7,9	6,4	30,3	24,6
III.15 Education and culture (T.15)	1 449,8	1 260,5	86,9	162,0	11,2	27,3	1,9
III.16 Communication (T.16)	223,1	182,8	81,9	20,8	9,3	19,5	8,7
III.17 Health and consumer protection (T.17)	582,5	447,8	76,9	42,6	7,3	92,1	15,8
III.18 Area of freedom, security and justice (T.18)	428,4	258,8	60,4	97,5	22,8	72,1	16,8
III.19 External relations (T.19)	3 429,3	3 264,6	95,2	67,7	2,0	97,0	2,8
III.20 Trade (T.20)	75,8	65,1	85,9	6,4	8,5	4,3	5,7
III.21 Development and relations with ACP States (T.21)	1 343,7	1 192,8	88,8	105,8	7,9	45,1	3,4
III.22 Enlargement (T.22)	1 793,2	1 748,5	97,5	19,6	1,1	25,1	1,4
III.23 Humanitarian aid (T.23)	764,3	755,6	98,9	6,9	0,9	1,7	0,2
III.24 Fight against fraud (T.24)	75,0	59,7	79,6	5,8	7,8	9,4	12,6
III.25 Commission's policy coordination and legal advice (T.25)	194,4	170,2	87,5	18,5	9,5	5,7	2,9
III.26 Commission's Administration (T.26)	1 154,7	965,4	83,6	150,9	13,1	38,5	3,3
III.27 Budget (T.27)	517,7	497,9	96,2	10,8	2,1	9,1	1,8
III.28 Audit (T.28)	10,8	8,9	83,0	1,0	9,4	0,8	7,5
III.29 Statistics (T.29)	133,6	102,0	76,4	12,6	9,4	18,9	14,2
III.30 Pensions (T.30)	997,5	994,5	99,7	0,0	0,0	3,0	0,3
III.31 Language Services (T.31)	415,9	373,4	89,8	36,0	8,7	6,5	1,6
III.40 Reserves (T.40)	—	—	—	—	—	—	—
IV Court of Justice (S. IV)	288,0	264,7	91,9	14,5	5,0	8,7	3,0
V Court of Auditors (S. V)	128,8	107,0	83,1	9,1	7,1	12,6	9,8
VI Economic and Social Committee (S. VI)	127,6	109,3	85,7	7,9	6,2	10,4	8,2
VII Committee of the Regions (S. VII)	77,7	67,5	86,9	6,2	8,0	4,0	5,1
VIII European Ombudsman (S. VIII)	8,6	7,3	84,0	0,6	6,4	0,8	9,6
IX European Data-protection Supervisor (S. IX)	6,4	4,2	66,7	1,0	16,0	1,1	17,3
Grand total appropriations for payments	120 021,4	113 953,3	94,9	4 603,3	3,8	1 464,8	1,2
<i>Financial Framework</i>							
1 Sustainable Growth	45 461,8	43 713,0	96,2	1 359,1	3,0	389,7	0,9
2 Preservation and Management of Natural Resources	57 019,7	54 648,4	95,8	1 957,7	3,4	413,6	0,7
3 Citizenship, freedom, security and justice	1 356,2	1 049,8	77,4	162,6	12,0	143,8	10,6
4 EU as a global player	7 779,5	7 291,8	93,7	184,0	2,4	303,8	3,9
5 Administration	7 959,5	6 805,6	85,5	940,0	11,8	214,0	2,7
6 Compensation	444,6	444,6	100,0	—	—	—	—
Grand total appropriations for payments	120 021,4	113 953,3	94,9	4 603,3	3,8	1 464,8	1,2

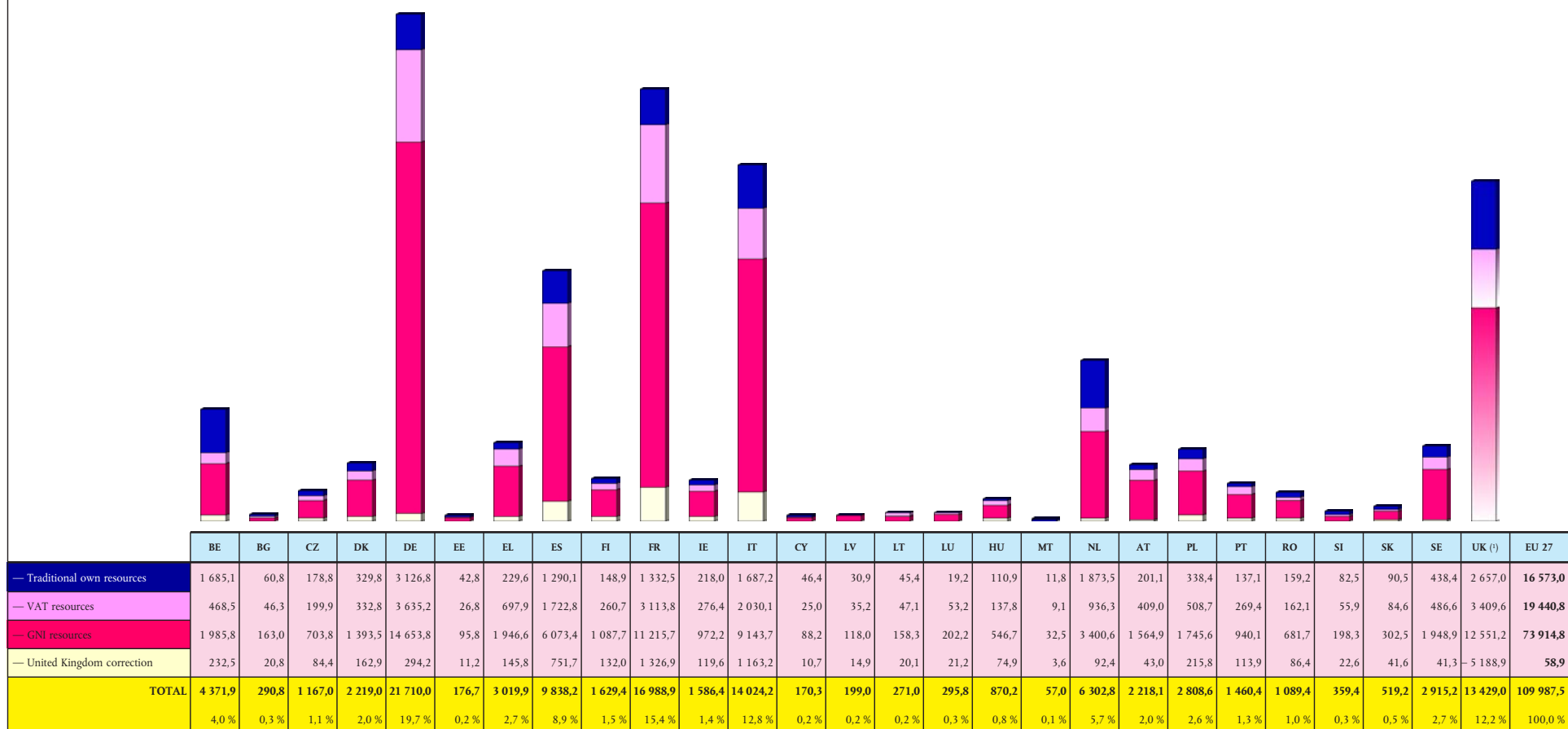
(1) Final budget appropriations after taking account of transfers between budget headings, appropriations relating to assigned revenue or similar and appropriations carried over from the previous financial year.

(2) For Section III (Commission) the titles (T) correspond to the activities/policy areas as defined by the institution for implementing activity based budgeting (ABB).

Diagram V
Own resources in 2007, by Member State

Revenue Outturn

(million euro and %)



(¹) For the United Kingdom a correction (5 188,9 million euro) is applied to the gross amount of own resources (18 617,8 million euro). The financing of this adjustment is borne by the other Member States. This correction was solely assigned to the VAT and GNI elements of gross own resources in accordance with their respective amounts.

Diagram VI

Payments made in 2007, in each Member State ⁽¹⁾

Note: Payments made in 2007 = payments against 2007 operating appropriations plus payments against carry-overs from 2006.

Financial framework headings

(million euro and %)

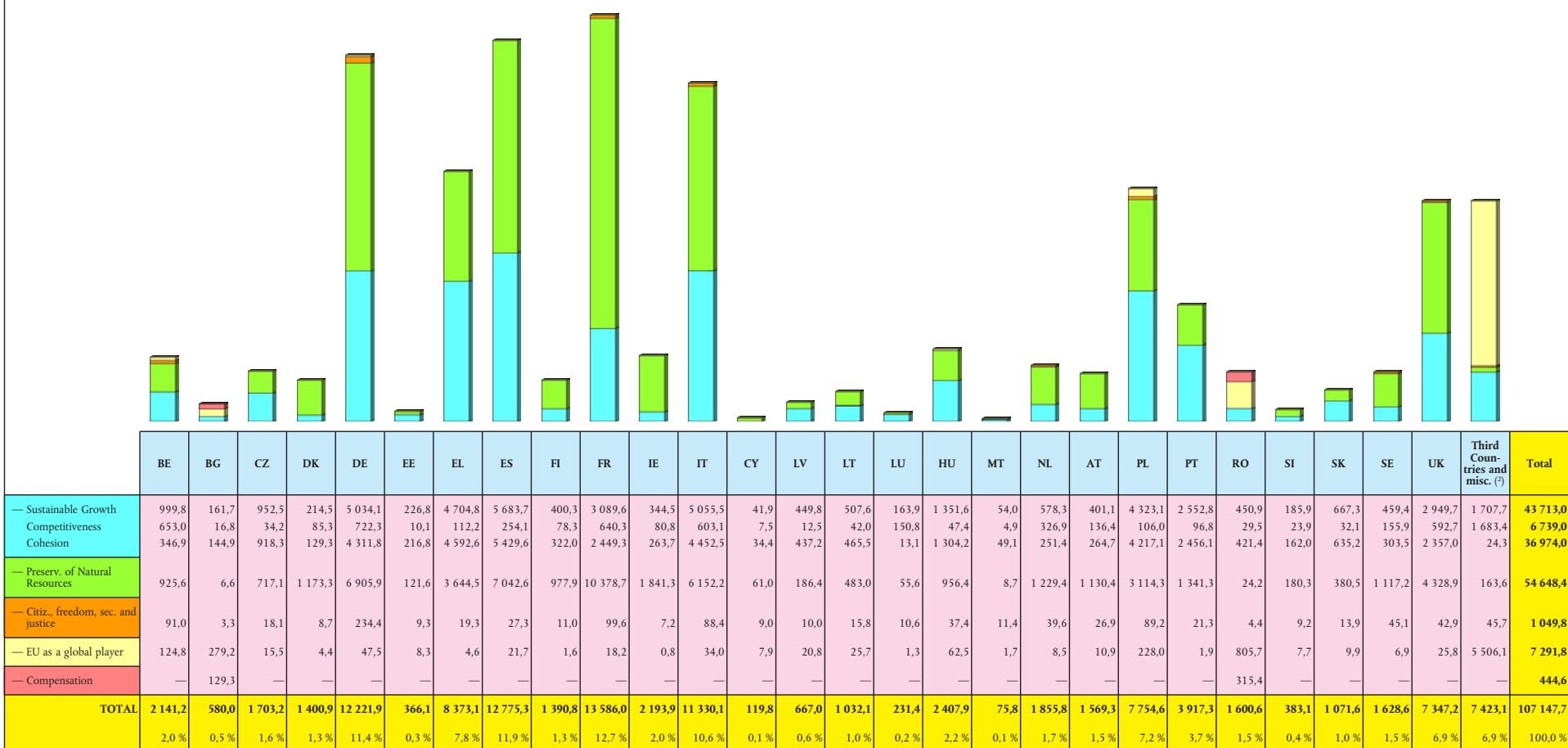
⁽¹⁾ The geographical breakdown is not by payments made to the Member States but by expenditure according to the data in the Commission's computerised accounting system ABAC.⁽²⁾ The amounts under 'Third Countries and miscellaneous' mainly include expenditure related to the projects implemented outside the Union and participation by third countries. Expenditure in respect of which the geographical distribution could not be made is also included.

Diagram VII

Consolidated balance sheet

(million euro)

	31.12.2007	31.12.2006
Non-current assets:		
Intangible assets	44,0	37,0
Property, plant and equipment	4 523,0	4 586,0
Long-term investments	1 973,0	2 157,0
Loans	1 806,0	2 023,0
Long-term pre-financing	14 015,0	22 425,0
Long-term receivables	127,0	328,0
	22 488,0	31 556,0
Current assets:		
Inventories	88,0	115,0
Short-term investments	1 420,0	1 426,0
Short-term pre-financing	20 583,0	8 055,0
Short-term receivables	12 051,0	9 796,0
Cash and cash equivalents	18 756,0	16 384,0
	52 898,0	35 776,0
Total assets	75 386,0	67 332,0
Non-current liabilities:		
Employee benefits	– 33 480,0	– 32 200,0
Long-term provisions	– 1 079,0	– 989,0
Long-term financial liabilities	– 1 574,0	– 1 862,0
Other long-term liabilities	– 1 989,0	– 2 020,0
	– 38 122,0	– 37 071,0
Current liabilities:		
Short-term provisions	– 369,0	– 379,0
Short-term financial liabilities	– 135,0	– 20,0
Accounts payable	– 95 380,0	– 94 080,0
	– 95 884,0	– 94 479,0
Total liabilities	– 134 006,0	– 131 550,0
Net assets	– 58 620,0	– 64 218,0
Reserves	2 806,0	2 855,0
Amounts to be called from Member States:		
<i>Employee benefits (long-term)</i>	– 33 480,0	– 32 200,0
<i>Other amounts</i>	– 27 946,0	– 34 873,0
Net assets	– 58 620,0	– 64 218,0

Diagram VIII
Consolidated economic outturn account

(million euro)

	31.12.2007	31.12.2006
Operating revenue		
Own resource and contributions revenue	112 084	105 118
Other operating revenue	9 080	8 368
	121 164	113 486
Operating expenses		
Administrative expenses	- 7 120	- 6 619
Operating expenses	- 104 682	- 106 803
	- 111 802	- 113 422
Surplus from operating activities	9 362	64
Financial revenue	674	621
Financial expenses	- 354	- 331
Movement in employee benefits liability	- 2 207	108
Share of net surplus (deficit) of associates and joint ventures	- 13	- 265
Economic outturn for the year	7 462	197

ANNEX II

List of Special Reports adopted by the Court of Auditors since the last Annual Report:

- Special Report No 6/2007 on the effectiveness of technical assistance in the context of capacity development
- Special Report No 7/2007 on the control, inspection and sanction systems relating to the rules on conservation of Community fisheries resources
- Special Report No 8/2007 concerning administrative cooperation in the field of value added tax
- Special Report No 9/2007 'Evaluating the EU Research and Technological Development (RTD) framework programmes — could the Commission's approach be improved?'
- Special Report No 1/2008 concerning the procedures for the preliminary examination and evaluation of major investment projects for the 1994-1999 and 2000-2006 programming periods
- Special Report No 2/2008 concerning Binding Tariff Information (BTI)
- Special Report No 3/2008 — The European Union Solidarity Fund: how rapid, efficient and flexible is it?
- Special Report No 4/2008 concerning the implementation of milk quotas in the Member States which joined the European Union on 1 May 2004
- Special Report No 5/2008 — The European Union's agencies: Getting results
- Special Report No 6/2008 concerning European Commission Rehabilitation Aid following the Tsunami and Hurricane Mitch
- Special Report No 7/2008 — Intelligent Energy 2003-2006

These reports can be accessed for consultation or downloading on the European Court of Auditors' website:
www.eca.europa.eu

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IV

(Notices)

NOTICES FROM EUROPEAN UNION INSTITUTIONS AND BODIES

COURT OF AUDITORS



In accordance with the provisions of Article 248(1) and (4) of the EC Treaty and Articles 129 and 143 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, as last amended by Council Regulation (EC) No 1525/2007 of 17 December 2007 and Articles 139 and 156 of Council Regulation (EC) No 215/2008 of 18 February 2008 on the Financial Regulation applicable to the 10th European Development Fund,

the Court of Auditors of the European Communities, at its meeting of 24 and 25 September 2008, adopted its

ANNUAL REPORTS**concerning the financial year 2007**

The reports, together with the institutions' replies to the Court's observations, were transmitted to the authorities responsible for giving discharge and to the other institutions.

The Members of the Court of Auditors are:

Vítor Manuel da SILVA CALDEIRA (President), Hubert WEBER, Maarten B. ENGWIRDA, Máire GEOGHEGAN-QUINN, David BOSTOCK, Morten Louis LEVYSOHN, Ioannis SARMAS, Július MOLNÁR, Vojko Anton ANTONČIČ, Gejza HALÁSZ, Jacek UCZKIEWICZ, Josef BONNICI, Irena PETRUŠKEVIČIENĚ, Igors LUDBORŽS, Jan KINŠT, Kersti KALJULOID, Kikis KAZAMIAS, Massimo VARI, Juan RAMALLO MASSANET, Olavi ALA-NISSILÄ, Lars HEIKENSTEN, Karel PINXTEN, Ovidiu ISPIR, Nadejda SANDOLOVA, Michel CRETIN, Harald NOACK, Henri GRETHEN.

ANNUAL REPORT ON THE ACTIVITIES
FUNDED BY THE SEVENTH, EIGHTH
AND NINTH EUROPEAN DEVELOPMENT
FUNDS (EDFS)

(2008/C 286/02)

**Annual Report on the activities funded by the seventh, eighth and ninth
European Development Funds (EDFs)**

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THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

INTRODUCTION

1. The European Development Funds (EDFs) are the result of international conventions or agreements ⁽¹⁾ between the Community and its Member States, of the one part, and certain African, Caribbean and Pacific (ACP) States, of the other part, and of Council Decisions on the association of overseas countries and territories (OCT).

1.-5. *The EDF is in effect the EU's main development aid instrument for the ACP countries. Although the Commission agrees with the Court's opinion on a number of points, we would like to point out the high risks associated with management of the EDF in view of:*

- *the significant volume of funds implemented,*
- *the weak administrations in certain partner countries,*
- *the numerous serious problems in most of the beneficiary countries, including weak governance.*

In view of these factors, the Commission has established a control strategy at different levels comprising the use of supervisors and auditors and controls not only by the contracting authorities but also directly by the Commission's delegations and central services.

This control strategy must of course take account of a risk analysis and also a cost/benefit ratio. The Commission considers that the provisions it has established are effective and that they meet the criteria established. Based on the remarks of the Court, but also on its own experience, the Commission has fine-tuned this strategy in recent years and will continue to do so in future.

The Court's report should be read in the light of the environment in which the Commission is obliged to operate and the risk inherent in this type of activity should be taken into account.

2. The Commission has responsibility for and takes charge of the management of most of the expenditure of the EDFs. The EDF's investment facility has been fully managed by the European Investment Bank ⁽²⁾ (EIB) since 1 April 2003. This facility is not covered by the Court's Statement of Assurance or the European Parliament's discharge procedure ⁽³⁾ ⁽⁴⁾.

⁽¹⁾ The Yaoundé I Convention dates back to 1964. The most recent agreement (Cotonou) dates from 23 June 2000 and was revised in Luxembourg on 25 June 2005.

⁽²⁾ Thus, under the ninth EDF, the initial allocation amounted to 13 800 million euro, of which the EIB is responsible for 2 200 million euro.

⁽³⁾ See Articles 96, 103 and 112 of the Financial Regulation of 27 March 2003 applicable to the ninth EDF (OJ L 83, 1.4.2003, p. 1). In its Opinion No 12/2002 on the proposal for this Regulation (OJ C 12, 17.1.2003), the Court stressed that these provisions reduce the scope of the European Parliament's powers of discharge.

⁽⁴⁾ A tripartite agreement between the EIB, the Commission and the Court (Article 112 of the Financial Regulation of 27 March 2003 applicable to the ninth EDF referred to above) sets out rules for the audit of these operations by the Court.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

3. Once programming is complete, EDF resources are mobilised in two stages. The Commission makes the financing decision (shown in the accounts as financial commitments) following receipt of a request from an ACP State. The Commission and the ACP State then lay down the rules for the implementation of these decisions by the National Authorising Officer (NAO) of the country concerned within the framework of a financing agreement or directly by the Commission. The NAO concludes contracts (shown in the accounts as individual legal commitments) and authorises payments, which will be checked and executed by the Commission.

4. Budget support is not subject to this system of management. Financing agreements constitute legal commitments and give rise to payments without any individual legal commitments being entered into. Once the Commission has checked that the conditions of the Cotonou Agreement and the financing agreement have been met, it makes an initial transfer of funds to the budget of the recipient country. Once transferred, these funds merge with the budget of the ACP State, where they are used and audited in accordance with the laws and procedures of the recipient country. The Commission, jointly with other main international donors, assesses both the improvements made to the management of public finances in these countries and the results in terms of poverty reduction. Before making subsequent disbursements, the Commission checks that the conditions laid down in the financing agreement have been met.

5. Within the Commission, most of the EDF programmes are managed by the EuropeAid Co-operation Office (hereafter called EuropeAid). A small proportion of the EDF projects ⁽⁵⁾ relates to humanitarian aid and is managed by the Directorate-General for Humanitarian Aid (DG ECHO).

CHAPTER I — IMPLEMENTATION OF THE SEVENTH, EIGHTH AND NINTH EDFs

Financial implementation

6. Following the closure of the sixth EDF in 2006, the seventh, eighth and ninth EDFs were implemented simultaneously in 2007. It is projected that the seventh EDF will be closed in 2008.

7. Total contributions received in 2007 from the Member States amounted to 2 679 million euro, including 39 million euro voluntary contributions to the African Peace Facility in the framework of Intra ACP cooperation ⁽⁶⁾. During the year, the Commission started calling up contributions under the ninth EDF as those due under the eighth EDF were fully exhausted.

6.-8. *In line with the Monterrey and Paris declarations, in 2007 the Commission continued its efforts to step up aid and make it more effective. 2007, like 2006, was a very successful year for implementation of the EDFs. Once again, there was a record level of contracts and payments made, a substantial reduction in old and 'dormant' commitments and progress towards the final closure of the 7th EDF. The objective for the end of 2007 was to commit all the 9th EDF appropriations, resulting in EUR 15,9 billion being implemented for 2003-2007, i.e. 100 % of the funds under the 9th EDF. This is the highest level ever in the history of the EDF.*

⁽⁵⁾ Representing 0,8 % of the 2007 payments.

⁽⁶⁾ Decision No. 2/2007 of the ACP-EC Council of Ministers of 25 May 2007 (OJ L 175, 5.7.2007, p. 35).

THE COURT'S OBSERVATIONS

8. The tenth EDF will be committed in the period from 2008 to 2013; it provides for Community aid to ACP countries for 21 966 million euro which represents a 62 % increase compared with the financial allocations of the ninth EDF.

9. **Tables 1 and 2** show the cumulative use of EDF resources managed by the Commission and the financial implementation. **Charts I and II** show the cumulative resources and decisions by sector of intervention. In May 2005, the Council decided that funds from the ninth EDF had to be committed before 31 December 2007 (7). In line with this so called 'sunset clause', virtually all funds under the ninth EDF had been committed by that date. This was achieved by the significant increase of 16,7 % of global commitments which amounted to 3 172 million euro. Net payments increased by 4,1 % and reached 2 874 million euro which is slightly lower than the initial target due to cash flow restraints at the end of the year.

10. As a result of this, outstanding payments increased from 10 281 million euro at the end of 2006 to 10 579 million euro at the end of 2007. Of total outstanding payments, 903 million euro relates to funds committed more than five years ago. Global commitments for which no individual legal commitments or payments have been made in the last two years decreased however significantly to 100 million euro at year-end. The implementation rate, as measured by the ratio of total unspent funds to annual payments, remained stable at 3,7 years.

THE COMMISSION'S REPLIES

As regards quality, in 2006 the Commission introduced total coverage by the Quality Support Group of all EDF financing proposals in the identification and assessment phases. This practice was also applied in 2007.

The Commission will continue its efforts to improve even further the implementation of the EDF and will continue to follow up the Court's recommendations in this connection.

The 10th EDF allocation of EUR 21 966 million (operational credits for the ACP, excluding the Overseas Countries Territories (OCTs)) covers a six-year period, against a five-year period for the 9th EDF (initial amount, without taking into account the transfer of the balances of the previous EDFs — see point 9 —, of EUR 13 500 million). For the sake of comparison, funds should be annualised, in which case the nominal increase is reduced to 35,6 %.

9. *This is the first time ever that an entire EDF has been committed before the entry into force of the next EDF. When the 9th EDF entered into force in April 2003, almost 2 billions EUR remained uncommitted under the 8th EDF.*

10. *The Commission's performance was exceptional in 2007. Payments increased significantly by 12 %, commitments increased by 9 % and the increase in outstanding commitments was kept down to 2,8 %.*

The implementation rate of 3,7 years corresponds to the average project implementation period.

(7) Decision 2005/446/EC of the Representatives of the Governments of the Member States meeting within the Council (OJ L 156, 18.6.2005, p. 19), as amended by Decision 2007/792/EC of 26 November 2007 (OJ L 320, 6.12.2007, p. 31).

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

11. The sector of social infrastructure, including education, health, water and basic sanitation, was the principal recipient of EU aid with 852 million euro (31 % of total payments) in 2007, followed by the transport, communication and energy sector with 799 million euro (28 %). Total payments made in the area of commodity aid and general programme assistance, including food aid and food security equalled 557 million euro, of which 455 million euro (16 % of total payments) had been spent by means of general budget support programmes. Aid implementation continued to involve close cooperation with UN organisations and the World Bank (306,5 million euro, i.e. 10,7 % of payments).

The Commission's annual report on the financial management of the EDFs

12. The Financial Regulation applicable to the ninth EDF ⁽⁸⁾ requires the Commission to report each year on the financial management of the EDFs. The Court carried out a review of this report to assess whether it fairly describes the achievement of objectives, the financial situation and the events that had a significant influence on the year's activities. The review included the verification of the accuracy of the financial data presented and the follow-up of observations made previously by the Court and recommendations made by the discharge authority.

13. In the Court's opinion, the report on the financial management presents an accurate description of the achievement of the objectives for the financial year, the financial situation and the events that had a significant influence on the activities carried out in 2007. However, the summary of the Commission's follow-up to observations by the Court does not provide, in a number of cases, sufficient information on the actions taken or planned; the Court presents its analysis of the situation in **table 4**. Moreover, the information provided by the ACP States with respect to the use of Stabex funds ⁽⁹⁾ and bank balances of accounts held at banks within the ACP States remains unreliable due to the complexity of the measure and the limited control by EuropeAid which is aware of this and intended to initiate audits of the Stabex funds in all ACP countries concerned in 2007. However, audits were carried out in only four out of the 38 beneficiary countries.

13. *The Commission attaches the greatest importance to the Court's recommendations, which have all been followed up. The Commission considers that, overall, satisfactory action has been undertaken with regard to the Court's recommendations but will provide more detailed information in the future.*

Although not required under the provisions of Article 212 of the Lomé IV Convention, the Commission decided to reinforce the control of Stabex funds, by performing audits. Out of a total of 38 beneficiary countries, 10 did not register any movement of those funds in 2007, and 14 were subject to audits concerning either the reliability of the Stabex Accounts (eight countries) or projects financed through Stabex funds (six countries).

⁽⁸⁾ Articles 96 and 102.

⁽⁹⁾ The financial importance of the Stabex programme is decreasing as the measure is being phased out. At end-2007, about 100 million euro remained at security accounts held in Europe under the sole control of the Commission compared to 192 million euro at end-2006. The Commission's target is that these funds are to be paid by 31 December 2010 provided that all disbursement conditions have been fulfilled.

CHAPTER II — STATEMENT OF ASSURANCE BY THE COURT OF AUDITORS ON THE EDFs

Statement of Assurance by the Court of Auditors on the seventh, eighth and ninth European Development Funds (EDFs) for the financial year 2007

I. Pursuant to the provisions of Article 248 of the Treaty the Court has audited

- (a) the 'Final annual accounts for the financial year 2007 of the 7th, 8th and 9th European Development Funds' which comprise the consolidated financial statements ⁽¹⁰⁾ and the consolidated report on the financial implementation of the seventh, eighth and ninth EDFs; and
- (b) the legality and regularity of the underlying transactions within the legal framework of the EDFs in respect of the part of the EDF resources for whose financial management the Commission is responsible ⁽¹¹⁾.

Management's responsibility

II. In accordance with the Financial Regulations applicable to the seventh, eighth and ninth EDFs, management ⁽¹²⁾ is responsible for the preparation and fair presentation of the final annual accounts of the EDFs and the legality and regularity of the underlying transactions:

- (a) The management's responsibility concerning the final annual accounts of the EDFs includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, selecting and applying appropriate accounting policies, on the basis of the accounting rules adopted by the EDF accounting officer ⁽¹³⁾, and making accounting estimates that are reasonable in the circumstances. The Commission approves the final annual accounts of the EDFs.

⁽¹⁰⁾ The consolidated financial statements comprise the balance sheet, the statement of economic outturn, the statement of cash flow and the table of items payable to the European Development Funds. The financial statements and information supplied by the EIB are not covered by this Statement of Assurance (see footnote 11).

⁽¹¹⁾ Pursuant to Articles 1 and 103(3) of the Financial Regulation applicable to the ninth EDF, the Statement of Assurance does not extend to the part of the ninth EDF resources that is managed by the EIB and for which it is responsible.

⁽¹²⁾ At the level of the Commission management includes the Members of the Institution, Authorising Officers by delegation and sub-delegation, the Accounting Officer and the leading staff of financial, audit or control units. At the level of Beneficiary States, management includes National Authorising Officers, Accounting Officers, Paying Agents and the leading staff of implementing organisations.

⁽¹³⁾ The accounting rules adopted by the EDF accounting officer are derived from International Public Sector Accounting Standards (IPSAS) issued by the International Federation of Accountants or, in their absence, International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. In accordance with the Financial Regulation, the 'Consolidated financial statements' for the financial year 2007 are prepared on the basis of these accounting rules adopted by the EDF accounting officer, which adapt accruals based accounting principles to the specific environment of the Communities, while the consolidated reports on implementation of the EDFs continue to be primarily based on movements of cash.

- (b) The way in which management exercises its responsibility for legality and regularity of underlying transactions depends on the method of implementation of the EDFs. In the case of direct centralised management, implementation tasks are performed by the Commission's departments. Under decentralised management implementation tasks are delegated to third countries and under indirect centralised management to other bodies. In the case of joint management, implementation tasks are shared between the Commission and international organisations. Implementation tasks have to comply with the principle of sound financial management, requiring designing, implementing and maintaining effective and efficient internal control including adequate supervision and appropriate measures to prevent irregularities and fraud and, if necessary, legal proceedings to recover funds wrongly paid or used. Regardless of the method of implementation applied, the Commission bears the ultimate responsibility for the legality and regularity of the transactions underlying the accounts of the EDFs.

Auditor's responsibility

III. The Court's responsibility is to provide, on the basis of its audit, the European Parliament and the Council with a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions. The Court conducted its audit in accordance with the IFAC and INTOSAI International Auditing Standards and Codes of Ethics, in so far as these are applicable in the EDF context. These standards require that the Court plans and performs the audit to obtain reasonable assurance whether the final annual accounts of the EDFs are free from material misstatement and the underlying transactions, taken as a whole, are legal and regular.

IV. In the context described under paragraph III, an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the final consolidated accounts and the legality and the regularity of the underlying transactions. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the final consolidated accounts and of material non-compliance of the underlying transactions with the requirements of the legal framework of the EDFs, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the preparation and fair presentation of the final consolidated accounts, and supervisory and control systems implemented to ensure legality and regularity of underlying transactions, in order to design audit procedures that are appropriate in the circumstances. An audit in this context also includes evaluating the appropriateness of accounting policies used and reasonableness of accounting estimates made, as well as evaluating the overall presentation of the final consolidated accounts and the annual activity reports.

V. The Court considers that the audit evidence obtained is sufficient and appropriate to provide a basis for its statement of assurance.

Opinion on the reliability of the accounts

VI. In the Court's opinion, the final annual accounts of the seventh, eighth and ninth EDFs present fairly, in all material respects, the financial position of the EDFs as of 31 December 2007, and the results of their operations and cash flows for the year then ended, in accordance with the provisions of the Financial Regulation and the accounting rules adopted by the accounting officer.

VII. Without qualifying the opinion expressed in paragraph VI, the Court draws attention to the fact that the validity of the assumptions used for the estimate of the provision for costs incurred has not been demonstrated by the Commission and that they may lead to an understatement of accrued expenditure, as well as to an overstatement of the amount of guarantees disclosed in the notes to the financial statements.

Opinion on the legality and regularity of the underlying transactions

VIII. In the Court's opinion, except for the effects of the matter described in paragraph IX, the transactions underlying the revenue and commitments for the financial year are, taken as a whole, legal and regular.

IX. The Court's audit revealed a material level of errors affecting transactions underlying payments.

X. Without calling into question the opinion expressed in paragraph VIII, the Court draws attention to the high fiduciary risk with regard to budget support resulting from the Commission's 'dynamic interpretation' of the eligibility criteria, which does not provide for countries to meet minimum standard of credible management of public finances before budget support is undertaken.

XI. The Court notes the improvements introduced by the Commission as regards its supervisory and control systems but underlines the need to continue to pursue efforts to clarify certain important elements of the overall control strategy and improve the design and/or implementation of certain systems.

18 September 2008

Vitor Manuel da SILVA CALDEIRA
President

European Court of Auditors
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THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Information in support of the Statement of Assurance*Scope and nature of the audit*

14. The aim of the work on the reliability of the accounts of the EDFs is to obtain appropriate sufficient evidence to conclude on the extent to which all revenue, expenditure, assets and liabilities have been properly registered and that the annual accounts faithfully reflect the financial positions at the end of the year. The observations regarding the reliability of the accounts, set out in paragraphs VI and VII of the Statement of Assurance, are based on an audit of the consolidated financial statements⁽¹⁴⁾ and the consolidated report on the financial implementation of the seventh, eighth and ninth EDFs⁽¹⁵⁾. The audit comprised an appropriate range of audit procedures designed to examine, on a test basis, evidence relating to the amounts and disclosures. It included an assessment of the accounting principles used, significant estimates made by management and the overall presentation of the consolidated accounts.

15. The observations regarding the legality and regularity of the underlying transactions, set out in paragraphs VIII to XI of the Statement of Assurance, are based on:

- (a) an evaluation of the supervisory and control systems at EuropeAid's central services and in five Delegations (Ghana, Guinea Bissau, Niger, Madagascar and Sudan) covering six countries;
- (b) an examination in each Delegation visited of a statistically selected sample of transactions covering all domains except budget support. A total of 90 payments and 15 individual legal commitments were audited;
- (c) for budget support, an examination of 30 payments and 15 financial commitments statistically selected. This selection represents 46,0 % and 62,1 % of total budget support payments and financial commitments respectively. The examination consisted of a desk review and, for 8 payments, a further analysis in four of the countries visited (Ghana, Guinea-Bissau, Niger and Madagascar);
- (d) an examination of 30 statistically selected payments authorised by EuropeAid's central services;

⁽¹⁴⁾ See Article 100 of the Financial Regulation of 27 March 2003 applicable to the ninth EDF: the financial statements shall comprise the balance sheet, the statement of economic outturn, the statement of cash flow, and the table of items payable to the EDF.

⁽¹⁵⁾ See Article 101 of the Financial Regulation of 27 March 2003 applicable to the ninth EDF: the reports on financial implementation shall comprise tables describing the appropriations, the commitments and the payments.

THE COURT'S OBSERVATIONS

- (e) an examination of 30 statistically selected transactions already checked *ex-post* by EuropeAid's central services;
- (f) an examination of 30 statistically selected financial commitments;
- (g) an examination of the Annual Activity Report and the declaration by the Director-General of EuropeAid and the procedure for preparing them.

Reliability of the accounts

16. As the Court already noted in its Annual Report on the EDF concerning the financial year 2006 ⁽¹⁶⁾, the accounting system used for the EDF does not have all the features necessary for efficient and effective reporting of economic information on an accruals basis. Consequently, the transformation of cash-based data into accrual-based annual accounts for the EDF requires extensive manual processing which increases the risk of error. Moreover, the financial impact of variations in currency exchange rates cannot be identified separately by the accounting system nor can it be extracted manually ⁽¹⁷⁾. The integration of the EDF into the accounting system already used by the Commission to account for budgetary expenditure was originally scheduled for 2006 but, due to technical difficulties, has been postponed on several occasions and is now planned for the start of 2009.

17. The annual accounts contain a provision for the costs incurred in the reporting period but for which no invoices have been received at the year-end. This provision is statistically estimated on a number of assumptions and amounts to 2 087 million euro, or 83 % of total liabilities. As the Court observed in its Annual Report on the EDF concerning the financial year 2006 ⁽¹⁸⁾, the validity of the assumption concerning the linearity of project expenditure has not been demonstrated by the Commission. The Court's analysis ⁽¹⁹⁾ indicates that the method used by EuropeAid may lead to an understatement of accrued expenditure. It is however not possible to quantify the impact on the consolidated balance sheet at the end of 2007.

⁽¹⁶⁾ Paragraph 15 (OJ C 259, 31.10.2007).

⁽¹⁷⁾ Its disclosure is required by IPSAS 4 — The Effects of Changes in Foreign Exchange Rates.

⁽¹⁸⁾ Paragraph 17.

⁽¹⁹⁾ As insufficient information was available relating to the situation at the end of 2007, the Court examined the validity of the method by checking the provision as at 31 December 2006 for a sample of 60 individual contracts statistically selected and relating to 18 projects in 13 ACP countries.

THE COMMISSION'S REPLIES

16. *The introduction of the new accounting system as from 2009 will overcome current limitations. The manual processing is subject to rigorous controls in order to reduce risks. The current accounting system of the EDF does not provide for the identification of the financial impact of variations in currency exchange rates, but nevertheless the net result for the financial year 2007 includes the gains and losses due to exchange rate differences.*

Moreover only 9 % of payments are executed in currencies subject to exchange rate fluctuations. Therefore, the Commission does not consider these potential exchange differences to be material in relation to the accounts as a whole.

17. *In 2007 the Commission further fine-tuned and improved its approach to calculating the provision by applying a specific implementation rate to each type of contract (grants, construction work, services and supplies).*

An individual analysis of each contract (there are around 8 000 ongoing contracts) would give rise to a disproportionate workload with respect to the mathematical approach currently used. The Commission plans to launch a study in order to reinforce the criteria used in this approach.

THE COURT'S OBSERVATIONS

18. The amount of guarantees disclosed in note 1.4 to the financial statements was 1 004 million euro as at the end of 2007. The Court found that this amount is overstated by 4,1 %.

Legality and regularity of the underlying transactions**Substantive testing of transactions****Project Commitments**

19. The Cotonou Agreement ⁽²⁰⁾ requires that financing agreements between the Commission and the ACP State or States concerned are drawn up within 60 days of the Commission's decision. The Court's audit revealed that a significant number of financing agreements (eight out of 30 Commission decisions examined) were not signed by the recipient country within this time limit.

20. Frequent errors (five errors affecting four out of the 15 individual legal commitments checked) were found concerning the legally prescribed bank guarantees in support of tenders and contracts. In the case of one individual legal commitment, a derogation to tendering rules was given although the legal condition allowing this was not fulfilled.

Project Payments

21. Out of eleven payments to UN organisations selected, the legality and regularity of two payments could not be fully audited because the Court could not obtain the underlying documentation from the UN organisations concerned ⁽²¹⁾. Therefore, the Court cannot conclude on the legality and regularity of these transactions. Furthermore, the Court draws attention to the fact that the audit of the other UN transactions was hampered by inadequate cooperation by the UN organisations and was eventually made possible only thanks to timely intervention by the Commission.

THE COMMISSION'S REPLIES

18. In 2007 the Commission made significant efforts to reinforce the quality of the information recorded in the accounting system. During the annual closure of accounts, additional verifications and corrections were made in order to establish the annual accounts. As a result, the impact on the annual accounts is very slight and is not considered to be significant.

19. The Commission and the recipient countries have not breached the 60-day rule laid down in the Cotonou Agreement, since this rule concerns the drawing up and not the signing of the financing agreements. The deadline for signing financing agreements is 31 December of year $n + 1$, year n being the year in which the Commission's financial commitment was adopted (Article 54(2) of the Financial Regulation applicable to the 9th EDF). The Commission follows the diligent practice of not only drawing up but also signing almost all financing agreements within 60 days of its decision.

20. The Commission considers that there is no financial risk since no payments are made before receipt of the bank guarantee.

With regard to the derogation, the Commission considers that it was justified on the grounds of extreme urgency.

21. The Commission fully supports the Court's request for obtaining from UN organisations necessary supporting evidence, and this principle is clearly stipulated in the FAFA. As soon as the Commission was informed by the Court of difficulties encountered in this respect, it approached its counterparts at the UN in order to find a solution and to ensure that the Court received the information required.

⁽²⁰⁾ Article 17, paragraph 2, of Annex 4.

⁽²¹⁾ United Nations Population Fund and United Nations Development Programme.

THE COURT'S OBSERVATIONS

22. The Court's audit of payments authorised by Delegations and EuropeAid's central services revealed a material level of error (27 errors affecting 24 out of 120 transactions examined) affecting the amount of the underlying transactions audited. Most of these errors are serious ⁽²²⁾ and mainly concern:

- the eligibility of the expenditure, such as payments made outside the permitted period, payment of VAT, payment in excess of the allowed budget and payment of types of expenditure not provided for by the contract (17 errors affecting 15 out of the 120 transactions examined);
- prefinancing cleared although expenditure had not yet been incurred (six errors affecting six out of the 120 transactions examined);
- payments of improper sums as a result of calculation errors, payment for quantities declared that did not correspond to reality and technical requirements for works not respected (three errors affecting three out of the 120 transactions examined).

23. Most of the errors should have been prevented or detected and corrected by the authorising officers before clearances of prefinancing or payments were authorised. Other errors are explained by inadequate controls carried out by supervisors or auditors. This indicates weaknesses in the supervisory and control systems (see paragraphs 32 to 47). While audits planned by the Commission might detect and correct some errors, the level of residual error is likely to remain material (see paragraph 39).

24. The Court's audit also revealed other recurring errors that may have an impact on the amount of the underlying transactions, mainly concerning legally prescribed bank guarantees and tender and contracting requirements (16 errors affecting 15 out of the 120 transactions examined). Errors which do not have an impact on the amount of the underlying transactions have also been identified, such as premature payments, the lack of visibility given to the EDF's financial support and expenditure allocated to the wrong programme estimate (six errors affecting six out of the 120 transactions examined).

THE COMMISSION'S REPLIES

22. *The control system established by the Commission to verify the legality and regularity of the expenditure is based on the work of external auditors and supervisors and on internal controls. The Commission is aware that this system entails a certain residual risk of error. However, since it is impossible to verify all the transactions given the costs involved in such control measures, the Commission will continue to improve its system based on a cost/effectiveness ratio providing reasonable assurance.*

23. *Most of the cases referred to relate either to payments made on the basis of an auditors' report and cost statements drawn up by the contracting authority, or clearances of advances that can subsequently be corrected.*

24. *Two cases relate to extensions of guarantees covering contracts being performed. There was therefore no residual risk. In all the other cases, the guarantees were provided after the contract had been signed, but no payment was made before receipt of the guarantees. There was therefore no financial risk.*

In April 2008 the Commission published a manual on the visibility of the EU for external actions.

⁽²²⁾ For the Court, errors are classified as 'serious' if their rate exceeds 2 %.

THE COURT'S OBSERVATIONS

Budget support commitments

25. The Cotonou Agreement states that direct budgetary assistance (budget support) shall be granted where public expenditure management is sufficiently transparent, accountable and effective⁽²³⁾. The Commission interprets this condition dynamically⁽²⁴⁾. In its view, the weaknesses affecting public finance management at the time of the financing decision do not preclude the launch of a budget aid programme, provided that the will for reform exists and the reforms planned are deemed to be satisfactory. The European Parliament has questioned the Commission's 'dynamic interpretation' of the eligibility criteria for budget support and stated that budget support should only be undertaken in countries that already meet a minimum standard of credible management of public finances⁽²⁵⁾.

26. The Court's audit showed that in five out of the 15 commitments examined⁽²⁶⁾, budget support is provided to ACP States where the requirements of the Cotonou Agreement for public expenditure management to be sufficiently transparent, accountable and effective are not met. The Court found serious weaknesses in the internal oversight of the budget, accounting systems, public procurement or anti-corruption measures. Important matters of concern are the failure to produce timely audited accounts and the ineffectiveness of external control which, as the Court has already underlined, are essential to demonstrate transparency and accountability. Providing budget support in these conditions implies a very high fiduciary risk. In its Annual Report on the

THE COMMISSION'S REPLIES

25. The Commission is aware that the 'dynamic interpretation' approach has been questioned by the European Parliament in its review of the follow-up to the 2006 discharge recommendations, as noted in the Court's observations. Nevertheless, the Commission continues to consider that this approach is useful and appropriate on a country-by-country basis as it allows the Commission to better support improvements in Public Finance Management (PFM) systems and in so doing enhances the overall development impact of budget support for the beneficiary. Apart from being methodologically difficult, establishing ex-ante benchmarks applicable to all countries would reduce the Commission's capacity to support PFM reforms both where such benchmarks would not be met as well as where they would be met. The Commission's approach, therefore, focuses on a comprehensive diagnostic review using the Public Expenditure and Financial Accountability (PEFA) methodology, the need for a credible and relevant reform strategy and the monitoring of its satisfactory implementation. Thus, as most other donors (including the Bretton Woods Institutions), the EC uses the initial PFM diagnostic as the baseline against which progress is benchmarked in the implementation of the reform strategy. Whilst the Commission acknowledges that its assessments of PFM reform progress need to be more structured and formalised, it notes that the increasing evidence produced, as more PEFA assessments become available, will allow it to better inform its assessment of a country position and its pace of progress. Finally, the Commission recalls that eligibility is verified throughout all programme phases and that in the particular case of countries in fragile situations, the Commission manages the ensuing risks by typically requiring the existence of an International Monetary Funds (IMF) programme addressing basic issues such as cash management and treasury control.

26. The Commission does not agree with the Court's assessment regarding the four countries in question. As indicated in paragraph 25, all commitments in those States in fragile situations mentioned by the Court were made following an evaluation of sufficient positive progress in PFM systems, backed by IMF assessments. The countries concerned have subsequently continued to show progress in PFM and have remained on track for further budget support.

The Commission did not understand the Court's recommendation as a request to set minimum standards applicable to all countries and, as outlined in paragraph 25, does not consider it appropriate. During 2007, the Commission continued to apply the dynamic approach, which it considers the appropriate one.

⁽²³⁾ Article 61(2)(a).

⁽²⁴⁾ See paragraphs 28 and 29 of Special Report No 2/2005 concerning EDF budget aid to ACP countries (OJ C 249, 7.10.2005).

⁽²⁵⁾ European Parliament report of 22 April 2008 on discharge in respect of the implementation of the budget for the Sixth, Seventh, Eighth and Ninth European Development Funds for the financial year 2006, point 32.

⁽²⁶⁾ The 5 commitments relate to Burundi, Central African Republic, Guinea-Bissau and Haiti. Budget support commitments for these countries in 2007 amount to 83,7 million euro i.e. 24,9 % of budget support commitments.

Anti-corruption measures are analysed in the context of Financing Agreements (FAs) and monitored in the framework of Delegations' PFM Annual Reports.

THE COURT'S OBSERVATIONS

EDF concerning the financial year 2006 ⁽²⁷⁾, the Court recommended that compliance with the Cotonou Agreement should be benchmarked against baseline requirements. This recommendation has not been acted upon.

27. In several cases (seven out of 33 financing agreements examined), provisions of the financing agreements for budget support were incomplete or unclear; they did not contain the general conditions for budget support, or ambiguously defined the method for the calculation of the amounts for disbursement; or referred to commitments made by government without defining a due date and the consequences when these commitments are not met.

Budget support payments

28. The Court's audit of budget support payments revealed a material level of error (four errors affecting four out of 30 payments examined) affecting the amount of the underlying transactions audited. The cases identified concern calculations of amounts for disbursement based on a positive conclusion as regards progress in public finance management which is not consistent with the underlying assessment of the situation and the use of a calculation method not provided for by the Financing Agreement. In three other cases, payments were made without up-to-date reports concerning public finance management being available. This implies a risk that eligibility conditions were not met.

THE COMMISSION'S REPLIES

27. *The Commission invokes the legal application of the Cotonou Agreement in all its FAs and assessments of tranche releases. The Commission nevertheless recognises that it is preferable that the eligibility criteria are explicitly mentioned in financing agreements and the general conditions therein, in line with the Guidelines on the Programming, Design and Management of GBS (General Budget Support). The Commission will therefore seek to further improve the quality of financing agreements under the 10th EDF. On the establishment of dates for the assessment of disbursement conditions, the timing included in the FA is only indicative.*

28. *In each of the four cases cited by the Court, the Commission sought to arrive at an informed decision based on a reasoned interpretation of the provisions of the respective Financing Agreements.*

In two out of the three cases (Botswana and Namibia) reports concerning the PFM situation were available in accordance with the guidelines on GBS, and eligibility was demonstrated. In the case of New Caledonia (2007BS-EE16) the commitments referred to by the Court are accompanying measures and not conditions for disbursement.

⁽²⁷⁾ Paragraph 55.

THE COURT'S OBSERVATIONS

29. In a significant number of cases (six out of 30 payments examined), the Commission did not demonstrate in a structured and formalised way whether the payment conditions relating to public finance management were respected. Situations encountered include assessments of progress being unreasonably optimistic or based on outdated or inappropriate information, conclusions not supported by the underlying information, reliance put on future occurrences rather than on events that had taken place and the inaccurate appraisal of indicators.

Activity Report by the Director-General of EuropeAid

30. The activity report by the Director-General of EuropeAid presents the policy achievements, the management performance of the services and the main results of the controls. The report also reflects the Commission's follow-up of recommendations made by the Court of Auditors, the Internal Audit Service (IAS) and the Internal Audit Capability (IAC) of EuropeAid.

31. The activity report includes specific indicators concerning legality and regularity ⁽²⁸⁾. The indicators do not however include financial information such as coverage of audits, error rates detected by the various controls, the amount of recovery orders issued and the amounts actually recovered. It is therefore unclear on what basis the Director-General of EuropeAid declared that he had obtained reasonable assurance that the control procedures put in place gave the necessary guarantees concerning the legality and regularity of the underlying transactions. The Court's audit revealed a material level of error and weaknesses in the supervisory and control systems.

THE COMMISSION'S REPLIES

29. *The Commission agrees that it is necessary to demonstrate in a structured and formalised way that payment conditions related to PFM are respected.*

The primary tool used by the Commission to assess a PFM system is the PEFA assessment, which is complemented by other information on the most recent progress in PFM reforms (often in concert with other development partners).

When making a payment, the Commission will base the decision on all the available information. In addition, Delegations are required to submit an Annual PFM Report, providing information on recent and planned reforms. Nevertheless, the Commission agrees that for some of the payments cited, Delegations could have been more explicit about the information they used to make their assessments.

As regards the observation related to being unreasonably optimistic in making assessments, the Commission takes into account PFM progress being made, the credible and relevant commitment to future reforms, the results of dialogue with partner countries and development partners, and the provision of complementary assistance. Thus, the Commission balances the progress made, the political commitment to reform and the remaining areas of concern to arrive at an informed decision.

31. *EuropeAid's AAR 2007 and its annexes included legality and regularity indicators as for instance the results of ex-post controls and the implementation of the Annual Audit Plans. Results of recovery activities carried out by EuropeAid services as well as of other controls were available to the Director General.*

The reasonable assurance of the Director General is not derived in a mechanical way from one single indicator. The declaration is based on the appreciation of a number of elements, including: regular management supervision activities, results of regular assessments of the functioning of the internal controls, regular reporting from the Authorising Officers by sub-delegation, implementation of the action plans stemming from the recommendations of the different control bodies, results of ex-post controls.

⁽²⁸⁾ EuropeAid Annual Activity Report 2007, p. 57.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Supervisory and control systems**Overall control strategy**

32. Following the Commission's Action Plan towards an Integrated Internal Control Framework and the Court's recommendation ⁽²⁹⁾ regarding the establishment of EuropeAid's overall control strategy, the description of the key management and control systems has been developed in internal control templates included in the activity report by the Director-General of EuropeAid. Whilst this constitutes significant progress, it does not contain yet important elements such as key indicators supporting the level of assurance to be obtained, the coverage of some controls and the coordination between *ex-ante* and *ex-post* controls.

33. The number of Commission staff compared to the funds committed is decreasing ⁽³⁰⁾. In addition, no significant increase of staff is foreseen despite the forecasted substantial increase of commitments under the 10th EDF. Whilst it is, of course, legitimate to assure an efficient use of human resources, there is a risk that shortage or inadequate distribution of staff or unavailability of specific skills and knowledge has an impact on the quality of the controls, verifications and monitoring. Concerns in this respect have been expressed by the European Parliament ⁽³¹⁾. In addition, the increase of budget support within the EDF creates the need for specific skills and knowledge, and the Court notes that EuropeAid's Internal Audit Capability (IAC) has recommended that a human resources policy in relation to budget support is developed to incorporate objectives on numbers, skills and knowledge of budget support staff.

32. EuropeAid is committed to improve the presentation of these elements of its control strategy.

33. The Commission agrees with the Court that adequate staffing, both in terms of number and skills, represents a challenge.

⁽²⁹⁾ See Opinion No 2/2004 of the Court of Auditors of the European Communities on the 'single audit' model (and a proposal for a Community internal control framework) (OJ C 107, 30.4.2004), the Annual Report on the activities funded by the sixth, seventh, eighth, and ninth EDFs concerning the financial year 2005 (OJ C 263, 31.10.2006, p. 205), paragraph 40, and the Annual Report on the activities funded by the sixth, seventh, eighth, and ninth EDFs concerning the financial year 2006, paragraph 54.

⁽³⁰⁾ 4,8 staff per 10 million euro committed in 2004 and 4,2 in 2007.

⁽³¹⁾ European Parliament resolution of 24 April 2007 with observations forming an integral part of the decision on the discharge for implementation of the budget of the Sixth, Seventh, Eighth and Ninth European Development Funds for the financial year 2005 (OJ C 74 E, 20.3.2008) and European Parliament resolution of 22 April 2008 with observations forming an integral part of the decision on the discharge for implementation of the budget of the Seventh, Eighth and Ninth European Development Funds for the financial year 2006.

THE COURT'S OBSERVATIONS

THE COMMISSION'S REPLIES

Implementing organisations

34. The Court found that small entities which manage programme estimates ⁽³²⁾, and beneficiaries of grant agreements are often characterised by weak internal control systems. These entities, for instance, often have no appropriate accounting system to record project expenditure. In addition, the audits mandated by implementing organisations often fail to detect issues affecting the legality and regularity of transactions.

Supervisors

35. For important works, supply or service contracts, an external supervisor is designated to direct and/or monitor the execution of the contract. In some cases, the Court's audit has shown that the quality of the controls carried out by supervisors was inadequate which affected the legality and regularity of transactions.

ACP States

36. The Commission continued its efforts to increase the capacity of the National Authorising Officer (NAO) administrations by providing technical assistance, equipment and training in order to enable effective control of EDF expenditure by NAO administrations. Nevertheless, the lack of involvement by the ACP States in many cases means that Delegations can place only limited reliance on the controls performed by the NAO administrations, resulting in a heavier workload for Delegation staff to ensure the adequacy of controls.

Authorising officers in Delegations and central services of EuropeAid

37. The Court found weaknesses in the quality of some of the checks made by authorising officers, notably in relation to the authorisation of clearances of prefinancing and the scrutiny of documentation justifying expenditure, including the work and results of auditors, as well as in the follow-up of audit findings. There is also an insufficient presence of Delegation staff in the field, for instance to monitor supervisors.

34. *To improve the quality of the internal control systems of the management units, the Commission has produced guides for them and provides regular training (in 22 countries in 2007). It is also studying the possibility of creating accounting and financial management tools for all users.*

Since February 2006, Terms of Reference concerning verification of expenditure have formed an integral part of grant agreements (Annex VII). The Terms of Reference strictly define the scope and methodology to be applied by the auditor authorised by the recipient organisation, and contribute to improving controls.

35. *The Commission has asked its Delegations to reinforce control of the work carried out by supervisors. It will examine the possibility of introducing a mechanism designed to ensure that the quality of the controls carried out by the supervisors meets the requirements concerning the legality and regularity of transactions, and to increase the effectiveness of the supervisory tasks.*

36. *The Commission is continuing its assistance and training drive. In 2007, 1 430 participants from 22 ACP countries received full training on the EDF's financial and contractual procedures.*

37. *To ensure compliance with the provisions of the Financial Regulation relating to the validation of expenditure by the authorising officer, the Commission uses standard financial circuits and control lists for each transaction performed, thereby contributing to the standardisation and quality of the transactions.*

The Commission will remind authorising officers of the principles of clearance of advances. With regard to the monitoring of audits, the authorising officers are careful to issue recovery orders whenever necessary.

⁽³²⁾ Public or semi-public agencies or departments of the State or States concerned or the legal person responsible for executing the operation.

THE COURT'S OBSERVATIONS

38. Audits of expenditure which are initiated by Delegations and EuropeAid's central services and entrusted to private audit firms are a key component of the Commission's supervisory and control systems and are designed to contribute to the provision of assurance over EDF expenditure.

39. The annual audit plan contains mandatory and risk based audits. Due to insufficient documentation on the risk analysis, there is a lack of clarity over the process by which the risk analysis is performed and whether this process is consistently performed by Delegations. The overall level of implementation of the annual audit plan, specifically at Delegations, is low, at 55 % of all audits planned being started within the year, the others being postponed or sometimes cancelled. This is partly due to the Delegations' limited capacity to organise and follow up audits. Furthermore, even when audits were launched, the cycle is a lengthy one with final reports being produced a significant amount of time after the expenditure has been incurred. Such weaknesses in the system may be to the detriment of the overall level of assurance available as compared with that which was planned.

40. The Commission has made an important step forward in the area of audits by issuing in October 2007 new terms of reference applicable to all audits. Though the effects of these have yet to be seen due to such recent implementation, there are positive signs that they should enable more consistent reporting from auditors, in particular with regard to the form of the audit opinion given and the materiality threshold which is applied.

Monitoring by the central services of EuropeAid

41. The main tool for monitoring the Delegations is the External Assistance Management Reports (EAMRs), six-monthly management reports prepared by the Delegations. They are a periodic information source which enables the devolved Delegations to send EuropeAid's central services the most important items of information on internal organisation, project implementation and external audits. Subsequently, EuropeAid's central services provide feedback to the Delegations. Issues regularly reported by Delegations concern the lack of capacity and resources at NAO administrations (see paragraph 36) and staff constraints (see paragraph 33).

THE COMMISSION'S REPLIES

39. *The process by which risk analysis is to be performed is clearly indicated in the Operational Guidelines for the Annual Audit Plan and Risk Analysis. The Commission agrees that the process of the documentation of the risk analysis should be reinforced.*

The Annual Audit Plan identifies the audits to be launched, which are generally linked to the verification of project expenditure. Some of these audits will be launched and received in the same year (n + 1) while some others in the following year (n + 2), depending on the pace of implementation of the project/programme and the audit process itself.

This results in adjustments to the initial plan, and each audit cancelled or postponed requires proper justification. This does not automatically imply that all the audits not started during the year are postponed. The implementation rate of the 2007 audit plan as results from such adjustments is 77 %. This is in line with previous years' plans, which have a life-cycle of 2 years.

Assurance is guaranteed by the fact that no payment subject to an audit is executed before receiving and taking into account the results of such an audit.

THE COURT'S OBSERVATIONS

42. There has been no centralised management information relating to the coverage and results of the audits initiated in 2007 by the Delegations. This means that the level of assurance that can be derived from these audits is much reduced compared with what could be obtained if a robust management information system were in place. An existing computerised tool, CRIS audit, has been modified in order to facilitate its use, which was made mandatory in January 2008. This recent implementation has not yet allowed for an assessment of its effectiveness but the signs that it will prove useful as a system for monitoring progress are positive. Certain refinements still need to be made to allow for the assessment of audit coverage of expenditure and the use of this system in collating, analysing and acting upon audit findings and recommendations to enable ongoing assessment of issues and to ensure that prompt and timely action is taken where necessary.

43. For years, audits mandated by EuropeAid's central services have been subject to rigorous control and a synthesis report is produced annually to collate information from these with a view to putting in place improvements to systems where necessary. A similar exercise was undertaken during 2007 to address the audits mandated by Delegations which represent the majority of audits. The approach to this is methodical and covers main areas of interest, such as adherence to the terms of reference. The report produced contained much factual information on numbers and classification of findings.

Verification by the central services of EuropeAid

44. Verifications by EuropeAid's central services include missions to verify the functioning of the Delegations' internal control systems, transactional *ex-post* controls and audits initiated by EuropeAid's central services.

45. In 2007, EuropeAid's central services carried out one monitoring mission to a Delegation consisting of an examination of the set-up and functioning of the supervisory and control systems. The mission was well designed and provided practical recommendations for improvements to control systems but this is the only mission of this kind that has taken place. In 2007 EuropeAid was developing a standardised methodology for these missions. In this process, two pilot missions were carried out during which priority was given to operational issues rather than the functioning of the supervisory and control systems.

THE COMMISSION'S REPLIES

42. *EuropeAid has developed appropriate tools to conduct audits while several mechanisms contribute to their quality control as well as to the consolidation and use of the systemic audit findings.*

The planning and follow-up of audit results are both ensured by the Delegations and Headquarters. No payment subject to an audit is authorised before receiving and taking into account the results of such audit. Results of previous audits are taken into account when establishing the Annual Audit Plan.

EuropeAid follows the implementation of the AAP at central level and, since 2005, has been performing a review of audit reports issued during the year. The objective of this review is to contribute to the monitoring of audit activity at Headquarters and in the Delegations and to further improve the audit system based, inter alia, on an analysis of the typology of audit findings.

45. *EuropeAid adopted a standardised methodology for these missions in March 2008.*

THE COURT'S OBSERVATIONS

46. EuropeAid's transactional *ex-post* control system provides an effective mechanism for the identification of errors affecting formal aspects of transactions but is less effective at identifying errors which have an impact upon the amount of the payment. As mentioned in the Annual Report concerning the financial year 2006, the transactional *ex-post* control can therefore make only a limited contribution to the overall assurance on systems and procedures, and the legality and regularity of the underlying transactions. The Court's review of a sample of transactions checked *ex-post* also revealed that these checks had in some cases not been appropriately documented, that some errors had not been detected and that findings were not always followed up in as timely a manner as they could have been.

47. Risk-based audits initiated by EuropeAid's central services identify a high level of error. The documentation of the risk analysis is not sufficient to demonstrate that EuropeAid has selected all high risk subjects for audit.

Internal audit

48. The principal objective of EuropeAid's IAC is to assess and evaluate the internal control system. The IAC performs its function effectively. The Court observes nevertheless that the risk analysis of the IAC does not sufficiently take account of EuropeAid's risk register and that the audit programme is not sufficiently flexible to adapt to modifications over time of the perceived risk. In 2007, the IAC completed audits on budget support, pool and trust funds; the identification process; selected internal control standards in selected Delegations and risk management in Delegations as well as a number of follow-up audits. The conclusions of the IAC are generally consistent with the Court's findings.

49. The Commission's Internal Audit Service (IAS) carried out an audit on *ex-post* control activities ⁽³³⁾ in EuropeAid. Its conclusions corroborate the Court's findings regarding the overall control strategy (see paragraph 32) and the planning and monitoring of audits (see paragraphs 38 and 42).

THE COMMISSION'S REPLIES

46. *Setting up a transactional ex-post control system and defining its characteristics are both based on an appreciation of residual risk and of the interaction with the other components of the control system. Ex-post transactional controls provide an additional layer of assurance for the appreciation of the elements which are subject to such control.*

This covers payments, recoveries and clearance of pre-financing transactions carried out by the Commission. The study of each transaction entails a systematic checking of the applicable contractual conditions.

The documentation requested for each type of transaction selected is clearly set out in the ex-post transactional control manual.

47. *The Commission agrees that the process of the documentation of the risk analysis should be reinforced.*

48. *The IAC risk analysis forms the basis for its own annual audit plan. In addition, the risks in EuropeAid's risk register are considered in relation to the impact they have on the area to be audited. While the IAC risk register might consider an area to be high risk that area might not appear in the audit plan for a particular year because the business process is not yet within the working practice of the DG or the management cycle for certain programmes. The IAC risk register is updated several times a year to take into account any evidence of changes to the risk environment of EuropeAid.*

49. *The IAS audit was carried out at a time when the control strategy was being prepared for formalisation. Its conclusions could not take into account the developments that occurred afterwards.*

⁽³³⁾ Transactional *ex-post* controls and financial audits.

THE COURT'S OBSERVATIONS

50. The IAS also performed a final follow-up audit on NGOs funding in EuropeAid and an audit of the eligibility of costs under the financial and administrative framework agreement (FAFA) with the United Nations. The latter confirmed that the design of the FAFA is appropriate, but also that the control mechanisms still need to be effectively and further implemented at both project and partner levels, for instance by strengthening controls on payments and ensuring an appropriate coverage of verification missions ⁽³⁴⁾.

Conclusions and recommendations

51. Based on its audit work, the Court concludes that EDF accounts for the financial year ending 31 December 2007 are, in all material respects, reliable but the Court draws attention to the observation in paragraph 17 concerning the provision for costs incurred.

52. Based on its audit work, the Court concludes that:

- (a) except for the effects of the matter described in paragraphs 19, 20 and 27, the transactions underlying the revenue and commitments of the EDFs are free from material error. Furthermore, the Court draws attention to the high fiduciary risk for the cases mentioned in paragraphs 25 and 26;
- (b) the transactions underlying the payments of the EDFs are affected by a material level of error.

53. The Court's assessment of the supervisory and control systems for the European Development Funds is that they are partially effective. **Table 3** gives an overview of the Court's assessment of EuropeAid's supervisory and control systems ⁽³⁵⁾.

THE COMMISSION'S REPLIES

50. *Significant progress has been made by EuropeAid since completion of the IAS audits carried out in 2006 and the beginning of 2007 on the FAFA:*

- *the formal analysis of the compliance of the UN agencies with the internationally recognised standards was conducted (97 % coverage),*
- *in line with the increase in the Commission's contributions to the UN, there was a significant increase in the number of UN verification missions (39 in 2007 compared with 7 in 2005-2006),*
- *the planning of these verifications is carried out annually,*
- *their results are consolidated,*
- *the Commission and the UN have signed common guidelines aimed at improving the quality of reporting.*

53. *Given the financial and human resources available to it, the Commission considers that it has set up control systems which provide reasonable assurance.*

⁽³⁴⁾ Annual report to the discharge Authority on internal audits carried out in 2007 (presented by the Commission (SEC(2008) 2361 final of 30.7.2008)).

⁽³⁵⁾ See chapter 8, External aid, development and enlargement, of the Annual Report of the Court of Auditors on the implementation of the budget concerning the financial year 2007 for an assessment of the supervisory and control systems of DG ECHO.

THE COURT'S OBSERVATIONS

54. EuropeAid has continued to remedy some shortcomings mentioned by the Court in its previous Annual Reports. EuropeAid has developed new terms of reference for audits and implemented a management information system, CRIS audit, relating to the coverage and results of the audits. The Court welcomes the efforts made by EuropeAid to develop a control strategy but there remains a lack of clarity as to the certain important elements, in particular concerning the coverage of some controls, the coordination between *ex-ante* and *ex-post* controls and key indicators supporting the overall assurance to be given by the Director General.

55. There is a need to continue to pursue efforts to improve the design and/or implementation of some systems. The following recommendations should be considered in this context:

- (a) EuropeAid's control strategy should include key indicators supporting the level of assurance to be given by the Director-General, the coverage of some controls, the coordination between *ex-ante* and *ex-post* controls, as well as the human resources required;
- (b) a review should be carried out to assess whether EuropeAid's central services and the Delegations have the level and type of human resources required to ensure the quality of controls;
- (c) the management of implementing organisations should be better supported. This should involve greater presence of Delegation staff in the field, supporting accounting systems and training especially for projects implemented by programme estimates;
- (d) checks performed by the Delegations before authorising payments should better scrutinise the payment requests and intensify the focus on the reality, eligibility and accuracy of the expenditure. The quality of the work performed by supervisors and auditors should be better monitored;
- (e) the implementation of CRIS Audit should allow monitoring of the audit coverage and the audit results. Qualitative information as to the recommendations made and the improvements which should be put in place to address the findings is vital to ensure that the ultimate objectives of commissioning audits are met;

THE COMMISSION'S REPLIES

54. *The Commission welcomes the Court's recognition of the continuous progress made during the previous years.*

55.

- (a) *EuropeAid is committed to improve the presentation of these elements of its control strategy.*
- (b) *The Commission agrees with the Court that adequate staffing, both in terms of number and skills, represents a challenge and is ready to carry out the review.*
- (c) *EuropeAid will develop several tools in order to improve the management of implementing organisations and will introduce new terms of reference for audits of new programme estimates.*
- (d) *To ensure compliance with the provisions of the Financial Regulation relating to the validation of expenditure by the authorising officer, the Commission uses standard financial circuits and control lists for each transaction performed, thereby contributing to the standardisation and quality of the transactions.*
- (e) *The entry into force of the new CRIS-Audit module on the 1 January 2008, by linking the amount of the contract to be audited to the audited amount, will facilitate the calculation of the audit coverage, as well as the analysis of audit findings, as per their typology.*

The Commission agrees with the Court's recommendation and yearly collates and analyses audit results with a view to learning lessons and to introducing appropriate improvements.

THE COURT'S OBSERVATIONS

- (f) transactional *ex-post* controls should include a better examination of supporting documentation to ensure that transactions are not affected by errors of eligibility and occurrence as well as to verify whether checks performed before the payment was authorised were adequate;
- (g) the standardised methodology for monitoring missions should be finalised and the number of such missions increased. The new methodology should maintain the focus on the examination of the set-up and functioning of the supervisory and control systems.

56. As regards budget support, the following recommendations should be considered:

- (a) compliance with the Cotonou Agreement should be benchmarked against baseline requirements, such as the availability of timely published and audited accounts, to be met before budget support is granted;
- (b) the performance indicators used should permit clear evidence of progress in public finance management to emerge where appropriate. This could be achieved by strengthening indicators which measure progress of results over time in combination with process indicators on the performance of one-off events;
- (c) in order to set out its conclusions as regards progress in public finance management in a structured manner, the Commission should ensure that the data used as a basis for disbursement decisions is reliable and should rely more on measurements of events that have already taken place than on predictions of future occurrences;
- (d) EuropeAid should ensure, before the start of a budget support programme, that there is a clear and complete assessment of the public finance management and that the recipient country has a credible and relevant reform programme to address all significant weaknesses over a foreseeable timetable;

THE COMMISSION'S REPLIES

- (f) *The Commission is continuously working to further improve its system and will pay specific attention to the issue of the detail of supporting documentation on programme estimates.*
- (g) *EuropeAid adopted a standardised methodology for these missions in March 2008 and the number of monitoring missions is planned to be increased.*

56.

- (a) *As stated in paragraph 25, as part of the dynamic approach, the Commission uses the initial PFM diagnostic and the programme of reform as the baseline against which progress is benchmarked on a country-by-country basis and considers the setting of common minimum standards to be uniformly applied for all countries as inappropriate.*
- (b) *Compared to other sectors, it is more difficult and complex to define result indicators for PFM. The Commission nevertheless favours the use of result indicators, where available, that measures the effect of reforms, but also uses process indicators and measures to monitor the progress in the implementation of reform programme.*
- (c) *When assessing eligibility, the Commission takes into account a balance between past performance and future commitments. At the same time, the Commission agrees that when assessing disbursements the emphasis should be placed on demonstrating achievements.*
- (d) *The Commission agrees that PFM systems need to be assessed before the provision of BS and the Commission prefers to carry out such an assessment within the PEFA framework. It is expected that in all countries receiving BS from the EDF, PEFA assessments will have taken place before the end of 2008. In most of cases, governments already have PFM reform programs in place which may have to be adapted according to the findings. In case new programs need to be drawn up, the Commission has to be convinced of the government's commitment to develop and implement required PFM reform measures, before BS is provided.*

THE COURT'S OBSERVATIONS

- (e) the quality of Financing Agreements should be improved by including general conditions in all cases, unambiguous stipulations and clear requirements for progress of public finance management;

- (f) a human resources policy should be developed on the basis of an analysis of the skills and knowledge needed in relation to the management of budget support in view of its increasing importance.

THE COMMISSION'S REPLIES

- (e) *The Commission will seek to ensure that FAs will include General Conditions and that the assessment of PFM eligibility will be carried out in a structured and formalised manner. Specific PFM performance indicators within variable tranches need to be clear and precise allowing to measure progress over time.*

- (f) *In addition to adapting personnel recruitment to the specific needs of BS programs, the responsible Commission services are carrying out a significant number of training courses for EC staff from Delegations and HQs, on specific issues related to BS (PFM, macro-economic, performance measurement, sector specific courses, etc.).*

Table 1 — Cumulative use of EDF resources managed by the Commission at 31 December 2007

(million euro)

	Situation at end of 2006		Budgetary implementation during the financial year 2007			Situation at end of 2007					
	Global amount	Implementation rate ⁽²⁾	7th EDF	8th EDF	9th EDF	Global amount	7th EDF	8th EDF	9th EDF	Global amount	Implementation rate ⁽²⁾
A — RESOURCES ⁽¹⁾	37 269,8		- 71,9	- 211,0	341,8	58,8	10 583,0	10 839,3	15 906,4	37 328,7	
B — USE ⁽³⁾											
1. Financial commitments	34 107,2	91,5 %	- 71,9	- 211,0	3 455,1	3 172,2	10 583,0	10 839,3	15 857,1	37 279,4	99,9 %
2. Individual legal commitments	28 699,1	77,0 %	- 5,5	35,0	3 317,3	3 346,9	10 517,2	10 484,6	11 044,2	32 046,0	85,8 %
3. Payments	23 826,0	63,9 %	96,7	483,4	2 293,9	2 874,0	10 340,8	9 605,5	6 753,7	26 700,0	71,5 %
C — OUTSTANDING PAYMENTS (B1-B3)	10 281,2	27,6 %					242,2	1 233,8	9 103,4	10 579,4	28,3 %
D — AVAILABLE BALANCE (A-B1)	3 162,6	8,5 %					0,0	0,0	49,3	49,3	0,1 %

⁽¹⁾ Initial allocations to the 7th, 8th and 9th EDFs, interest, sundry resources and transfers from previous EDFs.

⁽²⁾ As a percentage of resources.

⁽³⁾ 9th EDF amounts include Members states voluntary contributions to the African Peace facility (financial commitments: 39,1; individual legal commitments: 37,0; payments: 29,2).

Source: Court of Auditors, based on the EDF Reports on financial implementation and Financial statements at 31 December 2007.

Table 2 — Financial implementation in the financial years 2003-2007 inclusive

(million euro)





	2003	2004	2005	2006	2007
1. Financial commitments	3 395,8	2 375,2	3 035,1	2 718,7	3 172,2
2. Individual legal commitments	2 742,7	2 746,3	2 652,0	3 072,6	3 346,9
3. Payments	2 179,5	2 197,8	2 489,1	2 761,9	2 874,0

Source: Court of Auditors, based on the EDF Reports on financial implementation and Financial statements at 31 December 2007.

Table 3 — Assessment of supervisory and control systems

System concerned	Key internal control								Overall assessment
	Controls performed before transactions are authorised	Monitoring missions		Ex-post controls	External audits			Internal audit	
		Quality	Quantity		Quality	Quantity/ implementation of the audit plan	Follow-up of individual audit findings/Effective recovery proce- dures		
Central services Europe-Aid	Effective	Effective	Not effective	Partially effective	Effective	Effective	Effective	Partially effective	Partially effective
Delegations	Partially effective	N/A	N/A	N/A	Partially effective	Partially effective	Effective	N/A	Partially effective

Legend:

	Effective
	Partially effective
	Not effective
	Not applicable: does not apply or not assessed

Results of transaction testing

	Project payments	Budget aid payments
Sample estimate of the proportion of transactions affected by an error	30 %	30 %
Error rate	Above 5 %	Between 2 % and 5 %

Table 4 — Follow-up of key Statement of Assurance observations

	Court observation	Action taken	Court analysis	Commission reply
1.	<p>The control strategy should be established and made operational by the end of 2007. As already indicated by the Court, it should establish clear and consistent objectives, ensure coordination and set the type and intensity of checking. This should necessarily entail a balancing act between the costs of the various controls and the accompanying benefits, whilst taking account of the tolerable risk of errors in the underlying transactions. The control strategy should include a well-structured and documented risk analysis that formally involves the Delegations in a fully participative manner.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(a)).</p>	<p>EuropeAid has formalised its overall control strategy and included it in the activity report by the Director-General of EuropeAid. It presents a description of the control processes for each of the various management modes. There remains a lack of clarity as to certain important elements of the control strategy, in particular the coverage of some controls, the coordination between <i>ex-ante</i> and <i>ex-post</i> controls and key indicators supporting the overall assurance to be given by the Director General.</p>	<p>EuropeAid's control strategy should include key indicators supporting the level of assurance to be given by the Director-General, the coverage of some controls, the coordination between <i>ex-ante</i> and <i>ex-post</i> controls, as well as the human resources required (Annual Report concerning the financial year 2007, paragraph 55(a)).</p>	<p><i>EuropeAid is committed to further improving the presentation of these elements of its control strategy.</i></p>
2.	<p>The management of projects financed by work programmes should be better supported. This should involve greater presence of Delegation staff in the field supporting accounting systems and training. Carrying out more audits at an early stage of the implementation of projects would also help to monitor and, where necessary, improve the quality of the control systems implemented by beneficiaries.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(b)).</p>	<p>EuropeAid has pursued its efforts to improve the quality of projects managed in the form of programme estimates. To that end, it has produced a new practical guide and specific training courses are held regularly in the ACP countries.</p>	<p>The management of implementing organisations should be better supported. This should involve greater presence of Delegation staff in the field, supporting accounting systems and training especially for projects implemented by programme estimates. (Annual Report concerning the financial year 2007, paragraph 55(c)).</p>	<p><i>EuropeAid will develop several tools in order to improve the management of implementing organisations and will introduce new terms of reference for audits of new programme estimates.</i></p>
3.	<p>Checks performed by the Delegations before authorising payments should better scrutinise the payment requests and intensify the focus on the reality, eligibility and accuracy of the expenditure. The quality of the work performed by supervisors should be better monitored.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(c)).</p>	<p>No specific actions were taken by EuropeAid. The number of errors revealed following the Court's audit of individual payments corroborates the observation that the financial control exercised by the Delegations needs to be strengthened.</p>	<p>Checks performed by Delegations before authorising payments should better scrutinise the payment requests and intensify the focus on the reality, eligibility and accuracy of the expenditure. The quality of work performed by supervisors should be better monitored. (Annual Report concerning the financial year 2007, paragraph 55(d)).</p>	<p><i>The Commission is aware that improvements need to be made to the control of the execution of certain types of contract, and is examining the possibility of introducing a mechanism designed to ensure that the quality of the controls carried out by the supervisors meets the requirements concerning the legality and regularity of transactions. It will remind authorising officers of the principles of clearance of advances.</i></p>
4.	<p>The quality of the controls performed by external auditors should be enhanced by ensuring that the new terms of reference include a clear definition of the purpose of the audit; the materiality threshold to be applied; the sampling; the nature of the audit procedures to be performed; guidance on how errors should be treated; and how conclusions are to be reported upon. These standard terms of reference should also be used for all external audits initiated by the Delegations.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(d)).</p>	<p>In October 2007, EuropeAid has issued new terms of reference applicable to all audits. Though the effects of these have yet to be seen due to such recent implementation, there are positive signs that they should enable more consistent reporting from auditors, in particular with regard to the form of the audit opinion given and the materiality threshold which is applied.</p>	<p>Satisfactory action has been undertaken.</p>	
5.	<p>The central monitoring of the external audits organised by the Delegations should be improved so that the results can be effectively communicated to all relevant levels of management. This should be enhanced by the availability, by the end of 2007, of a management system that provides information on the audit process and facilitates access to relevant audit results</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(e)).</p>	<p>Modifications were made to the computerised tool, CRIS Audit, in order to facilitate its use, which was made mandatory in January 2008. Certain refinements still need to be made to allow for the assessment of the audit coverage and the use of this system in collating, analysing and acting upon audit findings and recommendations.</p>	<p>The implementation of CRIS Audit should allow monitoring of the audit coverage and the audit results. Qualitative information as to the recommendations made and the improvements which should be put in place to address the findings is vital to ensure that the ultimate objectives of commissioning audits are met. (Annual Report concerning the financial year 2007, paragraph 55(e)).</p>	<p><i>The entry into force of the new CRIS-Audit module on 1 January 2008, which links the amount of the contract to be audited to the audited amount, will facilitate the calculation of the audit coverage, as well as the analysis of audit findings, according to typology.</i></p> <p><i>The Commission agrees with the Court's recommendation and yearly collates and analyses audit results with a view to learning lessons and to introducing appropriate improvements.</i></p>

	Court observation	Action taken	Court analysis	Commission reply
6.	<p>Verification of the Delegations by EuropeAid's central services should be enhanced by increasing the number of missions.</p> <p>(Annual Report concerning the financial year 2006, paragraph 54(f))</p>	<p>The missions are well designed and provide practical recommendations for improvements to control systems. However, the number of missions has not been increased.</p>	<p>The number of monitoring missions should be increased. They should maintain the focus on the examination of the set-up and functioning of the supervisory and control systems.</p> <p>(Annual Report concerning the financial year 2007, paragraph 55(g)).</p>	<p><i>The standardised methodology for monitoring missions was finalised in March 2008. The number of such missions is to be increased in 2008.</i></p>
7.	<p>As the transactional <i>ex-post</i> controls are restricted in scope, they can only make a limited contribution to the overall assurance on systems and procedures and the legality and regularity of the underlying transactions. Moreover, they are carried out with much delay.</p> <p>(Annual Report concerning the financial year 2005, paragraphs 33 and 42).</p>	<p>The scope of the transactional <i>ex-post</i> controls still excludes aspects related to legal commitments as well as detailed supporting documentation of expenditure of work programmes.</p>	<p>Transactional <i>ex-post</i> controls should include a better examination of supporting documentation to ensure that transactions are not affected by errors of eligibility and occurrence as well as to verify whether checks performed before the payment was authorised were adequate. (Annual report 2007, paragraph 55(f)).</p>	<p><i>The Commission is continuously working to further improve its system and will pay specific attention to the issue of the detail of supporting documentation on programme estimates.</i></p>
8.	<p>Compliance with the Cotonou Agreement should be benchmarked against baseline requirements, such as the availability of timely published and audited accounts. A clear, formal presentation of the conclusions reached would require the parameters of the 'dynamic interpretation' to be made explicit, thus enabling the appropriateness of disbursement decisions to be assessed</p> <p>(Annual Report concerning the financial year 2006, paragraph 55(a)).</p>	<p>EuropeAid did not define baseline requirements. The Court's audit revealed that in 5 out of the 15 commitments examined, budget support is provided to ACP States where the Court considers that public expenditure management is not sufficiently transparent, accountable and effective. For the cases identified, the vigorous application of the Commission's dynamic interpretation of the budget support conditions of the Cotonou Agreement implies a very high fiduciary risk.</p>	<p>Compliance with the Cotonou Agreement should be benchmarked against baseline requirements, such as the availability of timely published and audited accounts, to be met before budget support is granted (Annual Report concerning the financial year 2007, paragraph 56(a)). EuropeAid should ensure, before the start of a budget support programme, that there is a clear and complete assessment of the public finance management and that the recipient country has a credible and relevant reform programme to address all significant weaknesses over a foreseeable timetable. (Annual Report concerning the financial year 2007, paragraph 56(d)).</p>	<p><i>During 2007 the Commission continued to apply the dynamic approach, which it considers appropriate.</i></p> <p><i>Before the start of a budget support programme, the Commission will continue to ensure that there is an assessment of the public finance management, preferably within the PEFA Framework, and that the recipient country has a credible and relevant reform programme to address significant weaknesses over a foreseeable timetable. This will warrant a rigorous application of the dynamic interpretation of the conditions of the Cotonou Agreement and a management of risk consistent with the Commission development objectives.</i></p> <p><i>Finally, the Commission disagrees with the Court's assessment regarding the five commitments in question.</i></p>
9.	<p>In order to set out its conclusions in a structured manner, the Commission should ensure that the data used as a basis for disbursement decisions rely more on measurements of events that have already taken place than on predictions of future occurrences;</p> <p>(Annual Report concerning the financial year 2006, paragraph 55(b)).</p>	<p>The 2007 audit revealed that in a significant number of cases, the Commission did not demonstrate in a structured and formalised way the respect of the Cotonou Agreement relating to public finance management. The explanation in some of these cases is that reliance put on future occurrences rather than on events that had taken place and the inaccurate appraisal of indicators.</p>	<p>In order to set out its conclusions as regards progress in public finance management in a structured manner, the Commission should ensure that the data used as a basis for disbursement decisions is reliable and should rely more on measurements of events that have already taken place than on predictions of future occurrences. (Annual Report concerning the financial year 2007, paragraph 56(c)).</p>	<p><i>When assessing eligibility, the Commission takes into account a balance between past performance and future commitments. At the same time the Commission agrees that when assessing disbursements the emphasis should be placed on demonstrating achievements.</i></p>
10.	<p>The indicators used should permit clear evidence of progress in public finance management to emerge where appropriate. This could be achieved by including indicators which can be measured over time, and compared from one period to the next, as opposed to indicators which rely on the performance of a one-off event.</p> <p>(Annual Report concerning the financial year 2006, paragraph 55(c)).</p>	<p>The current audit has revealed a frequent lack both of a clear analysis of the public finance management weaknesses at the start of the programme and of a structured approach to measure public finance management progress subsequently. As a result, it is more difficult to assess progress thoroughly and objectively.</p>	<p>The performance indicators used should permit clear evidence of progress in public finance management to emerge where appropriate. This could be achieved by strengthening indicators which measure progress of results over time in combination with process indicators on the performance of one-off events. (Annual Report concerning the financial year 2007, paragraph 56(b)).</p>	<p><i>Compared to other sectors, it is more difficult and complex to define result indicators for PFM. The Commission nevertheless favours the use of result indicators, where available, that measure the effect of reforms, but also uses process indicators and measures to monitor the progress in the implementation of reform programme.</i></p>

Charts illustrating the consolidated seventh, eighth and ninth EDFs as at 31 December 2007

Chart I: Cumulative resources

Total = 37 328,65 million euro ⁽¹⁾

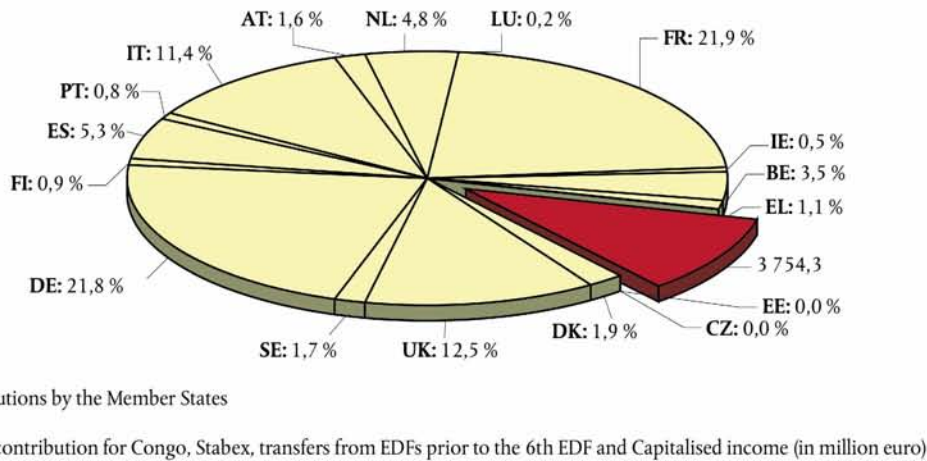
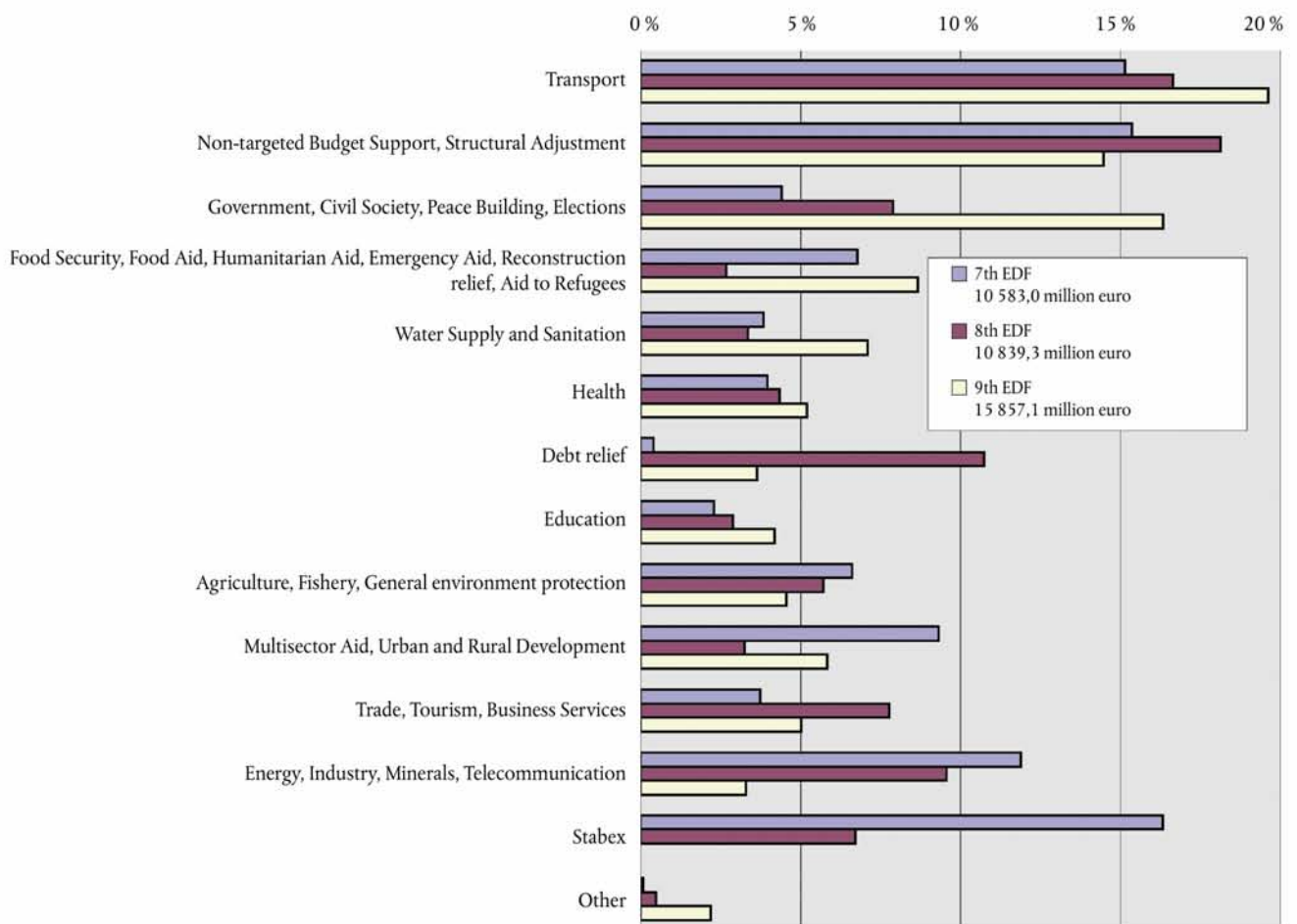


Chart II: Cumulative decisions

Total = 37 279,4 million euro ⁽¹⁾



Source: Court of Auditors, on the basis of the data in the accounting system.

⁽¹⁾ The difference between the cumulative resources (37 328,65 million euro) and the cumulative decisions (37 279,37 million euro), equals the available balance to be allocated (49,28 million euro).