

## IV

*(Notices)*

## NOTICES FROM EUROPEAN UNION INSTITUTIONS, BODIES, OFFICES AND AGENCIES

## COURT OF AUDITORS



In accordance with the provisions of Article 287(1) and (4) of the TFEU 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 Regulation (EU, Euratom) No 1081/2010 of the European Parliament and of the Council, 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 Union, at its meeting of 6 September 2012, adopted its  
ANNUAL REPORTS  
concerning the financial year 2011.**

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), David BOSTOCK, Ioannis SARMAS, Igors LUDBORŽS, Jan KINŠT, Kersti KALJULAIU,  
Karel PINXTEN, Ovidiu ISPIR, Nadejda SANDOLOVA, Michel CRETIN, Harald NOACK, Henri GRETHEN, Szabolcs FAZAKAS,  
Louis GALEA, Ladislav BALKO, Augustyn KUBIK, Milan Martin CVIKL, Rasa BUDBERGYTĖ, Lazaros S. LAZAROU, Gijs DE VRIES,  
Harald WÖGERBAUER, Hans Gustaf WESSBERG, Henrik OTBO, Pietro RUSSO, Ville ITÄLÄ, Kevin CARDIFF,  
Baudilio TOMÉ MUGURUZA.



# **ANNUAL REPORT ON THE IMPLEMENTATION OF THE BUDGET**

(2012/C 344/01)



# TABLE OF CONTENTS

	<i>Page</i>
General introduction .....	7
Chapter 1 — The Statement of Assurance and supporting information .....	9
Chapter 2 — Revenue .....	51
Chapter 3 — Agriculture: market and direct support .....	71
Chapter 4 — Rural development, environment, fisheries and health .....	95
Chapter 5 — Regional policy; energy and transport .....	119
Chapter 6 — Employment and social affairs .....	151
Chapter 7 — External relations, aid and enlargement .....	167
Chapter 8 — Research and other internal policies .....	185
Chapter 9 — Administrative and other expenditure .....	205
Chapter 10 — Getting results from the EU budget .....	223



## GENERAL INTRODUCTION

0.1. The European Court of Auditors is the institution established by the Treaty to carry out the audit of European Union (EU) finances. As the EU's external auditor it acts as the independent guardian of the financial interests of the citizens of the Union and contributes to improving EU financial management. More information on the Court can be found in its annual activity report which, together with its special reports on EU spending programmes and revenue and its opinions on new or amended legislation, are available on its website: [www.eca.europa.eu](http://www.eca.europa.eu).

0.2. This is the Court's 35th Annual Report on the implementation of the EU budget and covers the 2011 financial year. 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, together with its special reports, provides a basis for the discharge procedure, in which the European Parliament decides whether the Commission has satisfactorily carried out its responsibilities for implementing the budget. The Court forwards its annual report to national parliaments at the same time as to the European Parliament and the Council.

0.4. The central part of the annual report is the Court's statement of assurance (the 'DAS') on the reliability of the annual accounts of the EU and on the legality and regularity of transactions (referred to in the report as 'regularity of transactions'). The statement of assurance itself begins the report; the material which follows reports mainly on the audit work underlying the statement of assurance.

0.5. The report is organised as follows:

— Chapter 1 contains the statement of assurance and a summary of the results of the Court's audit on the reliability of accounts and on the regularity of transactions, as well as a summary report on the management of the budget in 2011. Annex 1.3 to Chapter 1 provides information from the 2011 consolidated accounts. To a large extent, this annex replaces the annex to previous annual reports on 'Financial information on the general budget'. More extensive 2011 financial information is presented in the published consolidated accounts and in the financial report prepared by the European Commission, both available on:

[www.ec.europa.eu/budget/biblio/documents/2011](http://www.ec.europa.eu/budget/biblio/documents/2011);

— Chapters 2 to 9 provide detailed audit findings in the form of 'specific assessments' of EU revenue and expenditure.

Chapter 2 deals with the revenue side of the EU budget; Chapters 3 to 9 with seven groups of policy areas within which spending from the EU budget is authorised and recorded. These groups of policy areas correspond broadly to the headings used in the 2007-2013 Financial Framework, which sets out the EU's broad multiannual spending plans;

— Chapter 10 analyses the assessment of performance set out in the annual activity reports presented by three of the Commission's directors-general; identifies significant common themes in the special reports which the Court has adopted in 2011 and covers briefly the Commission's evaluation report.

0.6. The structure of the specific assessments has been altered. In this year's Annual Report the single Chapter on agriculture and natural resources as presented in recent annual reports is replaced by two specific assessments and chapters:

— agriculture: market and direct support; and

— rural development, environment, fisheries and health.

0.7. In addition, the single Chapter on cohesion, energy and transport is replaced by two specific assessments and chapters:

— regional policy, energy and transport; and

— employment and social affairs.

0.8. The specific assessments are mainly based on: the results of the Court's testing of the regularity of transactions; on an assessment of the effectiveness of the principal supervisory and control systems governing the revenue or expenditure involved; and on a review of the reliability of Commission management representations.

0.9. As in previous years, the Annual Report comments on the European Commission's 'synthesis report', in which the Commission accepts political responsibility for management of the EU budget: see paragraphs 1.24 to 1.30. The Commission has chosen to include in its synthesis report for 2011 critical comments about the possible impact on estimates of error of the Court's current audit methods and of their developments being planned for 2012 and subsequent years.

0.10. The Court regards these comments as inaccurate and premature. Furthermore, the Court points out that such developments in its audit approach and methodology reflect evolutions in its audit environment, including the way expenditure is managed by the auditees. As it always does, the Court will adequately explain any developments in its methodology and their effects in a transparent manner at the appropriate time.

0.11. The Commission's replies to the Court's observations — or those of other EU institutions and bodies, where appropriate — are presented within the document. The Court's description of its findings and conclusions takes into account the relevant replies of the auditee. However it is the Court's responsibility, as external auditor, to report its audit findings, to draw conclusions from those findings, and thus to provide an independent and impartial assessment of the reliability of the accounts as well as of the regularity of transactions.



## CHAPTER 1

**The Statement of Assurance and supporting information**

## TABLE OF CONTENTS

	<i>Paragraph</i>
The Court's Statement of Assurance provided to the European Parliament and the Council — Independent auditor's report	I-XI
Introduction	1.1-1.5
Audit findings for the 2011 financial year	1.6-1.30
Reliability of accounts	1.6-1.8
Regularity of transactions	1.9-1.15
Summary of the DAS specific assessments	1.9-1.13
Comparison with previous year(s)' results	1.14-1.15
Reliability of Commission management representations	1.16-1.30
Introduction	1.16-1.18
Annual activity reports and declarations by directors-general	1.19-1.23
Synthesis report of the Commission	1.24-1.30
Budgetary management	1.31-1.38
Budgetary appropriations for commitments and payments	1.32-1.34
Utilisation of payment appropriations at year end	1.35
Outstanding budgetary commitments (RAL)	1.36-1.38

## THE COURT'S STATEMENT OF ASSURANCE PROVIDED TO THE EUROPEAN PARLIAMENT AND THE COUNCIL — INDEPENDENT AUDITOR'S REPORT

I. Pursuant to the provisions of Article 287 of the Treaty on the Functioning of the European Union (TFEU) the Court has audited:

- (a) the consolidated accounts of the European Union which comprise the consolidated financial statements <sup>(1)</sup> and the consolidated reports on implementation of the budget <sup>(2)</sup> for the financial year ended 31 December 2011; and
- (b) the legality and regularity of the transactions underlying those accounts.

### *Management's responsibility*

II. In accordance with Articles 310 to 325 of the TFEU and the Financial Regulation, management is responsible for the preparation and fair presentation of the consolidated accounts of the European Union and the legality and regularity of the transactions underlying them:

- (a) Management's responsibility in respect of the consolidated accounts of the European Union 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 <sup>(3)</sup>; and making accounting estimates that are reasonable in the circumstances. According to Article 129 of the Financial Regulation, the Commission approves the consolidated accounts of the European Union after the Commission's accounting officer has consolidated them on the basis of the information presented by the other institutions and bodies 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 Union in all material aspects.
- (b) The way in which management exercises its responsibility for ensuring the legality and regularity of underlying transactions depends on the method of implementation of the budget foreseen in 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 Union (Article 317 of the TFEU).

### *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 transactions underlying them. 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. These standards require that the Court plans and performs the audit to obtain reasonable assurance whether the consolidated accounts of the European Union are free from material misstatement and the transactions underlying them are legal and regular.

<sup>(1)</sup> The consolidated financial statements comprise the balance sheet, the economic outturn account, the cash flow table, the statement of changes in net assets and a summary of significant accounting policies and other explanatory notes (including segment reporting).

<sup>(2)</sup> 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.

<sup>(3)</sup> 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 2011 financial year were 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 European Union, while the consolidated reports on implementation of the budget continue to be primarily based on cash movements.

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 are selected based on the auditor's judgment, including an 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 Union, whether due to fraud or error. In assessing those risks, 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 context of revenue, the Court's audit of value added tax and gross national income-based own resources takes as its starting point the receipt by the Commission of the macroeconomic aggregates prepared by the Member States, and then assesses the Commission's systems for processing the data until they are included in the consolidated accounts and the contributions by the Member States have been received. For traditional own resources, the Court examines the accounts of the customs authorities and analyses the flow of duties until the amounts are recorded in the accounts and received by the Commission.

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

### **Reliability of the accounts**

#### *Opinion on the reliability of the accounts*

VII. In the Court's opinion, the consolidated accounts of the European Union present fairly, in all material respects, the financial position of the Union as of 31 December 2011, and the results of its operations and its 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.

### **Legality and regularity of the transactions underlying the accounts**

#### **Revenue**

#### *Opinion on the legality and regularity of revenue underlying the accounts*

VIII. In the Court's opinion, revenue underlying the accounts for the year ended 31 December 2011 is legal and regular in all material respects.

#### **Commitments**

#### *Opinion on the legality and regularity of commitments underlying the accounts*

IX. In the Court's opinion, commitments underlying the accounts for the year ended 31 December 2011 are legal and regular in all material respects.

**Payments***Basis for adverse opinion on the legality and regularity of payments underlying the accounts*

X. The Court concludes that the examined supervisory and control systems are partially effective in ensuring the legality and regularity of payments underlying the accounts. The policy groups agriculture: market and direct support; rural development, environment, fisheries and health; regional policy, energy and transport; employment and social affairs as well as research and other internal policies are materially affected by error. The Court's estimate for the most likely error rate for payments underlying the accounts is 3,9 %.

*Adverse opinion on the legality and regularity of payments underlying the accounts*

XI. In the Court's opinion, because of the significance of the matters described in the basis for adverse opinion on the legality and regularity of payments underlying the accounts paragraph, the payments underlying the accounts for the year ended 31 December 2011 are materially affected by error.

6 September 2012

Vitor Manuel da SILVA CALDEIRA

*President*

European Court of Auditors

12, rue Alcide De Gasperi, 1615 Luxembourg, LUXEMBOURG

## THE COURT'S OBSERVATIONS

**INTRODUCTION**

1.1. This Chapter of the Annual Report:

- sets out the background to the Court's Statement of Assurance (DAS)<sup>(4)</sup> and summarises and analyses the audit findings and conclusions which underlie this statement (see paragraphs 1.2 to 1.30);
- analyses key 2011 budgetary management data (see paragraphs 1.31 to 1.38);
- explains how the Court carries out its DAS audit (see **Annex 1.1**); and
- presents the actions taken by the Commission as regards the observations on the reliability of the accounts of previous years. It also includes the Commission's response to the Court's recommendations, in particular on recoveries and financial corrections as well as on the increased use of pre-financing, in its previous annual reports (see **Annex 1.2**).

1.2. 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 Court may supplement this statement with specific assessments of each major area of EU activity<sup>(5)</sup>.

1.3. The aim of the work on the reliability of the accounts of the European Union is to obtain sufficient appropriate evidence to conclude on the extent to which revenue, expenditure, assets and liabilities have been properly recorded and that the consolidated accounts faithfully reflect the financial position as of 31 December 2011, and the results of its operations and cash flows for the year then ended (see paragraphs 1.6 to 1.8).

<sup>(4)</sup> From French: 'Déclaration d'assurance'.

<sup>(5)</sup> See article 287 of the Treaty on the Functioning of the European Union.

---

THE COURT'S OBSERVATIONS

---

1.4. The aim of the work on the regularity of the transactions underlying the 2011 accounts is to obtain sufficient appropriate evidence to conclude on whether those transactions are in accordance with the applicable regulations or contractual provisions, and have been correctly calculated (see paragraphs 1.9 to 1.15 for an overview of the results and Chapters 2 to 9 for more details).

1.5. The aim of the work on the reliability of Commission management representations, i.e. the declarations by the directors-general and the annual activity reports of the Commission's services and the related synthesis report, is to assess the extent to which they provide a fair assessment of the quality of financial management (including residual levels of error), and contribute to the Court's overall assurance (see paragraphs 1.16 to 1.30 and related observations in the sections 'Effectiveness of systems' in Chapters 2 to 9).

## AUDIT FINDINGS FOR THE 2011 FINANCIAL YEAR

### Reliability of accounts

1.6. The Court's observations concern the consolidated accounts of the European Union for the financial year 2011 prepared by the Commission's accounting officer and approved by the Commission in compliance with the Financial Regulation<sup>(6)</sup> and received by the Court on 31 July 2012. The consolidated accounts comprise:

- (a) the consolidated financial statements covering the balance sheet (setting out the assets and liabilities at the end of the year), the economic outturn account (covering the income and expenses of the year), the cash-flow table (showing how changes in the accounts affect cash and cash equivalents) and the statement of changes in net assets as well as the related notes;
- (b) the consolidated reports on the implementation of the budget covering the revenue and expenditure for the year as well as the related notes.

---

<sup>(6)</sup> 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 Regulation (EU, Euratom) No 1081/2010 of the European Parliament and of the Council (OJ L 311, 26.11.2010, p. 9), requires that the final consolidated accounts shall be sent before 31 July of the following financial year (see Article 129).

---

THE COURT'S OBSERVATIONS

---

1.7. The Commission's accounting officer provided the Court with a representation letter confirming that the consolidated accounts are complete and reliable in all material respects.

1.8. The Court's audit of the 2011 consolidated accounts found that these were free from material misstatements (see also **Annex 1.2**).

### **Regularity of transactions**

#### *Summary of the DAS specific assessments*

1.9. The Court provides specific assessments on revenue in Chapter 2 and on the different expenditure policy groups based on Activity Based Budgeting (ABB) policy areas in Chapters 3 to 9 (see **Table 1.1**).

Table 1.1 — Payments in 2011 by Annual Report chapters

(million euro)

Sections (S), Titles (T) and Chapters (C) <sup>(1)</sup> corresponding to the 2011 budgetary nomenclature allocated per chapter of the Court's Annual Report	Payments made in 2011 <sup>(2)</sup>	in % of total
<b>Annual Report chapters</b>		
<b>Chapter 3: Agriculture: market and direct support</b>	<b>43 809</b>	<b>33,9 %</b>
European Agricultural Guarantee Fund (T.05 C01-03, 06-08)	43 809	33,9 %
<b>Chapter 4: Rural development, environment, fisheries and health</b>	<b>13 876</b>	<b>10,7 %</b>
Rural development (T.05 C04-05)	12 399	9,6 %
Environment and climate action (T.07)	240	0,2 %
Maritime affairs and fisheries (T.11)	731	0,6 %
Health and consumer protection (T.17)	506	0,4 %
<b>Chapter 5: Regional policy, energy and transport</b>	<b>34 842</b>	<b>26,9 %</b>
Mobility and transport (T.06)	1 042	0,8 %
Regional policy (T.13)	32 911	25,4 %
Energy (T.32)	889	0,7 %
<b>Chapter 6: Employment and social affairs</b>	<b>10 299</b>	<b>8,0 %</b>
Employment and social affairs (T.04)	10 299	8,0 %
<b>Chapter 7: External relations, aid and enlargement</b>	<b>6 201</b>	<b>4,8 %</b>
External relations (T.19)	3 156	2,4 %
Development and relations with ACP States (T.21)	1 175	0,9 %
Enlargement (T.22)	835	0,6 %
Humanitarian aid (T.23)	1 035	0,8 %
<b>Chapter 8: Research and other internal policies</b>	<b>10 591</b>	<b>8,2 %</b>
Economic and financial affairs (T.01)	319	0,2 %
Enterprise (T.02)	1 213	0,9 %
Competition (T.03)	0	0,0 %
Research (T.08)	4 283	3,3 %
Information society and media (T.09)	1 357	1,0 %
Direct research (T.10)	89	0,1 %
Internal market (T.12)	34	0,0 %
Education and culture (T.15)	2 283	1,8 %
Communication (T.16)	134	0,1 %
Area of freedom, security and justice (T.18)	868	0,7 %
Trade (T.20)	11	0,0 %
<b>Chapter 9: Administrative and other expenditure</b>	<b>9 777</b>	<b>7,6 %</b>
Parliament (S. I)	1 580	1,2 %
Council (S. II)	547	0,4 %
Commission (S. III)	6 264	4,8 %
Court of Justice (S. IV)	334	0,3 %
Court of Auditors (S. V)	137	0,1 %
European Economic and Social Committee (S. VI)	126	0,1 %
Committee of the Regions (S. VII)	91	0,1 %
European Ombudsman (S. VIII)	9	0,0 %
European Data-protection Supervisor (S. IX)	7	0,0 %
European External Action Service (S.X)	682	0,5 %
<b>Grand Total</b>	<b>129 395</b>	<b>100,0 %</b>

<sup>(1)</sup> The budgetary Titles 14 and 24 to 31 of Section III of the general budget concerning primarily administrative expenditure are reported in the European Commission Section of Chapter 9.

<sup>(2)</sup> Administrative expenditure is deducted from policy groups and shown separately under its own heading; this leads to differences in comparison with Chapters 3 to 9.



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

1.10. The Court concludes that revenue (130 000 million euro) <sup>(7)</sup> and payments in the policy group administrative and other expenditure (9 777 million euro) were free from material error and that the examined supervisory and control systems were effective (see **Table 1.2** and paragraphs 2.35 to 2.36 and 9.30 to 9.32). Commitments in all policy groups were also free from material error.

1.11. The Court concludes that the policy group external relations, aid and enlargement (6 201 million euro) was free from material error and that the examined supervisory and control systems were partially effective. However, interim and final payments were subject to material error (see **Table 1.2** and paragraphs 7.26 to 7.27).

1.12. The Court concludes that the following policy groups were affected by material error: agriculture: market and direct support (43 801 million euro reimbursed expenditure <sup>(8)</sup>), rural development, environment, fisheries and health (13 310 million euro reimbursed expenditure <sup>(8)</sup>), regional policy, energy and transport (33 373 million euro reimbursed expenditure <sup>(8)</sup>), employment and social affairs (10 171 million euro reimbursed expenditure <sup>(8)</sup>) and research and other internal policies (10 591 million euro payments). Furthermore, the Court concludes that for these policy groups the examined supervisory and control systems were partially effective (see **Table 1.2** and paragraphs 3.42 to 3.43, 4.51 to 4.52, 5.70 to 5.71, 6.27 to 6.28 and 8.37 to 8.38).

1.13. The Court concludes that overall payments were materially affected by error and that the examined supervisory and control systems for payments were, in general, partially effective (see **Table 1.2**).

**1.11.** *The Commission has designed its controls to cover the full lifecycle of its multiannual projects. It believes that these supervisory and control systems are effective and have significantly improved year on year.*

**1.12-1.13.** *In relation to agriculture: Market and Direct Support, the Commission considers the most likely error determined by the Court for the financial year 2011 represents a slight increase compared to last year but is still within the normal range of statistical variation from one year to another and does not point to a deterioration of the overall quality in the management and control of expenditure by Member States. The Commission considers that the error rates determined by the Court over the last years taken together provide reliable evidence that the most likely error rate for EAGF is relatively close to the 2 % materiality threshold. In relation to Rural development, the Commission's own appreciation of the level of undue payments, on the basis of the control statistics provided by Member States in 2011, shows a deterioration of the situation. This led the Director-General for DG AGRI to issue a reservation in his Annual Activity Report 2011. A number of corrective actions are being identified in order to address the situation. Regarding the supervisory and control systems in place in agriculture, the Commission is of the opinion that IACS which accounted for 91 % of total EAGF expenditure, is generally an effective control system for limiting the risk of error or irregular expenditure, and wishes to recall that the remaining risk for the EU budget is adequately covered by the conformity clearance procedure. See replies to paragraphs 3.10, 3.14-3.15, 3.42, 4.10, 4.43, 4.51 and 4.52.*

<sup>(7)</sup> For the scope of the audit of revenue, see paragraphs 2.9 and 2.13.

<sup>(8)</sup> Interim and final payments based on declarations of expenditure incurred at the level of final recipients (see paragraphs 3.9, 4.9, 5.27 and 6.12).

## THE COMMISSION'S REPLIES

The combined most likely error for Regional Policy, Transport, Energy and Employment and Social Affairs, as shown in Table 1.3, decreases considerably compared to 2010, from 7,7 % to 5,1 %. Also, for the third consecutive year, the level of error for each part of the former policy group Cohesion, Energy and Transport (MLE 6,0 % for Regional Policy, Energy and Transport and, 2,2 % for Employment) remains well below those reported by the Court in the period 2006-2008. This positive development derives from the reinforced control provisions of the 2007-2013 programming period, from the Commission's strict policy of interruptions/suspensions when deficiencies are identified, in line with its 2008 Action Plan and from the positive impact of the simplification measures provided in the regulations for the current programming period. The Commission will continue to focus its actions on the most risky programmes and/or Member States.

Regarding research and other internal policies, the Commission considers that seen from a management perspective — i.e. when balancing the objectives in terms of legality and regularity with considerations on risk-proportionality and cost-effectiveness of controls — its management and control systems provide reasonable assurance subject to the reservations issued by the Authorising Officers by Delegation.

Finally, with particular reference to the provisions of the Financial Regulation applicable to the EU Budget (Article 22a(2)(f) of the Regulation laying down detailed rules for the implementation of the Financial Regulation and Article 28(2b)(g) of the new Financial Regulation), and in view of the proposed reduction of its available resources and of the current measures taken by the Member States, the Commission will consider the cost and benefits of the Court's recommendations before taking and/or proposing appropriate action.

Table 1.2 — 2011 Summary of findings on regularity of transactions

Policy group	Payments (million euro)	Assessment of examined supervisory control systems <sup>(2)</sup>	Most likely error (MLE) (%)	Confidence interval (%)		Frequency of errors <sup>(3)</sup> (%)	Audit conclusions
				Lower error limit (LEL)	Upper error limit (UEL)		
Agriculture: market and direct support <sup>(1)</sup>	43 801 <sup>(4)</sup>	Partially effective	<b>2,9</b> <sup>(9)</sup>	1,1	4,7	39	Affected by material error
Rural development, environment, fisheries and health <sup>(1)</sup>	13 310 <sup>(5)</sup>	Partially effective	<b>7,7</b> <sup>(10)</sup>	4,5	10,9	57	Affected by material error
Regional policy, energy and transport <sup>(1)</sup>	33 373 <sup>(6)</sup>	Partially effective	<b>6,0</b>	3,0	9,0	59	Affected by material error
Employment and social affairs <sup>(1)</sup>	10 171 <sup>(7)</sup>	Partially effective	<b>2,2</b>	0,9	3,4	40	Affected by material error
External relations, aid and enlargement	6 201	Partially effective	<b>1,1</b>	0,0	2,4	33	Free from material error
Research and other internal policies	10 591	Partially effective	<b>3,0</b>	1,1	4,9	49	Affected by material error
Administrative and other expenditure	9 777	Effective	<b>0,1</b>	0,0	0,3	7	Free from material error
<b>Overall audited population</b>	127 224 <sup>(8)</sup>	Partially effective	<b>3,9</b> <sup>(11)</sup>	3,0	4,8	<b>44</b>	<b>Affected by material error</b>
Revenue	130 000 <sup>(12)</sup>	Effective	<b>0,8</b>	0,0	2,4	2	Free from material error

<sup>(1)</sup> In the 2010 Annual Report, the policy groups agriculture: market and direct support and rural development, environment, fisheries and health as well as the policy groups regional policy, energy and transport and employment and social affairs were single policy groups. The aggregated results for 2011, based on the previous structure, are presented in **Table 1.3**.

<sup>(2)</sup> 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. For details see the section 'Audit scope and approach' in Chapters 2 to 9.

<sup>(3)</sup> The frequency of errors represents the proportion of the sample affected by quantifiable and non-quantifiable errors. Percentages are rounded.

<sup>(4)</sup> Reimbursed expenditure (see paragraph 3.9).

<sup>(5)</sup> Reimbursed expenditure (see paragraph 4.9).

<sup>(6)</sup> Reimbursed expenditure (see paragraph 5.27).

<sup>(7)</sup> Reimbursed expenditure (see paragraph 6.12).

<sup>(8)</sup> The difference between the payments in 2011 (129 395 million euro — see **Table 1.1**) and the total amount of the overall audited population in the context of the regularity of transactions corresponds to advances paid for the policy groups agriculture: market and direct support (8 million euro), rural development, environment, fisheries and health (565 million euro), regional policy, energy and transport (1 469 million euro), and employment and social affairs (128 million euro) (see paragraphs 3.9, 4.9, 5.27 and 6.12).

<sup>(9)</sup> In contrast to previous years, failure to meet cross-compliance obligations has been included in the calculation of the most likely error. The errors found represent around 0,2 percentage points of the total most likely error (see paragraph 3.9, second indent and paragraph 3.13).

<sup>(10)</sup> In contrast to previous years, failure to meet cross-compliance obligations has been included in the calculation of the most likely error. The errors found represent around 0,2 percentage points of the total most likely error (see paragraph 4.9, second indent and paragraphs 4.16 to 4.18).

<sup>(11)</sup> In contrast to previous years, failure to meet cross-compliance obligations by recipients of payments under the CAP has been included in the calculation of the most likely error. The errors found represent around 0,1 percentage point of the most likely error estimated by the Court for payments as a whole (see also footnotes 9 and 10).

<sup>(12)</sup> The audit involved examination at the Commission's level of a sample of recovery orders covering all types of revenue (see paragraphs 2.8, 2.9 and 2.13).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Comparison with previous years' results*

1.14. The Court's estimate of the most likely error concerning payments for 2011 is higher than in 2010 in:

— Agriculture: market and direct support; and rural development, environment, fisheries and health (as compared with the former policy group agriculture and natural resources);

— Research and other internal policies.

**1.14.**

— *For Agriculture: Market and direct support, the Commission considers that the slight increase compared to last year is still within the normal range of statistical variation from one year to another and does not point to a deterioration of the overall quality in the management and control of expenditure by the Member States.*

*As regards rural development, the Commission agrees that there is a deterioration of the situation, albeit of a more limited magnitude than the one reported by the Court.*

*The Commission notes that the Court's conclusion is on the policy group as a whole, not on subgroups.*

*The Commission considers that seen from a management perspective — i.e. when balancing the objectives in terms of legality and regularity with considerations on risk-proportionality and cost-effectiveness of controls — its management and control systems applicable to the research and other Internal Policies programmes provide reasonable assurance, subject to the reservations issued by the Authorising Officers by Delegation.*

## THE COURT'S OBSERVATIONS

In the policy groups regional policy, energy and transport; and employment and social affairs (as compared with the former policy group cohesion, energy and transport) the Court's estimate of the most likely error rate decreased.

In the other policy groups (external relations, aid and enlargement; and administrative and other expenditure) the Court's estimate of the most likely error remained stable (see **Table 1.3**).

1.15. Taken together the most likely error estimated by the Court for payments as a whole remained stable as compared to 2010 (3,9 % in 2011 and 3,7 % in 2010, see also **Table 1.3** and **Graph 1.1**)<sup>(9)</sup>. The Court found around two fifths of the transactions tested to be affected by error (2010: around one third of the transactions). The frequency of errors detected by the Court increased for all policy groups, except the former policy group cohesion, energy and transport and administrative and other expenditure for which it remained stable (see **Table 1.3**).

## THE COMMISSION'S REPLIES

*The Commission notes that for the third consecutive year, the level of error remains well below those reported by the Court in the period 2006-2008. This positive development derives from the reinforced control provisions of the 2007-2013 programming period and its strict policy of interruptions/suspensions when deficiencies are identified, in line with its 2008 Action Plan. As shown in Table 1.3, the combined most likely error for regional policy, transport, energy and employment and social affairs also decreased considerably compared to 2010, from 7,7 % to 5,1 %.*

**1.15.** *After taking into account the new valuation of cross-compliance errors in agriculture, the Commission notes the most likely error estimated by the Court is very close to that of 2010 despite a number of adverse technical and structural factors (EU multiannual programmes entering a critical phase with increasing complex payments necessarily more prone to errors).*

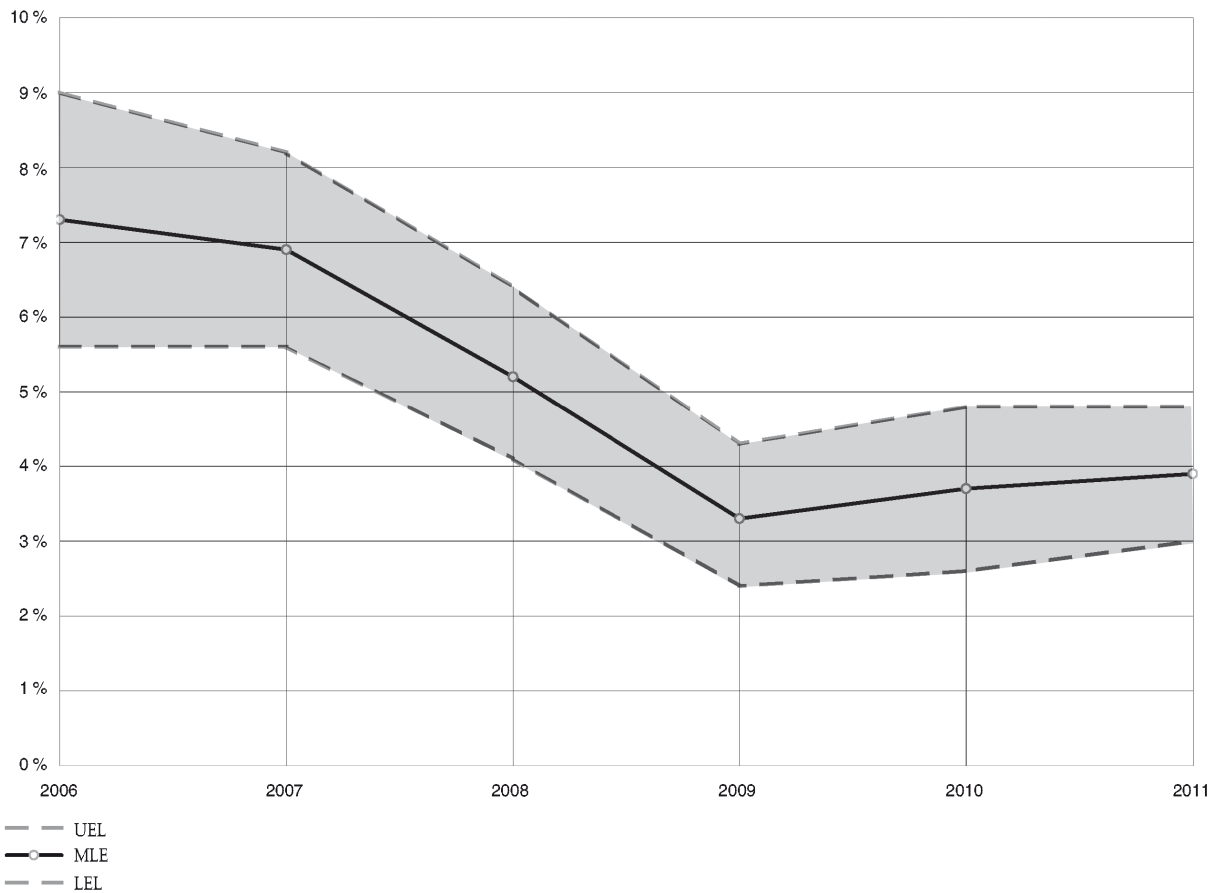
<sup>(9)</sup> In contrast to previous years, failure to meet cross-compliance obligations by recipients of payments under the CAP has been included in the calculation of the most likely error. The errors found represent around 0,1 percentage point of the most likely error estimated by the Court for payments as a whole (see paragraph 3.9, second indent, paragraph 3.13, paragraph 4.9, second indent, and paragraphs 4.16 to 4.18).

Table 1.3 — Comparison of audit results for 2010 and 2011

Policy group	Most likely error (MLE) (%)		Confidence interval (%)				Frequency of errors (%)		Audit conclusions					
			Lower error limit (LEL)		Upper error limit (UEL)									
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011				
Agriculture: market and direct support		2,9		1,1		4,7		39		Affected by material error				
Rural development, environment, fisheries and health	2,3	4,0 <sup>(1)</sup>	7,7	0,8	2,5	4,5	3,8	5,6	10,9	37	48	57	Affected by material error	Affected by material error
Regional policy, energy and transport		6,0		3,0		9,0		59		49	50	59	Affected by material error	Affected by material error
Employment and social affairs	7,7	5,1	2,2	4,7	3,2	0,9	10,7	7,1	3,4			40	Affected by material error	Affected by material error
External relations, aid and enlargement	1,7	1,1	0,1	0,0	3,3	2,4	23	33	Free from material error	Free from material error				
Research and other internal policies	1,4	3,0	0,6	1,1	2,1	4,9	39	49	Free from material error	Affected by material error				
Administrative and other expenditure	0,4	0,1	0,0	0,0	1,1	0,3	7	7	Free from material error	Free from material error				
<b>Overall audited population</b>	<b>3,7</b>	<b>3,9 <sup>(2)</sup></b>	<b>2,6</b>	<b>3,0</b>	<b>4,8</b>	<b>4,8</b>	<b>36</b>	<b>44</b>	<b>Affected by material error</b>	<b>Affected by material error</b>				
Revenue	0,0	0,8	N/A	0,0	N/A	2,4	N/A	2	Free from material error	Free from material error				

<sup>(1)</sup> In contrast to previous years, failure to meet cross-compliance obligations has been included in the calculation of the most likely error (see paragraphs 3.9, 3.13, 4.9 and 4.16 to 4.18). The errors found represent around 0.2 percentage points of the total most likely error.

<sup>(2)</sup> In contrast to previous years, failure to meet cross-compliance obligations by recipients of payments under the CAP has been included in the calculation of the most likely error. The errors found represent around 0.1 percentage point of the most likely error estimated by the Court for payments as a whole (see also footnote 1).

Graph 1.1 — The Court's estimate of the most likely error (2006-2011) <sup>(1)</sup>

<sup>(1)</sup> In contrast to previous years, failure to meet cross-compliance obligations by recipients of payments under the CAP has been included in the calculation of the most likely error for 2011. The errors found represent around 0,1 percentage point of the most likely error estimated by the Court for payments as a whole.

## THE COURT'S OBSERVATIONS

**Reliability of Commission management representations***Introduction*

1.16. In accordance with Article 317 of the TFEU, the Commission is ultimately responsible for the implementation of the EU budget. A keystone of the Commission's present system for managing EU funds (which was revised thoroughly on the basis of a reform launched in April 2000<sup>(10)</sup> in response to a resolution adopted by the European Parliament<sup>(11)</sup>) is the responsibility of the directors-general. The latter must put in place effective supervisory and control systems which meet pre-defined standards<sup>(12)</sup>.

1.17. The Commission's directors-general report annually on the performance of their duties in activity reports<sup>(13)</sup>. These are accompanied by declarations *inter alia* on the extent to which resources have been used for their intended purpose, and control procedures ensure the legality and regularity of transactions. When they identify significant problems in these respects directors-general may include reservations in their declarations.

1.18. The Commission assumes political responsibility for management by its directors-general through the synthesis report. This report draws on representations provided by directors-general in their annual activity reports, as well as on other sources, such as the overall opinion of the internal auditor. The report also describes the measures taken by the Commission to address management and control deficiencies.

<sup>(10)</sup> White Paper 'Reforming the Commission', COM(2000) 200 final of 5.4.2000.

<sup>(11)</sup> European Parliament resolution of 19 January 2000 on action to be taken on the second report of the Committee of Independent Experts on reform of the Commission (OJ C 304, 24.10.2000, p. 135).

<sup>(12)</sup> The Commission's internal control standards are largely inspired by the COSO principles. COSO is a voluntary private-sector organisation dedicated to improving the quality of financial management and reporting through business ethics, effective internal controls and corporate governance.

<sup>(13)</sup> The term 'director-general' is used in the broad sense of persons responsible. In fact, the 48 declarations have been signed by 1 secretary-general, 36 directors-general, 7 directors and 4 heads of service.



THE COURT'S OBSERVATIONS

---

*Annual activity reports and declarations by directors-general* <sup>(14)</sup>**Increased amount of payments under reservation**

1.19. Although all directors-general declared that the control procedures put in place give the necessary guarantees concerning the regularity of transactions, the number of directorates-general or services which have issued one or more reservations increased to 16 in 2011 (2010: 13). The total number of reservations increased to 27 in 2011 (2010: 17), the majority of which, as in previous years, refer to weaknesses concerning the regularity of transactions. The estimated total financial impact of reservations increased to 1 959 million euro or 1,5 % of the payments made in 2011 (2010: 423 million euro or 0,3 %) (see **Table 1.4** and Chapters 2 to 9).

---

<sup>(14)</sup> Performance aspects of the annual activity reports are treated in Chapter 10.

Table 1.4 — Reservations issued by Commission's directorates-general for 2011

(million euro)

DG/Service <sup>(1)</sup>	Reservations	Total payments for relevant ABB activities <sup>(2)</sup>	Financial impact of reservations <sup>(3)</sup>
AGRI	1 — Serious deficiencies in the IACS in BG and PT		Reputational risk
	2 — Rural development expenditure	12 292,02	278,00
	3 — Deficiencies in the supervision and control of certified organic products		Reputational risk
BUDG	1 — Reliability doubts on the Belgian clearance and accounting procedures and system and on the correctness of the TOR amounts transferred to the EU budget		Not estimated
CLIMA	1 — Significant security weakness identified in the national registries of the EU Emissions Trading System (ETS) following cyber-attacks in several Member States in 2010 and 2011		Reputational risk
COMM	1 — Potential non-compliance with applicable legislation on intellectual property rights		Not estimated
EACEA	Materiality of the 2011 value at risk resulting from the error rates in grant payments of the 2011 programme budget for the LLP programme (2007-2013)	1 189,68	4,26
EMPL	1 — Deficiencies in the management and control systems (2007-2013 period) for identified ESF OPs in BE, CZ, DE, ES, IT, LV, LT, RO, SK and UK and for the former Yugoslav Republic of Macedonia IPA Component IV programme	9 557,19	58,70
	2 — Deficiencies in the management and control systems (2000-2006 period) for identified ESF OPs in DE, FR, IT, and ES which have not been subject to sufficient control and corrective measures by the national authorities	437,04	0,00
ENER	1 — Residual error rate with regard to the accuracy of cost claims in FP6 contracts	25,79	1,15
	2 — Residual error rate with regard to the accuracy of cost claims in FP7 contracts	133,43	5,26
ENTR	1 — Accuracy of cost claims in FP6	4,17	0,16
	2 — Accuracy of cost claims in FP7	419,65	0,93
	3 — Reliability of the financial reporting by ESA about the joint implementation of the space component of GMES and the implementation of EGNOS and Galileo programmes		Not estimated
HOME	1 — Residual error rate in the non-audited population of grants in the programmes under ABB activity security and safeguarding liberties	132,90	3,09
	2 — Continued risk of delay of the SIS II project		Reputational risk
INFSO	1 — Accuracy of cost claims in the FP7 grant agreements	1 217,06	22,60
MARE	1 — Management and control systems for the FIFG OPS in DE (Objective 1)		Reputational risk
	2a — Management and control systems for EFF programmes in CZ, ES, IT, NL, RO, SK, FI and SE	444,42	9,11
	2b — Eligibility of expenditure for investments on board		10,71
MOVE	1 — Accuracy of cost claims in FP6 contracts	19,29	0,86
	2 — Accuracy of cost claims in FP7 contracts	39,68	1,23
REA	Accuracy of cost claims impacting on granted EU funding for research for space and security themes of the cooperation specific programme under FP7	432,82	3,63
REGIO	1 — ERDF/Cohesion Fund/IPA management and control systems (2007-2013 period) in BG, CZ, DE, EE, ES, FR, IT, LV, LT, NL, AT, PL, SI, SK, UK and territorial cooperation programmes	30 044,46	1 427,00
	2 — ERDF/Cohesion Fund/IPA management and control systems (2000-2006 period) in DE, IE, ES, IT, HU and cross-boarder programmes		Reputational risk
RTD	1 — Accuracy of cost claims in FP6 grants	517,11	20,56
	2 — Accuracy of cost claims in FP7 grants	3 765,16	100,80
SANCO	1 — Accuracy of MS' cost claims under the animal disease eradication and monitoring programmes in the food and feed policy area	256,23	10,70
<b>Total</b>		<b>60 919,10</b>	<b>1 958,75</b>

<sup>(1)</sup> For the full list of Commission's DGs/services please see <http://publications.europa.eu/code/en/en-390600.htm><sup>(2)</sup> Source: 2011 consolidated accounts.<sup>(3)</sup> Source: 2011 annual activity reports. REGIO and REA have indicated minimum and maximum amounts. Only the latter have been taken into account.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

1.20. The increases in the number of reservations, directorates-general concerned and financial impact estimated reflect the recognition, by the directors-general, of a high risk of error in some areas, such as rural development, cohesion or the 7th Framework Programme (FP7). This also corroborates the Court's audit results for 2011 (see paragraphs 1.10 to 1.15).

**Commission estimates of a 'residual error rate'**

1.21. Each directorate-general is required to assess the extent to which transactions remain affected by error after the operation of supervisory and control systems. This can be done by calculating a residual error rate (RER). In the simplest terms the RER is the error rate obtained from an examination of a representative sample of transactions less any corrections resulting from the supervisory and control systems. If the RER exceeds 2%, the director-general must include a reservation in the declaration which is included in the annual activity report.

1.22. The Commission for the first time provided directorates-general with guidance on how to calculate the RER in the instructions for preparing the 2011 annual activity reports. This led to an improvement in some declarations, in particular for the cohesion directorates-general (see paragraphs 5.66 and 6.25) and the Directorates-General for Research and Innovation and for the Information Society and Media (see paragraphs 8.35 to 8.36). However, the Court found weaknesses in these instructions and their implementation. Some directorates-general provided unclear information and/or underestimated RERs, which meant that they failed to make reservations or understated their seriousness<sup>(15)</sup>. For example:

- the guidance did not sufficiently explain what to do when it was not possible to calculate a reliable RER;
- amounts were included in the calculation although, due to long delays, they had not been received or otherwise recovered;

**1.20.** The Commission has reported its analysis of the various reasons behind this increase in the Synthesis report for 2011. These are outlined in paragraph 1.27 below. For regional policy, the increase in the number of reservations is mainly due to the application of a stricter methodology in particular by assessing the cumulative residual risk, to address observations made by the Court in its former Annual Reports. For the first year, programmes are put under reservation when the cumulative residual risk is above 2%.

**1.21.** The examination of a representative sample of transactions typically requires an audit effort which is beyond the means of directorates-generals and services outside the four main expending areas (agriculture, Structural Funds, external aid and research). The AAR standing instructions provide extensive guidance on how to provide assurance when the available control indicators are not statistically representative of the transaction population. For cohesion policy the regulations provide that Member States audit representative samples of transactions for programmes or groups of programmes each year. The resulting error rates are then reviewed and confirmed by the Commission services and used for their assurance process.

**1.22.** The Commission welcomes the acknowledgement of its improved guidance as a response to the Court's recommendations made in its 2010 Annual Report.

*It considers that the DGs referred to by the Court followed the instructions and made appropriate reservations.*

- The AAR instructions include specific, step-by-step guidance on how to proceed in case this information is not available.
- In line with the Commission's instructions, only financial corrections that were officially agreed by national authorities and recorded by the Certifying Authority in their books were taken into consideration when calculating the residual error rate. Provided that these requirements are met, the Commission ensures that all agreed financial corrections are deducted from the next payment claim submitted by the relevant authorities.

<sup>(15)</sup> See paragraphs 3.40 to 3.41, 4.48 to 4.50, 5.67 to 5.69, 6.24 to 6.26 and 7.25.

## THE COURT'S OBSERVATIONS

— different types of corrective actions (financial corrections/withdrawals and recoveries) were included in the calculation of the RER despite their inherent differences<sup>(16)</sup>. Furthermore, the instructions also foresaw suspensions to be included.

1.23. The Court concludes that the RER is not yet a reliable indicator of the extent to which transactions remain affected by error.

*Synthesis report of the Commission*

1.24. In the introduction to the synthesis report<sup>(17)</sup>, the Commission takes overall political responsibility for management of the EU budget primarily based on the assurances and reservations in the AARs from directors-general and heads of service.

1.25. The principal sources for the synthesis report are the AARs. The Commission notes that they all give reasonable assurance concerning the regularity of the underlying transactions. The Court has noticed improvements in some AARs recognising a high risk of error and providing quantitative indicators for measuring regularity of transactions (see paragraphs 1.20 and 1.22). However, the Court emphasises that issues previously identified remain unresolved (see paragraph 1.22 and **Annex 1.2**, paragraph 2).

1.26. The synthesis report also draws on the second overall opinion issued by the Commission's Internal Auditor. The overall opinion is based on the work carried out from 2009 to 2011 by the IAS and the Internal Audit Capabilities as well as the assurance given in the AARs for 2011 by senior management. Compared to last year, the overall opinion has improved by providing more detail on the matters raised. The opinion remains positive, building in most cases on the same reservations as contained in the AARs. The Court considers that the issues identified by the Internal Auditor as requiring further attention — such as the weaknesses in the external aid area<sup>(18)</sup> — should be appropriately addressed by the directorates-general concerned.

## THE COMMISSION'S REPLIES

— *The Commission agrees that suspensions should not be included in the residual error rate calculation and no directorate-general has done so.*

**1.23.** *The Commission acknowledges that wider and more consistent use of the RER indicator is desirable. Yet, it recalls that it is not intended to be either solely or universally used. Most DGs and services will continue to rely on other indicators to assess the amount at risk. Medium-size directorates-general would in particular be facing unfavourable ratios for cost-efficiency of controls.*

**1.25.** *See Commission reply to paragraph 1.22 and Annex 1.2, paragraph 2.*

**1.26.** *The Internal Auditor ensures coherence between the qualifications to his overall opinion and the reservations of the directorates-general and heads of service through a dialogue lasting from the conclusion of his audits until the statements of assurance are signed. The opinion is built on the audit work undertaken over three years on all material areas.*

*All risks brought to the attention of Authorising officers by delegation by the Internal Auditor are appropriately addressed by the directorates-general concerned through the drawing up and implementation of action plans which are rigorously monitored by directorates-general and by the Audit Progress Committee of the Commission.*

<sup>(16)</sup> See paragraphs 1.32 to 1.50 of the Court's 2009 Annual Report.

<sup>(17)</sup> Communication from the Commission to the European Parliament, the Council and the Court of Auditors — Synthesis of the Commission's management achievements in 2011, COM(2012) 281 final of 6.6.2012.

<sup>(18)</sup> Information about the overall quality of financial management is absent in the external aid DGs, but no reservation has been provided for this (see paragraph 7.25 and paragraphs 52 to 53 in the 2011 EDF Annual Report).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

1.27. The Commission recognises the high risk of error by increasing the amount of payments under reservation (see paragraph 1.20). It states that this effect can be attributed to a series of factors of which some are:

- the multiannual implementation cycle is up to full speed for most 2007-2013 programmes;
- for many spending areas, more reliable indicators for the quality of financial management are now available; and
- new guidance for these indicators has prevented pre-financing from averaging down the error rates detected in interim and final payments.

1.28. In relation to this, the Commission also acknowledges that further improvement is required to present transparent information on the quality of financial management and proposes action to address these concerns, such as:

- reporting in the relevant AARs on implementation, results and audits of financial instrument activities;
- disclosing, for the AARs concerned, indicators that are relevant to multiannual control strategies as is done for cohesion and further harmonising the materiality criteria in the AARs between cohesion directorates-general and other directorates-general responsible for funds under shared management; and

1.27. See Commission reply to paragraph 1.20.

1.28.

- *The amendment of Council Regulation (EC) No. 1083/2006 of 13 December 2011, initiated by the Commission in July 2011, introduced formal requirement for the Managing Authorities to report on financial instruments (FIs) in the annual and final reports on implementation of operational programmes. The Commission will provide a summary of this data in the AAR, on the progress made in financing and implementing financial instruments. The Commission's summary report will be produced by 1 October 2012.*

*In addition, further to the Court's observations concerning financial instrument activities in its 2010 Annual Report, the Commission has conducted specific audit work in 2011 focusing on this area and reported its results in the AARs of DG REGIO (page 73) and DG EMPL (pages 45-46). The Commission intends to pursue with its audit work in this area in 2012 and subsequent years.*

- *AARs indicators such as the cumulative residual risk relevant to multiannual strategies will be further harmonised, to the extent possible, with other structural actions directorates-general.*

## THE COURT'S OBSERVATIONS

— the modifications which it has proposed to the Financial Regulation and the sectoral regulations for the 2014 to 2020 period (which are currently being discussed by the European Parliament and the Council) with a view to improving the design of funding schemes, addressing the risk of error, limiting the administrative burden for beneficiaries and other stakeholders, reducing the operating costs of controls and obtaining annual management declarations of assurance for all programmes under shared management.

1.29. The Court considers that the initiatives of the Commission to strengthen accountability and improve transparency of information on the quality of financial management are steps in the right direction. However, the Court has recently pointed out that although these proposals might contribute to increasing assurance that expenditure is legal and regular, the Commission has not shown how it intends to use this information to arrive at the situation that transactions are free from material error<sup>(19)</sup>.

1.30. Interruption and suspension of payments may be a useful tool to prevent deficiencies resulting in irregular expenditure, but these instruments need to be complemented by actions correcting the errors (i.e. financial corrections and recoveries). The Court considers that when presenting figures concerning financial correction and recoveries the Commission needs to put these into an appropriate context — the related data from Member States is still incomplete or not fully audited and/or validated and the inherent difference and impact of the two corrective instruments is still not adequately taken into account.

**BUDGETARY MANAGEMENT**

1.31. This section analyses some key 2011 budgetary management data, notably the implementation of budgetary appropriations for commitments and payments, the utilisation of payment appropriations at year end and the level of outstanding budgetary commitments (RAL).

## THE COMMISSION'S REPLIES

— *The aim of the Commission is to improve the arrangements put in place for 2007-2013 whilst ensuring sufficient continuity and avoiding an overhaul of systems. Reinforced result orientation is one of the overarching aims of the Commission. Planning, implementation, monitoring, evaluation as well as control and audit arrangements have been adjusted or redesigned to encourage and facilitate achievement as well as the measurement of results.*

**1.29.** *The Commission proposal of a single logical assurance chain supporting the Commission services' own management declarations — if adopted by the legislative Authority — is seen as a major step forward as this will provide for assurance from all levels of management of all EU funds.*

*The relevant Commission managers will take full account of the underlying assurance declarations in framing their own management declarations thus providing a solid basis for assurance and action to address weaknesses in the management and control systems where necessary.*

**1.30.** *The Commission agrees that a strict interruptions and suspensions policy is an effective tool to prevent deficiencies resulting in irregular expenditure, as demonstrated in the Staff Working Document (SEC(2011) 1179). The Commission complements these preventive mechanisms with strict financial corrections when necessary. The Commission has reported on the first results of its risk-based audit of the Member States' corrective capacity in the concerned AARs, and has provided detailed guidance to Member States to improve the reporting of figures. The results of the ongoing audits on Member States' figures will be used to further improve guidance if necessary and good practices will be shared with Member States.*

<sup>(19)</sup> See Opinion No 6/2010 on a proposal for a regulation of the European Parliament and of the Council on the Financial Regulation applicable to the general budget of the European Union of the European Court of Auditors (OJ C 334, 10.12.2010, p. 1).

## THE COURT'S OBSERVATIONS

**Budgetary appropriations for commitments and payments**

1.32. The EU budget in 2011 included budgetary appropriations for commitment <sup>(20)</sup> of 142,5 billion euro <sup>(21)</sup>, and appropriations for payment <sup>(22)</sup> of 128,3 billion euro <sup>(23)</sup>. The implementing institutions arrived at high implementation rates: 99,3 % of appropriations for commitment (the same as in 2010) and 98,6 % of appropriations for payment (2010: 96,6 %) <sup>(24)</sup>. Appropriations, excluding carryovers, were below the financial framework ceilings in commitments by 0,1 billion euro and in payments by 7,0 billion euro, all reserves included.

1.33. Implementation of the budget overall resulted in a budgetary surplus <sup>(25)</sup> at the end of 2011 of 1,5 billion euro (2010: 4,5 billion euro). This will offset, in principle, the own resources to be collected from Member States in the following year(s).

---

<sup>(20)</sup> Amounts available for commitments in this and future years.

<sup>(21)</sup> Includes appropriations for commitment carried over from 2010 amounting to 259 million euro and an overall 284 million euro increase in appropriations for commitment arising from the seven amending budgets approved during 2011. It excludes assigned revenue which in 2011 amounts to 6,2 billion euro for commitments and 6,7 billion euro for payments. Assigned revenues are used to finance specific items of expenditure (see Article 18 of the Financial Regulation — Regulation (EC, Euratom) No 1605/2002). They cover inter alia refunds arising from recovery of amounts paid in error, which are re-allocated to their budget line of origin, contributions from EFTA members increasing budget lines, and revenue from third parties where agreements have been concluded involving a financial contribution to EU activities.

<sup>(22)</sup> Amounts available for payments in the year.

<sup>(23)</sup> Includes appropriations for payment carried over from 2010 amounting to 1 582 million euro and an overall 200 million euro increase in appropriations for payment arising from the seven amending budgets approved during 2011.

<sup>(24)</sup> In 2011 appropriations for commitment were higher than in 2010 by 0,6 billion euro (0,4 %), and appropriations for payment were higher by 3,6 billion euro (2,9 %).

<sup>(25)</sup> The budgetary surplus (budget outturn) is the result of the implementation of the budget. However, it is not a reserve and it cannot be accumulated and used in future years to finance expenditure.

## THE COURT'S OBSERVATIONS

1.34. However, in the three main funds of the heading 1b of the multiannual financial framework 'Cohesion for growth and employment' (European Social Fund (ESF), European Regional Development Fund (ERDF) and Cohesion fund (CF)) there was an acceleration of payment requests by Member States towards the end of the year. In fact, payments could have been up to 5 billion euro higher had the increased need for funds been correctly anticipated and had the required payment appropriations been made available, e.g. by transfers of unused amounts in other areas <sup>(26)</sup>.

### Utilisation of payment appropriations at year end

1.35. The Court notes that under some budget titles a disproportionately high amount of payments was made in the month of December compared to the total payments in the rest of the year <sup>(27)</sup>. Such a concentration of a significant proportion of payments in a limited period may adversely affect the effectiveness of supervisory and control systems and increase the risk of error.

## THE COMMISSION'S REPLIES

**1.34.** As a general rule, the legal base foresees that payment applications are submitted three times a year with a last submission until end October. However, this provision is not binding and Member States may send their claims until year end to avoid automatic decommitments, which explains the high number of claims transmitted at the end of the year.

Moreover, interruptions and suspensions decisions are elements which can hardly be taken into account when forecasting appropriations needed. Interruptions may last up to six months according to the regulation. Upon correction of the deficiency by the Member States and application of financial corrections if necessary, the Commission lifts the interruption and as a consequence, payments may resume.

The Commission wrote to Member States in the beginning of 2012 to emphasise the need to transmit most of the claims by 31 October. It would allow the Commission, in addition to the global transfer exercise, to request an amending budget to the budgetary Authority to increase the payment appropriations to honour the claims received, based on payment claims actually received instead of on the basis of forecasts.

**1.35.** Concentration of payments depends on the rhythm by which cost claims from Member States and other beneficiaries are sent to the Commission. The Commission is also of the view that not all budget titles mentioned in the footnote present a high percentage of payments at year end.

<sup>(26)</sup> In the case of the ESF an underutilisation in 2010 (see the Court's 2010 Annual Report, paragraph 1.41) led to additional payments in 2011. This, together with accelerated payment requests towards the end of the year, increased the actual payments to 114 % of the original budget. The additional payment requests for the ESF were mainly covered by transfers from ERDF and CF. However, unforeseen inflow of payment requests for ERDF and CF towards the end of the year overturned predictions and increased actual payments to such a level that additional payments could have been made from these funds, if appropriations had been available — see also 'Report on budgetary and financial management accompanying the Community accounts — Financial year 2011', pp. 42-45.

<sup>(27)</sup> High percentages of payments in December compared to the actual payments made in the year: Title 06 — Mobility and transport 26 % (295 million), Title 17 — Health and consumer protection 44 % (266 million), Title 19 — External relations 31 % (1 016 million), Title 21 — Development and relations with African, Caribbean and Pacific States 27 % (403 million), Title 22 — Enlargement 28 % (264 million) and Title 32 — Energy 23 % (219 million).



### Outstanding budgetary commitments (RAL)

1.36. Outstanding budgetary commitments (RAL) <sup>(28)</sup> for which payment and/or decommitment have not yet been made <sup>(29)</sup> increased by 13 billion euro (6,7 %) to 207 billion euro, mostly in policy areas financed through differentiated appropriations <sup>(30)</sup>, and represent the equivalent of 2,3 years worth of differentiated commitments or 2,7 years of differentiated payments at the 2011 spending rate.

1.37. Most outstanding commitments concern cohesion <sup>(31)</sup> (see **Graph 1.2**). In this field, outstanding commitments amounted to 136 billion euro <sup>(32)</sup> (65,5 % of the total amount), representing 2,7 years worth of commitments or 3,2 years worth of payments in that area at the 2011 spending rate. The vast majority of these outstanding commitments (124,6 billion euro or 92 % of the total amount) concerns the current period 2007-2013 <sup>(33)</sup>.

**1.36-1.37** Outstanding commitments derive from the normal management of multiannual programmes and from the growth in the overall level of new commitments. As far as Structural Funds are concerned, the size of the RAL is controlled by the N+2/N+3 rule defined by the corresponding regulations. Following this rule, the expected level of the RAL must be equivalent to two or three years of commitments. Consequently, the RAL situation is normal, as shown in Graph 1.2 comparing the situation of the RAL for the 2000-2006 period and the first years of implementation of the 2007-2013 period.

The validity of the indicator '2011 spending rate' is relative for payments, because of the lack of available appropriations at year end (see item 1.34 last sentence).

<sup>(28)</sup> From French: 'Reste à liquider'.

<sup>(29)</sup> Outstanding budgetary commitments arise as a direct consequence of differentiated appropriations (see footnote 30), where expenditure programmes take a number of years to be completed and commitments made in earlier years remain outstanding until the corresponding payments are made.

<sup>(30)</sup> The budget distinguishes between two types of appropriation: non-differentiated appropriations and differentiated appropriations. Non-differentiated appropriations are used to finance operations of an annual nature, e.g. administrative expenditure. Differentiated appropriations were introduced to manage multiannual operations; the related payments can be made during the year of the commitment and during the following years. Differentiated appropriations are used mainly for the Structural Funds and the Cohesion Fund.

<sup>(31)</sup> For cohesion, the following total commitments were foreseen in the Financial Framework 2000-2006: 261 billion euro (see 2006 accounts) and the Financial Framework 2007-2013: 348 billion euro (see 2011 accounts), i.e. an increase of 33 %.

<sup>(32)</sup> For cohesion see 'Report on budgetary and financial management accompanying the Community accounts — Financial year 2011', pp. 28, 42-45.

<sup>(33)</sup> The automatic decommitment rule (n + 2 rule/n + 3 rule) helps to clear outstanding commitments. This rule requires automatic decommitment of all funds not spent or not covered by a payment request by the end of the second/third year following the year of allocation. As part of the 'third simplification' package, the n + 2/n + 3 rule was last amended for the 2007 commitments in cohesion (see Council Regulation (EC) No 1083/2006 (OJ L 210, 31.7.2006, p. 26), amended by Regulation (EU) No 539/2010 of the European Parliament and of the Council (OJ L 158, 24.6.2010, p. 1).

## THE COURT'S OBSERVATIONS

1.38. The substantially higher level of accumulated outstanding commitments shown for the programming period 2007-2013 can be explained to a large extent by the late implementation of programmes<sup>(34)</sup>. Payments could only be made once Member States' management and control systems were approved by the Commission, as required by the relevant regulations for Structural Funds. According to the interinstitutional agreement on budgetary discipline and sound financial management<sup>(35)</sup>, it must be ensured that sufficient payment appropriations are made available in future years to cover the widening gap between outstanding commitments and appropriations for payments (see also paragraph 1.34).

## THE COMMISSION'S REPLIES

**1.38.** *The mechanism of prior approval of Member States' management and control systems before any interim payment is made, introduced for the first time for the 2007-2013 period, is a major improvement in securing the EU payments for cohesion. During the programming period, the requirements for presenting the payment request were modified for 2007 commitments and more flexibility was introduced for major projects. These measures slowed down the spending levels.*

*Full execution of the available credits by the Structural Funds in both 2010 and 2011 show that the growth in the RAL can also result from a lack of budget credits available at year end (see also point 1.34).*

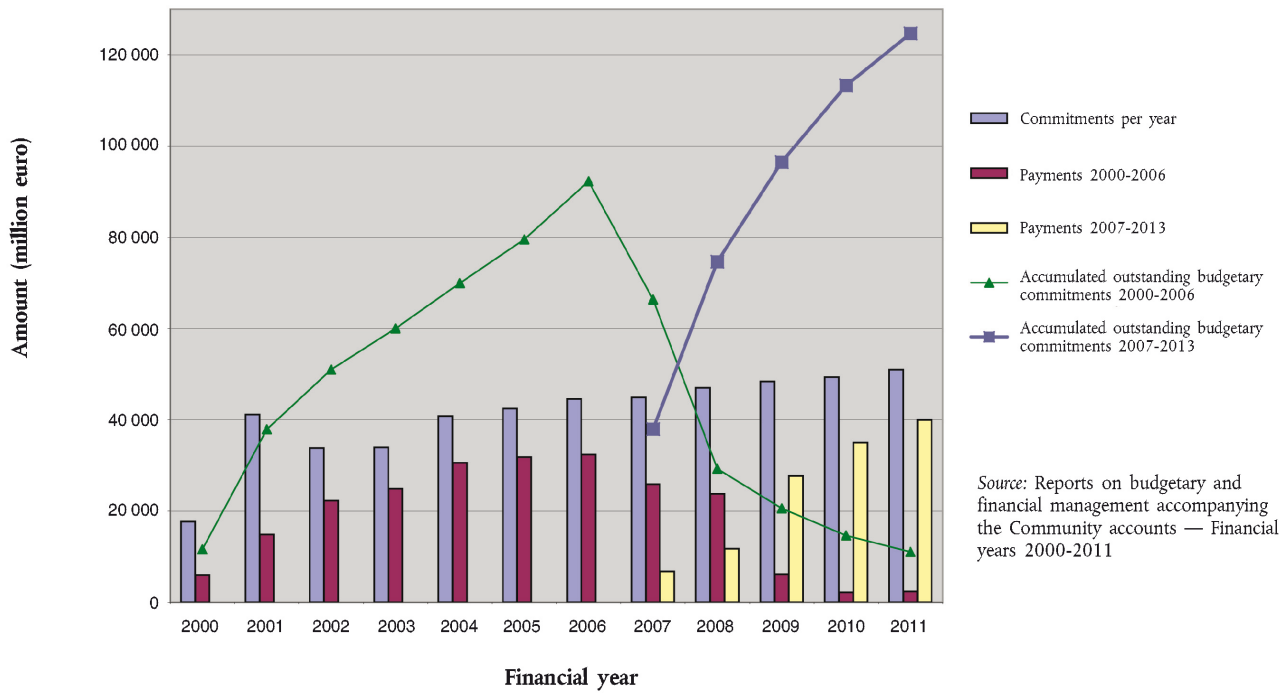
*Graph 1.2 gives evidence of the likely absorption of outstanding commitments accumulated during the financial framework programming period.*

*Finally, the Commission agrees that sufficient payment appropriations need to be made available in future years. The Commission is firmly committed to present draft budgets covering the widening gap between outstanding commitments and appropriations for payments.*

<sup>(34)</sup> See the Court's 2008 Annual Report, paragraphs 6.8 and 6.26 to 6.28. More details are available in the Commission Report on budgetary and financial management accompanying the Community accounts — Financial year 2008, p. 42, and in the Commission Analysis of the budgetary implementation of the Structural and Cohesion Funds in 2008, p. 5 and pp. 13-17.

<sup>(35)</sup> OJ C 139, 14.6.2006, p. 1. See also Article 3 of Council Decision 2007/436/EC, Euratom of 7 June 2007 on the system of the European Communities Own Resources (OJ L 163, 23.6.2007, p. 17).

**Graph 1.2 — Development of accumulated outstanding commitments of the Structural Funds and the Cohesion Fund 2000-2006 and cohesion area 2007-2011**



## ANNEX 1.1

## AUDIT APPROACH AND METHODOLOGY

**PART 1 — Audit approach and methodology for the reliability of accounts (financial audit)**

1. In order to assess whether the consolidated accounts, consisting of the consolidated financial statements and the consolidated reports on the implementation of the budget <sup>(1)</sup>, present fairly, in all material respects, the financial position of the European Union, and the results of operations and cash flows at the year end, the main assessment criteria are:

- (a) *legality and regularity*: the accounts are drawn up in accordance with the rules, and budgetary appropriations are available;
- (b) *completeness*: all revenue and expenditure transactions and all assets and liabilities (including off-balance sheet items) proper to the period are entered in the accounts;
- (c) *reality of the transactions and existence of the assets and liabilities*: each revenue and expenditure transaction is justified by an event which pertains to the entity and is proper to the period; the asset or liability exists at the balance sheet date and is proper to the reporting entity;
- (d) *measurement and valuation*: the revenue and expenditure transaction and the asset or liability is entered in the accounts at an appropriate value, bearing in mind the principle of prudence;
- (e) *presentation of information*: the revenue and expenditure transaction, asset or liability is disclosed and described in accordance with the applicable accounting rules and conventions and the principle of transparency.

2. The audit consists of the following basic elements:

- (a) an update of the evaluation of the accounting control environment;
- (b) checking of the functioning of key accounting procedures and the year-end closure process;
- (c) analytical checks (consistency and reasonableness) on the main accounting data;
- (d) analyses and reconciliations of accounts and/or balances; and
- (e) substantive tests of commitments, payments and specific balance sheet items based on representative samples.

**PART 2 — Audit approach and methodology for the regularity of transactions (compliance audit)**

3. The approach taken by the Court to audit the regularity of the transactions underlying the accounts comprises:

- direct testing of transactions in revenue and in each spending area (see **Table 1.1**) in order to ascertain how far they are regular; and
- an assessment of the effectiveness of supervisory and control systems ensuring the regularity of transactions.

4. This is supplemented by evidence provided by the work of other auditors (where relevant) and an analysis of Commission management representations.

*How the Court tests transactions*

5. The direct testing of transactions within each specific assessment (Chapters 2 to 9) is based on a **representative sample** of the recovery orders (in the case of revenue) and payments contained within the policy group concerned <sup>(2)</sup>. This testing provides a statistical estimation of the extent to which the transactions in the population concerned are irregular.

<sup>(1)</sup> Including the explanatory notes.

<sup>(2)</sup> Additionally to this, a horizontal representative sample of commitments is drawn and tested for compliance with the relevant rules and regulations.

6. In order to determine the sample sizes necessary to produce a reliable result, the Court uses an **audit assurance model**. This involves an assessment of the risk of errors occurring in transactions (inherent risk) and the risk that the systems do not prevent or detect and correct such errors (control risk).

7. Transaction testing involves a **detailed check** of each transaction selected by the samples, including determination of whether or not the claim or payment was correctly calculated and in compliance with the relevant rules and regulations. The Court samples the transactions recorded in the budgetary accounts and traces the payment down to the level of the final recipient (e.g. farmer, organiser of training course, or development aid project promoter) and tests compliance at each level. When the transaction (at any level) is incorrectly calculated or does not meet a regulatory requirement or contractual provision, it is considered to contain an **error**.

*How the Court evaluates and presents the results of transaction testing*

8. **Errors** in transactions occur for a variety of reasons and take a number of different forms depending on the nature of the breach and specific rule or contractual requirement not followed. Errors in individual transactions do not always affect the total amount paid.

9. The Court **classifies errors** as follows:

- whether they are *quantifiable* or *non-quantifiable*, depending on whether it is possible to measure how much of the amount paid or received from the EU budget was affected by error; and
- in terms of their *nature*, in particular *eligibility* (payment does not meet the eligibility rules), *occurrence* (reimbursement of a cost which is not proven to have been incurred) or *accuracy* (payment incorrectly calculated).

10. Public procurement is one area where the Court often finds significant errors. EU and national public procurement law consists essentially of a series of procedural requirements. To ensure the basic principle of competition foreseen in the Treaty the contracts have to be advertised; bids must be evaluated according to specified criteria; contracts may not be artificially split to get below thresholds, etc.

11. For its audit purposes the Court puts a value on failure to observe a procedural requirement. The Court:

- (a) regards as 'serious' those errors which frustrate the objectives of the public procurement rules: fair competition and award of the contract to the best qualified bidder <sup>(3)</sup>;
- (b) quantifies the impact of 'serious' infringements of the public procurement rules as affecting the entire value of the payment related to the contract — a 100 % quantifiable error <sup>(4)</sup>;
- (c) treats less serious errors which do not affect the outcome of the tendering procedure as non-quantifiable errors <sup>(5)</sup>.

The quantification by the Court may differ from that used by the Commission or Member States when deciding how to respond to misapplication of the public procurement rules.

12. The Court expresses the **frequency** by which errors occur by presenting the proportion of the sample affected by quantifiable and non-quantifiable errors. This indicates how widespread errors are likely to be within the policy group as a whole. This information is given in Annexes X.1 of Chapters 2 to 9 when material error is present.

13. On the basis of the errors which it has quantified, the Court, using standard statistical techniques, estimates the **most likely rate of error** (MLE) in each specific assessment and for spending from the budget as whole. The MLE is the weighted average of the percentage error rates found in the sample <sup>(6)</sup>. The Court also estimates, again using standard statistical techniques, the range within which it is 95 % confident that the rate of error for the population lies in each specific assessment (and for spending as whole). This is the range between the lower error limit (LEL) and the upper error limit (UEL) <sup>(7)</sup> (see illustration).

<sup>(3)</sup> There are essentially two award systems: the lowest offer or the most advantageous offer.

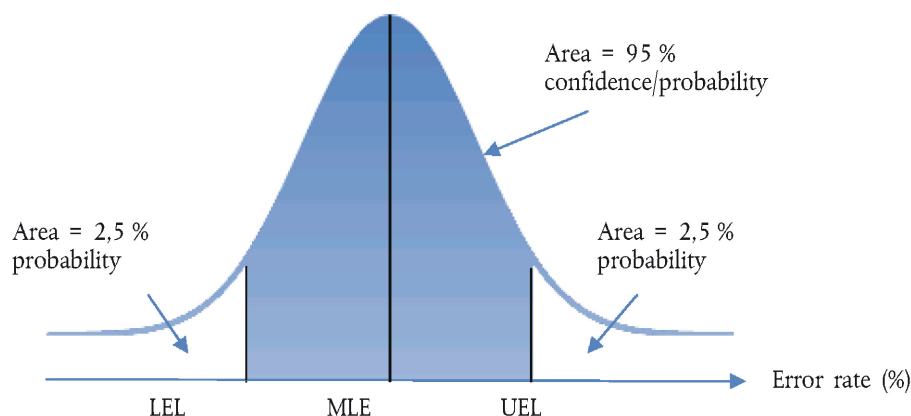
<sup>(4)</sup> Examples of a quantifiable error: no or restricted competition (except where this is explicitly allowed by the legal framework) for the main or a supplementary contract; inappropriate assessment of bids with an impact on the outcome of the tender; substantial change of the contract scope; splitting of the contracts for different construction sites, which fulfil the same economical function.

The Court applies in general a different approach to misapplication of the public procurement rules by the EU institutions, on the grounds that the contracts concerned generally still remain valid. Such errors are not quantified in the DAS.

<sup>(5)</sup> Examples of a non-quantifiable error: inappropriate assessment of bids without impact on the outcome of the tender, formal weaknesses of tender procedure or tender specification, formal aspects of the transparency requirements not respected.

<sup>(6)</sup>  $MLE = \frac{1}{\sum ASI_i} * \sum_i \left( ASI_i * \frac{\text{error amount}_i}{\text{audited amount}_i} \right)$ , where ASI is the average sampling interval and i is the numbering of transactions in the sample.

<sup>(7)</sup>  $LEL = MLE - t_{n,97,5\%} * \frac{s}{\sqrt{n}}$  and  $UEL = MLE + t_{n,97,5\%} * \frac{s}{\sqrt{n}}$ , where t is the t-distribution factor, n is the sample size and s is the standard deviation of the percentage errors.



14. The percentage of the shaded area below the curve indicates the probability that the true error rate of the population is between the LEL and the UEL.

15. In planning its audit work, the Court seeks to undertake procedures allowing it to compare the estimated rate of error in the population with a planning **materiality** of 2%. In assessing audit results, the Court is guided by this level of materiality and takes account of the nature, amount and context of errors when forming its audit opinion.

#### *How the Court assesses systems and reports the results*

16. **Supervisory and control systems** are established by the Commission and Member and beneficiary States in the case of shared or decentralised management, to manage the risks to the budget, including the regularity of transactions. Assessing the effectiveness of systems in ensuring regularity is therefore a key audit procedure, and particularly useful for identifying recommendations for improvement.

17. Each policy group is subject to a multitude of individual systems, likewise revenue. The Court therefore normally selects a sample of systems to assess each year. The results of the **systems assessments** are presented in the form of a table called 'Results of examination of systems' given in Annexes X.2 of Chapters 2 to 9. Systems are classified as being *effective* in mitigating the risk of error in transactions, *partially effective* (when there are some weaknesses affecting operational effectiveness) or *not effective* (when weaknesses are pervasive and thereby completely undermine operating effectiveness).

18. In addition and when supported by evidence, the Court provides an **overall assessment** of systems for the policy group (also provided in Annexes X.2 of Chapters 2 to 9), which takes into account both the assessment of selected systems, as well as the results of transaction testing.

#### *How the Court assesses Commission management representations and reports the results*

19. As required by International Standards on Auditing, the Court obtains a letter of representation from the Commission, confirming that the Commission has fulfilled its responsibilities, and disclosed all information that could be relevant to the auditor. This includes confirmation that the Commission has disclosed all information in respect of the assessment of the risk of fraud, all information in respect of fraud or suspected fraud of which the Commission is aware, and all material instances of non-compliance with laws and regulation.

20. In addition, Chapters 2 to 9 consider the annual activity reports of relevant directorates-general. These report on the achievement of policy objectives and the supervisory and control systems in place to ensure the regularity of transactions and sound use of resources. Each annual activity report is accompanied by a declaration of the director-general on inter alia the extent to which resources have been used for their intended purpose, and control procedures ensure the regularity of transactions<sup>(8)</sup>.

21. The Court assesses the annual activity reports and accompanying declarations in order to determine how far they provide a fair reflection of financial management in relation to regularity of transactions and identify the necessary measures to address any serious control deficiencies. The Court reports on the results of this assessment in the section 'Effectiveness of systems' in Chapters 2 to 9<sup>(9)</sup>.

<sup>(8)</sup> Further information on these processes, as well as links to the most recent reports can be found at [http://ec.europa.eu/atwork/synthesis/index\\_en.htm](http://ec.europa.eu/atwork/synthesis/index_en.htm)

<sup>(9)</sup> In previous years, the results of this assessment were represented in a specific section 'Reliability of Commission management representations'.

*How the Court arrives at its opinions in the statement of assurance*

22. The Court arrives at its opinion on the regularity of transactions underlying the European Union's accounts, set out in the statement of assurance, on the basis of all its audit work as reported in Chapters 2 to 9 of this report and including an assessment of the pervasiveness of error. A key element is the consideration of the results of testing of spending transactions. Taken together, the Court's best estimate of the rate of error for overall spending in 2011 is 3,9 %. The Court has 95 % confidence that the rate of error for the population is between 3,0 % and 4,8 %. The error rate estimated for different policy areas varies as described in Chapters 3 to 9. The Court assessed error as pervasive — extending across the majority of spending areas. The Court gives an overall opinion on the regularity of commitments based on an additional horizontal sample.

*Irregularity or fraud*

23. The overwhelming majority of errors arise from misapplication or misunderstanding of the often complex rules of EU expenditure schemes. If the Court has reason to suspect that fraudulent activity has taken place, it reports this to OLAF, the Union's anti-fraud office, which is responsible for carrying out any resulting investigations. In fact, the Court reports around four cases per year to OLAF, based on its audit work.

## FOLLOW-UP OF OBSERVATIONS OF PRIOR YEARS CONCERNING THE RELIABILITY OF ACCOUNTS

Observations raised in prior years	Court's analysis of the progress made	Commission reply
<b>1. Pre-financing, accounts payable and cut-off procedures</b>	<b>1. Pre-financing, accounts payable and cut-off procedures</b>	<b>1. Pre-financing, accounts payable and cut-off procedures</b>
<p>For pre-financings, accounts payable and related cut-off, since the financial year 2007 the Court has identified accounting errors with an immaterial financial impact overall but a high frequency. This underlines the need for further improvement in the basic accounting data at the level of certain directorates-general.</p> <p>As regards accounting for amounts pre-financed, the Court also identified:</p> <ul style="list-style-type: none"> <li>— that the clearing of outstanding pre-financings is not always carried out correctly. A number of clearings were either not carried out at all or for incorrect amounts;</li> <li>— that some directorates-general do not process the available information on progress made and related costs incurred and do not clear the corresponding pre-financing according to this progress, but use approximations when determining the cut-off;</li> </ul>	<p>The Commission continued to work on improving the accuracy of its accounting data through ongoing actions such as the accounting quality project and the validation of local systems.</p> <p>The Court's audit of representative samples of pre-financing and of invoices/cost claims again identified errors with an immaterial financial impact overall but a high frequency. Therefore, the Commission should continue to make further efforts to improve the basic accounting data at the level of certain directorates-general.</p> <p>Despite the efforts of the accounting officer's services to improve the situation, the Court found that several directorates-general continue to record estimates in the accounts even when they have an adequate basis for clearing the corresponding pre-financings.</p>	<p><i>The Commission will continue its efforts to further improve the quality of the accounting data and local systems are updated continuously to meet the accounting requirements.</i></p> <p><i>The Accounting Services have prepared a set of guidelines on the clearing of pre-financing which will be distributed once the review of the Financial Regulation will be completed.</i></p>



Observations raised in prior years	Court's analysis of the progress made	Commission reply
<p>— for the first time in its 2010 Annual Report that in a growing number of cases the Commission has failed to properly record payments giving rise to an asset, in particular for financial engineering instruments and advances for other aid schemes.</p> <p>Furthermore, as already mentioned in the Court's 2009 Annual Report, some directorates-general did not comply with the requirement to register the invoices and cost statements within five working days of receipt.</p> <p>The Court noted in its 2010 Annual Report that the increased use of pre-financing in the EU budget and of new types of financial instruments makes it a matter of urgency for the Commission to revisit the relevant accounting rule in order to provide adequate guidance on the recognition and clearing of pre-financing.</p>	<p>The issue of the financial engineering instruments was already addressed in the 2010 accounts on receipt of information provided by Member States on a voluntary basis. The Commission also proposed to amend the current legal framework and made appropriate proposals for the post 2013 period in order to make the transmission of the necessary information compulsory.</p> <p>For the advances paid to Member States for other aid schemes and for contributions to the European Globalisation Adjustment Fund, a corresponding asset of 2 512 million euro has been recognised for the first time in the 2011 consolidated accounts.</p> <p>Prior to 2011, Member States did not provide data to the Commission which would have allowed a reliable estimate to be made. Information now available indicates that these amounts would not have been material.</p> <p>Except for the advances for the aid schemes related to the European Agricultural Fund for Rural Development, the unused amounts recognised for the aforementioned financial engineering instruments and other aid schemes have been established on the basis of the amounts contributed by the Commission, taking into consideration an estimate of the unused amounts on a straight line basis. The lack of information on the amounts actually used reduces significantly the usefulness of this information for management purposes.</p> <p>Despite improvements noted in the time taken to register new cost claims, some directorates-general still do not fully comply with the requirement to register their invoices and cost claims promptly.</p> <p>The relevant accounting rule was updated in 2012 in order to take into consideration the need to recognise the unused amounts of contributions to financial engineering instruments and advances paid for other aid schemes as an asset.</p>	<p><i>The legal basis for the financial engineering instruments as well as for the State aid prepaid amounts, including an annex to the declaration of expenditure has been implemented (amendment to the Council Regulation (EC) No 1083/2006 on 13 December 2011). Following this amendment, the European Commission has a legal basis to request the required information from the Member States.</i></p> <p><i>The above information will be used for the accounting purposes at the closure of the 2012 accounts. The unpaid amounts to the final beneficiaries are based on pro-rata temporis estimation.</i></p> <p><i>Since DG REGIO is currently at the sixth out of a seven year-programming period, it is not advisable to modify the methodology. Nevertheless, this approach is foreseen to be modified for the next programming period, providing it is accepted by the Member States with the new Financial Regulation.</i></p> <p><i>Once the legal basis for the new programming period of Structural Funds enters into force the Commission will be entitled to receive information on the amounts actually used, which will be used for the preparation of the annual accounts. These new requirements should also improve management information.</i></p> <p><i>The method used by the Commission for the 2011 accounts is the most cost-effective and has already been used in the 2010 accounts.</i></p> <p><i>The Commission's services will continue their efforts in this direction. To this end local systems are updated constantly, for example cost claims received by DG AGRI and DG REGIO are treated within the delay.</i></p> <p><i>The services are implementing the rule in the light of the Financial Instruments and State aid related payments (see reply above).</i></p>

Observations raised in prior years	Court's analysis of the progress made	Commission reply
<p><b>2. Disclosures concerning recoveries and financial corrections</b></p>	<p><b>2. Disclosures concerning recoveries and financial corrections</b></p>	<p><b>2. Disclosures concerning recoveries and financial corrections</b></p>
<p>In its 2007 Annual Report, the Court already stated that although the Commission had taken steps to increase and improve the information it provided on the corrective mechanisms applied to the EU budget, the information was not yet completely reliable because the Commission did not always receive reliable information from Member States.</p> <p>Furthermore, the need to refine the financial reporting guidelines pertaining to what information is to be included and how it should be treated should be examined.</p> <p>For the first time in its 2009 Annual Report, the Court criticised that for some areas of expenditure, the Commission does not systematically provide information reconciling the year in which the payment concerned is made, the year in which the related error is detected and the year in which the resulting financial correction is disclosed in the notes to the accounts.</p>	<p>Despite the weaknesses still affecting the reliability and completeness of the data presented by the Member States, in particular in the area of cohesion, certain improvements were noted over the years. At the beginning of 2011, the Commission launched an audit of the Member States' systems for recoveries in the area of cohesion. The Commission's on-the-spot controls showed that the systems for recording and reporting data are not yet completely reliable in all Member States visited. Therefore, data from Member States in the area of cohesion are not disclosed in the notes to the 2011 financial statements.</p> <p>The accounting officer's instructions provide the authorising officers by delegation guidance on the data to be supplied. The Court's audit found improvements in the application of this guidance. However, additional efforts are needed to improve the quality of the data presented.</p> <p>Information reconciling payments, errors, recoveries and financial corrections is not yet presented. The Court maintains its position that, wherever it is possible, such a reconciliation should be provided. Furthermore, a clear link should be established between amounts included in annual activity reports, in particular for establishing the residual error rate, and information on recoveries/financial corrections presented in the accounts.</p>	<p><i>For agriculture, the Commission has booked the outstanding debts at Member State level and the corresponding value reduction, as well as the amounts recovered by the Member States in the 2011 accounts.</i></p> <p><i>For cohesion, the reliability of data on recoveries received from Member States has improved in comparison to the last period, but the Commission agrees it should be further improved. To this effect the Commission has launched beginning of 2011 a risk-based audit of the Member States' systems for recoveries, based on the reporting made each year as at 31 March with the objective to improve reporting of national financial corrections to the Commission, and ensure completeness, accuracy and timeliness of reporting. The first results have been reported in the 2011 annual activity reports of structural actions' directorates-general.</i></p> <p><i>The Commission will continue its efforts to further improve the quality of the data presented.</i></p> <p><i>The Commission takes note of the requests of the Court and points out that this is seldom possible.</i></p> <p><i>In shared management financial corrections are not meant to recover irregular spending (which remains under the responsibility of the Member States) but rather to protect the EU budget from such irregularities. It is therefore not correct to link error rates of a given year to financial corrections and recoveries disclosed in the annual accounts of that same year.</i></p>

Observations raised in prior years	Court's analysis of the progress made	Commission reply
		<p>In addition, the differences in the timing of financial corrections and actual recoveries on one side, and error rates on the other also prevent this reconciliation. This later comment is not only relevant for shared management, but also for direct management, where recovery orders are either issued after the end of the (multiannual) grant period, or not issued, as a corrected cost statement is submitted by the beneficiary.</p> <p>The Commission repeats its comment that expenditure is controlled several years after the actual year of a given payment, primarily at programme closure. Furthermore, the financial correction may be the result of the detection of weaknesses in the control systems of Member States, in which case no direct link exists with payments. As a consequence it is neither possible nor relevant to reconcile the year of the payment concerned with the year that the financial correction is disclosed in the notes to the accounts. Additionally, Member States are primarily responsible for the prevention, detection and correction of errors and irregularities in the area of shared management.</p> <p>For agriculture, all amounts in the different tables in note 6 can be reconciled either with data available at Commission level or with the Member State declarations.</p> <p>As regards regional policy, the link between amounts used for the residual error rate in the annual activity report and information in the provisional accounts is possible for previous year's reporting and for information provided by Member States in advance of the regulatory deadline of 31 March, which is also the deadline for establishing the provisional accounts. The Commission encouraged Member States to report corrections as early as possible before 31 March to avoid this timing issue.</p>

Observations raised in prior years	Court's analysis of the progress made	Commission reply
<p>At year end 2010, for cohesion, a total amount of 2,5 billion euro still remained to be implemented (i.e. 'cashed' through the receipt of a repayment by the Commission or payment by the Commission on the basis of a claim from which the Member State has deducted ineligible expenditure). The low implementation rate of 71 % was explained by the ongoing closure process for the programming period 2000-2006. Payment claims received end-2010 were not yet authorised, which meant that the related financial corrections could not be taken into account in the 2010 implementation figures.</p> <p>The explanatory notes to the consolidated accounts contain information that some payments are likely to be corrected at a later date by the Commission's services or the Member States. However, despite repeated requests by the Court since 2005, the amounts and areas of expenditure which may be subject to further verification and clearance of accounts procedures are still not identified in the notes.</p>	<p>At the end of 2011, an amount of 2,5 billion euro remained to be implemented (implementation rate of 72 %). The amount as well as the implementation rate stayed at a similar level to last year because payment claims received end-2010 could still not be authorised.</p> <p>Amounts subject to further verification and clearing are not yet disclosed in the notes to the consolidated accounts (contrary to quantifiable amounts of potential recoveries).</p>	<p><i>The closure of programmes is a complex procedure where numerous documents submitted by the Member State are checked, and where further information can be requested by the Commission so as to get evidence that the Member State did indeed deduct the financial corrections decided, especially for complex operational programmes, thus putting off further the calculation of the final balance to pay. In addition, the Commission only recognises the implementation of a financial correction when the final payment is duly authorised by the authorising officer, a step which is completed at the very end of the verification chain.</i></p> <p><i>For cohesion, the amount of corrections accepted by Member States but still to be implemented relates to 2000-2006 programmes and is reflected in final payment claims received by the Commission but not yet authorised due to the closure process where the Commission has to assess all information provided as coherent and complete. The Court recommended the Commission to take this prudent approach not to report such corrections as implemented, until final payments are authorised.</i></p> <p><i>The Financial Regulation allows the Commission to make ex-post checks on all expenditure for several years after the actual year of expenditure. The accounts should not imply that, because of verifications in future years, all the expenditure concerned remains to be accepted. Otherwise, all budgetary expenditure would be considered provisional until an ex-post check is made or the said limitation period has lapsed. Where the amounts of potential recoveries are quantifiable, they are disclosed in note 6 to the consolidated accounts.</i></p> <p><i>In agriculture, a financial clearance decision is taken around six months after the end of the financial year in question, through which the Commission establishes the amount of expenditure recognised as chargeable to the EU budget for that year. This role of the financial clearance decision is not called into question by the fact that subsequently financial corrections may be imposed on Member States through conformity decisions. The amount of expenditure which is likely to be excluded from EU financing by such future conformity decisions is disclosed in a note to the financial statements.</i></p>

Observations raised in prior years	Court's analysis of the progress made	Commission reply
<p><b>3. Transfer of assets of Galileo</b></p>	<p><b>3. Transfer of assets of Galileo</b></p>	<p><b>3. Transfer of assets of Galileo</b></p>
<p>The agreements for the transfer to the Union of the ownership of all assets created, developed or acquired for the Galileo programme have not yet been fully implemented. As all expenditure incurred since 2003 was treated as research expenses there was no impact on the balance sheet at 31 December 2010. However, the Commission should ensure that all information is available at the time when the transfer takes place in order to safeguard assets effectively.</p> <p>In its 2010 Annual Report, the Court drew attention to the reservation made by the responsible director-general in his 2010 annual activity report concerning the reliability of the European Space Agency's financial reporting.</p>	<p>The Commission is working with the European Space Agency to ensure that at the time of the transfer all the necessary accounting and technical information will be available to guarantee a smooth handover. This transfer is planned for the end of the in orbit validation phase (end of 2012 at the earliest). In the meantime, the Commission recognised in 2011 an amount of 219 million euro as assets under construction relating to the Galileo project. This amount reflects the costs incurred by the Commission since 22 October 2011, the date on which the first two satellites of the system were successfully launched. Prior to this date the Commission considered the project still to be in a research phase and all costs incurred were expenses.</p> <p>However, the Court's review revealed immaterial weaknesses in the cut-off procedure establishing the amount of assets under construction.</p> <p>The responsible director-general maintained the reservation in his 2011 annual activity report and widened its scope.</p>	<p><i>The Commission considers the amounts recognised on the balance sheet as reasonably accurate and reliable.</i></p> <p><i>The accounting methodology and procedures for the valuation of the Galileo assets are in full compliance with the EU accounting rules and the IPSAS standards.</i></p> <p><i>The valuation of the assets was determined with the support of independent external accounting experts based on data provided by ESA. The Commission has performed necessary checks to reasonably ensure the reliability of the outcome.</i></p> <p><i>The Commission will continue auditing the financial reports provided by ESA and will encourage and support ESA in implementing its actions towards further improving the quality of financial reporting to the Commission. An external review of the control systems of the European Space Agency was finalised in 2012, disclosing satisfactory results. Given the actions currently under way, the Commission expects the issues to be corrected soon which will enable reducing and finally lifting this reservation.</i></p>

## ANNEX 1.3

EXTRACTS FROM THE 2011 CONSOLIDATED ACCOUNTS <sup>(1)</sup>

Table 1 — Balance sheet (\*)

	(million euro)	
	31.12.2011	31.12.2010
<b>Non-current assets:</b>		
Intangible assets	149	108
Property, plant and equipment	5 071	4 813
Long-term investments:		
<i>Investments accounted for using the equity method</i>	374	492
<i>Financial assets: Available for sale assets</i>	2 272	2 063
Financial assets: Long-term loans	41 400	11 640
Long-term receivables and recoverables	289	40
Long-term pre-financing	44 723	44 118
	<b>94 278</b>	<b>63 274</b>
<b>Current assets:</b>		
Inventories	94	91
Short-term investments:		
<i>Financial assets: Available for sale assets</i>	3 619	2 331
Short-term receivables and recoverables:		
<i>Financial assets: Short-term loans</i>	102	2 170
<i>Other receivables and recoverables</i>	9 477	11 331
Short-term pre-financing	11 007	10 078
Cash and cash equivalents	18 935	22 063
	<b>43 234</b>	<b>48 064</b>
<b>Total assets</b>	<b>137 512</b>	<b>111 338</b>
<b>Non-current liabilities:</b>		
Pension and other employee benefits	(34 835)	(37 172)
Long-term provisions	(1 495)	(1 317)
Long-term financial liabilities	(41 179)	(11 445)
Other long-term liabilities	(2 059)	(2 104)
	<b>(79 568)</b>	<b>(52 038)</b>
<b>Current liabilities:</b>		
Short-term provisions	(270)	(214)
Short-term financial liabilities	(51)	(2 004)
Payables	(91 473)	(84 529)
	<b>(91 794)</b>	<b>(86 747)</b>
<b>Total liabilities</b>	<b>(171 362)</b>	<b>(138 785)</b>
<b>Net assets</b>	<b>(33 850)</b>	<b>(27 447)</b>
Reserves	3 608	3 484
Amounts to be called from Member States	(37 458)	(30 931)
<b>Net assets</b>	<b>(33 850)</b>	<b>(27 447)</b>

(\*) The balance sheet is presented using the layout as in the consolidated accounts of the European Union.

<sup>(1)</sup> The reader is advised to consult the full text of the consolidated accounts of the European Union for the financial year 2011 including both the consolidated financial statements and explanatory notes and the consolidated reports on implementation of the budget and explanatory notes.

Table 2 — Economic outturn account (\*)

	<i>(million euro)</i>	
	<b>2011</b>	<b>2010</b>
<b>Operating revenue</b>		
Own resource and contributions revenue	124 677	122 328
Other operating revenue	5 376	8 188
	<b>130 053</b>	<b>130 516</b>
<b>Operating expenses</b>		
Administrative expenses	(8 976)	(8 614)
Operating expenses	(123 778)	(103 764)
	<b>(132 754)</b>	<b>(112 378)</b>
<b>(Deficit)/Surplus from operating activities</b>	<b>(2 701)</b>	<b>18 138</b>
Financial revenue	1 491	1 178
Financial expenses	(1 355)	(661)
Movement in pension and other employee benefits liability	1 212	(1 003)
Share of net deficit of joint ventures and associates	(436)	(420)
<b>Economic outturn for the year</b>	<b>(1 789)</b>	<b>17 232</b>

(\*) The economic outturn account is presented using the layout as in the consolidated accounts of the European Union.

Table 3 — Cashflow table (\*)

	(million euro)	
	2011	2010
Economic outturn for the year	(1 789)	17 232
<b>Operating activities</b>		
Amortisation	33	28
Depreciation	361	358
(Increase)/decrease in long-term loans	(29 760)	(876)
(Increase)/decrease in long-term pre-financing	(605)	(2 574)
(Increase)/decrease in long-term receivables and recoverables	(249)	15
(Increase)/decrease in inventories	(3)	(14)
(Increase)/decrease in short-term pre-financing	(929)	(642)
(Increase)/decrease in short-term receivables and recoverables	3 922	(4 543)
Increase/(decrease) in long-term provisions	178	(152)
Increase/(decrease) in long-term financial liabilities	29 734	886
Increase/(decrease) in other long-term liabilities	(45)	(74)
Increase/(decrease) in short-term provisions	56	1
Increase/(decrease) in short-term financial liabilities	(1 953)	1 964
Increase/(decrease) in payables	6 944	(9 355)
Prior year budgetary surplus taken as non-cash revenue	(4 539)	(2 254)
Other non-cash movements	(75)	(149)
<b>Increase/(decrease) in pension and employee benefits liability</b>	(2 337)	(70)
<b>Investing activities</b>		
(Increase)/decrease in intangible assets and property, plant and equipment	(693)	(374)
(Increase)/decrease in long-term investments	(91)	(176)
(Increase)/decrease in short-term investments	(1 288)	(540)
<b>Net cashflow</b>	<b>(3 128)</b>	<b>(1 309)</b>
Net increase/(decrease) in cash and cash equivalents	(3 128)	(1 309)
Cash and cash equivalents at the beginning of the year	22 063	23 372
Cash and cash equivalents at year end	18 935	22 063

(\*) The cashflow table is presented using the layout as in the consolidated accounts of the European Union.



Table 4 — Statement of changes in net assets (\*)

(million euro)

	Reserves (A)		Amounts to be called from Member States (B)		Net assets = (A) + (B)
	Fair value reserve	Other reserves	Accumulated surplus/(deficit)	Economic outturn for the year	
<b>Balance as at 31 December 2009</b>	<b>69</b>	<b>3 254</b>	<b>(52 488)</b>	<b>6 887</b>	<b>(42 278)</b>
Movement in Guarantee Fund reserve		273	(273)		0
Fair value movements	(130)				(130)
Other		4	(21)		(17)
Allocation of the economic outturn 2009		14	6 873	(6 887)	0
Budget result 2009 credited to Member States			(2 254)		(2 254)
Economic outturn for the year				17 232	17 232
<b>Balance as at 31 December 2010</b>	<b>(61)</b>	<b>3 545</b>	<b>(48 163)</b>	<b>17 232</b>	<b>(27 447)</b>
Movement in Guarantee Fund reserve		165	(165)		0
Fair value movements	(47)				(47)
Other		2	(30)		(28)
Allocation of the economic outturn 2010		4	17 228	(17 232)	0
Budget result 2010 credited to Member States			(4 539)		(4 539)
Economic outturn for the year				(1 789)	(1 789)
<b>Balance as at 31 December 2011</b>	<b>(108)</b>	<b>3 716</b>	<b>(35 669)</b>	<b>(1 789)</b>	<b>(33 850)</b>

(\*) The statement of changes in net assets is presented using the layout as in the consolidated accounts of the European Union.

Table 5 — EU budget outturn (\*)

<i>(million euro)</i>		
European Union	2011	2010
Revenue for the financial year	130 000	127 795
Payments against current year appropriations	(128 043)	(121 213)
Payment appropriations carried over to year N+1	(1 019)	(2 797)
Cancellation of unused payment appropriations carried over from year N-1	457	741
Exchange differences for the year	97	23
<b>Budget outturn (**)</b>	<b>1 492</b>	<b>4 549</b>

(\*) The EU budget outturn table is presented using the layout as in the consolidated accounts of the European Union.

(\*\*) Of which EFTA amounts total (5) million euro in 2011 and 9 million euro in 2010.

## CHAPTER 2

**Revenue**

## TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	2.1-2.14
Specific characteristics of revenue	2.2-2.7
Audit scope and approach	2.8-2.14
Traditional own resources	2.9-2.12
VAT- and GNI-based own resources	2.13-2.14
Regularity of transactions	2.15-2.18
Traditional own resources	2.16
VAT- and GNI-based own resources	2.17
Other revenue	2.18
Effectiveness of systems	2.19-2.34
Traditional own resources	2.20-2.22
VAT-based own resources	2.23-2.25
GNI-based own resources	2.26-2.28
General and specific reservations	2.26-2.27
Verification of GNI inventories	2.28
Other revenue: Fines and penalties	2.29-2.34
Enforced recovery	2.29-2.31
Minimum credit ratings of financial institutions that issue guarantees	2.32-2.34
Conclusions and recommendations	2.35-2.38
Conclusions	2.35-2.36
Recommendations	2.37-2.38

## THE COURT'S OBSERVATIONS

## INTRODUCTION

2.1. This Chapter presents the Court's specific assessment of revenue, which comprises own resources and other revenue. Key information on revenue in 2011 is provided in **Table 2.1**. Own resources constitute by far the main source of financing of budgetary expenditure (91 %).

Table 2.1 — Revenue — Key information 2011

Budget Title	Type of revenue	Description	Revenue 2011	
			million euro	%
1	Traditional own resources (TOR)	Sugar levies	132	0,1
		Customs duties	16 646	12,8
	VAT-based own resources	VAT (value added tax)-based resources from the current financial year	14 077	10,8
		GNI-based own resources	GNI (gross national income)-based resources from the current financial year	87 258
	Correction of budgetary imbalances	UK correction	52	0,0
	Reduction of GNI-based contribution	Granted to the Netherlands and Sweden	- 1	0,0
		<b>TOTAL OWN RESOURCES</b>	<b>118 164</b>	<b>90,9</b>
3		Surpluses, balances and adjustments	6 370	4,9
4		Revenue accruing from persons working with the institutions and other Union bodies	1 207	0,9
5		Revenue accruing from the administrative operation of the institutions	587	0,5
6		Contributions and refunds in connection with Union/Community agreements and programmes	2 454	1,9
7		Interest on late payments and fines	1 183	0,9
8		Borrowing and lending operations	1	0,0
9		Miscellaneous revenue	34	0,0
		<b>TOTAL OTHER REVENUE</b>	<b>11 836</b>	<b>9,1</b>
<b>TOTAL REVENUE FOR THE YEAR</b>			<b>130 000</b>	<b>100,0</b>

Source: 2011 annual accounts of the European Union.

## THE COURT'S OBSERVATIONS

**Specific characteristics of revenue**

2.2. There are three categories of own resources <sup>(1)</sup>: traditional own resources (TOR) (customs duties collected on imports and sugar production charge), own resources calculated on the basis of value added tax (VAT) collected by Member States, and own resources derived from Member States' gross national income (GNI).

2.3. TOR are established and collected by the Member States. Three quarters of these amounts are paid to the Union budget (16 778 million euro, 12,9 % of revenue), the remaining quarter being retained to cover collection costs. Each Member State sends the Commission a monthly statement of established duties (the 'A accounts') and a quarterly statement of those established duties which are not included therein (the 'B accounts') <sup>(2)</sup>. The principal risks regarding TOR are the completeness, accuracy and timeliness of the duties made available to the Union.

2.4. The VAT-based own resources are contributions resulting from the application of a uniform rate to Member States' notionally harmonised VAT assessment bases (14 077 million euro, 10,8 % of revenue). The GNI-based own resources result from the application of a uniform rate to the Member States' GNI (87 258 million euro, 67,1 % of revenue). The principal risk to regularity in respect of these own resources is that the underlying statistics either are not compiled in compliance with Union rules or are not processed according to these rules and that, as a result, an incorrect amount of VAT- and/or GNI-based own resources is paid by all Member States.

<sup>(1)</sup> Council Decision 2007/436/EC, Euratom of 7 June 2007 on the system of the European Communities' own resources (OJ L 163, 23.6.2007, p. 17) and Council Regulation (EC, Euratom) No 1150/2000 of 22 May 2000 implementing Decision 2007/436/EC, Euratom on the system of the European Communities' own resources (OJ L 130, 31.5.2000, p. 1), as last amended by Regulation (EC, Euratom) No 105/2009 (OJ L 36, 5.2.2009, p. 1).

<sup>(2)</sup> When 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 these separate accounts.

## THE COURT'S OBSERVATIONS

2.5. The United Kingdom is granted a correction in respect of budgetary imbalances (the UK correction) which involves a reduction in its payments of GNI-based own resources<sup>(3)</sup>. In addition, Germany, the Netherlands, Austria and Sweden benefit from a reduced call rate for VAT, and the Netherlands and Sweden have a gross reduction in their annual GNI contribution for the period 2007-2013<sup>(4)</sup>. The principal risk is that the Commission makes an error in these calculations, notably in respect of the complex UK correction calculations.

2.6. After taking into account the total of TOR, VAT-based own resources and other revenue, the GNI-based own resources are used to balance the budget. Any understatement (or overstatement) of GNI for particular Member States — while not affecting the overall GNI-based own resources — has the effect of increasing (or decreasing) the contributions from the other Member States, until the problem is corrected.

2.7. The principal risks in other revenue include the Commission's management of fines and the determination of the financial corrections the Commission imposes on agricultural and cohesion expenditure.

### Audit scope and approach

2.8. **Annex 1.1, Part 2**, of Chapter 1 describes the Court's overall audit approach and methodology. For the audit of revenue, the following specific issues should be noted:

- (a) The audit involved examination at the Commission level of a sample of 55 recovery orders<sup>(5)</sup> covering all types of revenue (see **Annex 2.1**).

<sup>(3)</sup> Article 4 of Decision 2007/436/EC. This reduction was approximately 4 billion euro in 2011. The 52 million euro referred to in **Table 2.1** represents the effect of exchange rate differences.

<sup>(4)</sup> Articles 2(4) and 2(5) of Decision 2007/436/EC. The 1 million euro reduction in the GNI-based contribution in **Table 2.1** is the effect of exchange rate differences.

<sup>(5)</sup> A recovery order is the procedure by which the Authorising Officer (AO) registers an entitlement by the Commission in order to retrieve the amount which is due.

## THE COURT'S OBSERVATIONS

- (b) The assessment of systems covered:
- (i) the systems for TOR, VAT-based and GNI-based own resources;
  - (ii) the Commission systems underlying the calculation of the UK correction (including an examination of the calculation of the definitive amount in respect of 2007) <sup>(6)</sup>;
  - (iii) the Commission's management of fines and penalties;
  - (iv) the Commission's management representations, in particular the Annual Activity Report of Directorate-General for Budget (DG BUDG).

*Traditional own resources*

2.9. The Court's audit of transactions underlying the accounts cannot cover undeclared imports or those that have escaped customs surveillance.

2.10. The Court carried out an assessment of supervisory and control systems in Germany, Spain and France, which together contribute more than one third of the total of TOR. It reviewed their accounting systems and examined the flow of TOR from establishment until declaration to the Commission in order to obtain reasonable assurance that the amounts recorded were accurate and complete. The audit included testing key controls relating to the application of preferential duty rates in France, Local Clearance Procedures (LCP) in Germany and Spain, and warehousing and the treatment of freight and insurance costs in Germany, Spain and France.

2.11. In addition, the Court reconciled the seven TOR recovery orders included in the sample referred to in paragraph 2.8(a) with the corresponding monthly statement from the Member States concerned <sup>(7)</sup>.

2.12. Lastly, the Court assessed the supervisory and control systems at the Commission, including its inspections in Member States, the procedure for writing off irrecoverable amounts and the procedure for following up both its and the Court's previous findings.

<sup>(6)</sup> See paragraph 2.16 of the 2010 Annual Report.

<sup>(7)</sup> Belgium, Germany, Spain and the Netherlands.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*VAT- and GNI-based own resources*

2.13. VAT- and GNI-based own resources are based on statistical data for which the underlying transactions cannot be audited directly. For this reason, the audit took as its starting point the Commission's receipt of the macroeconomic aggregates prepared by the Member States, and then assessed the Commission's systems for processing the data in order to determine the amounts to be included in the final budgetary accounts. The Court thus examined the drawing-up of the EU budget and the correctness of the contributions by Member States.

2.14. The Court assessed the Commission's supervisory and control systems, which are intended to provide reasonable assurance that these resources are correctly calculated and collected. The audit also covered the Commission's management of VAT and GNI reservations and its verification of GNI inventories in the Member States. The Court's audit cannot provide a judgement on the quality of VAT and GNI data received by the Commission from Member States.

**REGULARITY OF TRANSACTIONS**

2.15. **Annex 2.1** contains a summary of the results of transaction testing. The Court's testing of its sample of transactions found 1,8 % to be affected by error. The most likely error estimated by the Court is 0,8 % <sup>(8)</sup>.

**2.15.** See reply to point 2.18.

**Traditional own resources**

2.16. The Court found that, overall, the recovery orders raised by the Commission reflect the A accounts' statements sent by the Member States.

**VAT- and GNI-based own resources**

2.17. The Court's audit did not find any error in the calculation of Member States' contributions and their payment.

<sup>(8)</sup> The Court calculates its estimate of error from a representative statistical sample. The figure quoted is the best estimate (known as the MLE). The Court has 95 % confidence that the rate of error in the population lies between LEL 0,0 % and UEL 2,4 % (the lower and upper error limits respectively).



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Other revenue**

2.18. The Court found that one of the six transactions tested in respect of other revenue contained an error. The Court reviewed the calculation of a financial correction imposed by the Commission on a Member State in the field of agricultural expenditure (Title 6 in **Table 2.1**). While the Court does not call into question the methodology used by the Commission, it found an error in its application with the result that the Commission underestimated the loss to the EU budget. The financial correction should have been 30 million euro instead of the 21 million euro calculated <sup>(9)</sup>.

**EFFECTIVENESS OF SYSTEMS**

2.19. **Annex 2.2** contains a summary of the results of the Court's examination of supervisory and control systems. Some deficiencies in the systems were found, as reported below.

**Traditional own resources**

2.20. In the Member States visited, the Court's audit (see paragraph 2.10) revealed deficiencies in national customs supervision in:

- (a) the application of preferential duty rates <sup>(10)</sup>;
- (b) the control and *ex-post* audit of Local Clearance Procedures (LCP) <sup>(11)</sup>;

**2.18.** *The Commission welcomes that the Court does not call into question its methodology for assessing the loss to the EU budget. This was done in line with the Court's recommendation to calculate the loss rather than to use a flat-rate correction.*

*With regard to the case mentioned by the Court, the calculation of the error rate was made by the Member State on the basis of a methodology accepted by the Commission and using the best information available at that time. The Member State later provided additional and more precise information on the population at risk and the Commission considered it justified to take that information into account without, at that very late stage, re-opening the whole conformity clearance procedure in order to recalculate the error rate.*

**2.20.** *The Commission will follow up the Court's findings exhaustively, taking into account that Member States' customs controls should be risk-based.*

- (a) *In the case of two import declarations out of 50 the Court did not find in the files examined any document evidencing direct transport of the goods to the EU.*

*The two cases where evidence of direct transport is missing will be followed up by the Commission in order to determine whether there are any financial consequences.*

- (b) *The risk analysis carried out by the Member States should take due account of the prescription period and in some cases it may not require that an audit of the Local Clearance Procedure is carried out every three years.*

<sup>(9)</sup> In 2006 the Commission found that a Member State had been using out of date orthophotos. The Commission calculated an error rate of 1,34 % by wrongly including regions that were not affected by the problem of outdated orthophotos. According to the Court the correct error rate to be used should have been 1,91 %, resulting in a difference of 9 million euro.

<sup>(10)</sup> France.

<sup>(11)</sup> Germany and Spain. In addition the Commission's own inspections of LCP revealed system weaknesses in 11 of the 21 Member States it inspected in 2011.

## THE COURT'S OBSERVATIONS

- (c) the *ex-post* audit of customs warehousing <sup>(12)</sup>;
- (d) the risk analysis applied at import stage <sup>(13)</sup>;
- (e) the treatment of freight and insurance costs <sup>(14)</sup>.

Partially effective national customs supervision increases the risk that incorrect amounts of TOR are collected.

2.21. In its 2010 Annual Report the Court reported that, for one A statement relating to a Member State <sup>(15)</sup>, it was not possible to reconcile the amount of TOR declared with the underlying accounting documents. In DG BUDG's Annual Activity Report for 2011 there is now a reservation on the reliability of the accounting data of this Member State.

2.22. The Court found that several findings reported by it or by the Commission in previous years continue to be reported by these two institutions without remedial action being taken by the relevant Member States (for example the findings raised in the Court's Special Report No 1/2010: 'Are simplified customs procedures for imports effectively controlled?' <sup>(16)</sup>).

## THE COMMISSION'S REPLIES

- (c) *The risk analysis carried out by the Member States should take due account of the prescription period and in some cases it may not require that an audit of warehousing is carried out every three years.*
- (d) *The Commission will follow up this finding with the Member States concerned.*
- (e) *The Commission will follow up the individual cases with the Member States concerned in order to determine whether there are financial consequences.*

**2.21.** *DG Budget has made the reservation on the reliability of this Member State's clearance and accounting procedures and systems for TOR on the basis of three consecutive Commission inspections and on the findings of the Court.*

*Remedial action is underway. The Member State submitted a plan of action at the end of November 2011 setting out the corrective measures that will be taken. The plan contains short-term (2012), medium-term (2012-2013) and long-term objectives (2013-2014 and subsequent years). The Commission is monitoring the implementation of the plan. The first stage consists in carrying out an external audit of the accounting system.*

**2.22.** *Court and Commission findings are exhaustively followed up. It can take time for Member States to improve their systems, particularly where disagreements arise or systemic and structured changes are required. The Commission services use all the means at their disposal to ensure Member States satisfactorily address findings and, where relevant, require the Member States to recover any traditional own resources underpaid. This may include taking infringement proceedings where there is a clear ongoing transgression of EU customs legislation. In recent years the Commission has carried out inspections of simplified procedures, custom control strategy and local clearance. A thematic report on custom control strategy was provided to the Advisory Committee on own resources in 2011 and the thematic report on local clearance will be presented in 2012.*

<sup>(12)</sup> Spain and France.

<sup>(13)</sup> Germany and France.

<sup>(14)</sup> Spain and France.

<sup>(15)</sup> Paragraph 2.15: Belgium.

<sup>(16)</sup> See ECA website: <http://eca.europa.eu>

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**VAT-based own resources**

2.23. A reservation is a means by which a doubtful element in a VAT statement submitted by a Member State can be kept open for correction after the statutory time limit of four years. The use of reservations is thus part of the internal control process. However, the Commission and Member States should endeavour to resolve doubtful elements as soon as possible.

2.24. In 2011, the Commission placed 46 reservations and lifted 42. According to the Commission, the net effect was to decrease VAT-based own resources by approximately 88 million euro<sup>(17)</sup>. At the end of the year, a total of 156 reservations were in place (see **Table 2.2**). Of the reservations put in place by the Commission, 51 relate to infringements of VAT legislation. These can only be lifted after the infringement procedure has been closed and the effect on the VAT base for the years concerned has been determined.

2.25. The Commission is continuing its efforts to lift long-outstanding VAT reservations. The Court defines such reservations as relating to a year at least 10 years previously, that is reservations still in place at the end of 2011 concerning 2002 and earlier years. There were 15 such reservations at the year end, some dating back to 1995, compared to 16 at the end of 2010 (paragraph 2.23 of the 2010 Annual Report).

**2.24.** *The figures used in this report slightly differ from those the Commission provides in the relevant annex to its annual accounts. This is because the Court and the Commission use slightly different methods for counting the stock of reservations. The Court uses the date of notification and the Commission the date the associated internal administrative procedures are completed.*

**2.25.** *There has been an ongoing improvement in the frequency of consultations with Member States plus enhancement of the levels of cooperation between the Commission and Member States which will continue. The proportion of reservations that the Court defines as long-outstanding is continuing to decrease — being now less than 10 % of the total. Even with enhanced cooperation, there will always be some long-outstanding reservations as some have many ramifications to explore, including issues of principle, and may entail more than one attempt to reach a solution. The definition of long-outstanding, adopted by the Court, risks over-accentuating the time apparently taken to resolve reservations. Of the new reservations set by the Commission in 2011, 75 % covered 2007 so were according to the Court's methodology already almost halfway to being long-outstanding.*

<sup>(17)</sup> The balance of an increase of 8 million euro and a decrease of 96 million euro.

Table 2.2 — VAT reservations as at 31 December 2011

Member State	Reservations outstanding at 31.12.2010	Reservations placed in 2011	Reservations lifted in 2011	Reservations outstanding at 31.12.2011	Earliest year to which reservations apply
Belgium	0	1	0	1	2007
Bulgaria	2	5	1	6	2007
Czech Republic	8	9	4	13	2004
Denmark	9	2	3	8	2005
Germany	1	5	0	6	2003
Estonia	9	1	0	10	2004
Ireland	10	2	7	5	1998
Greece	7	0	0	7	1999
Spain	1	2	0	3	2003
France	6	1	0	7	2001
Italy	8	2	3	7	1995
Cyprus	6	0	2	4	2004
Latvia	6	0	1	5	2004
Lithuania	2	0	0	2	2005
Luxembourg	2	0	2	0	
Hungary	4	0	0	4	2004
Malta	10	0	0	10	2004
Netherlands	8	6	5	9	2004
Austria	6	0	0	6	2002
Poland	6	0	1	5	2004
Portugal	14	0	9	5	2003
Romania	0	5	1	4	2007
Slovenia	0	0	0	0	
Slovakia	0	0	0	0	
Finland	8	3	1	10	1995
Sweden	10	2	1	11	1995
United Kingdom	9	0	1	8	1998
<b>TOTAL</b>	<b>152</b>	<b>46</b>	<b>42</b>	<b>156</b>	

Source: European Court of Auditors.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**GNI-based own resources***General and specific reservations*

2.26. General reservations<sup>(18)</sup> existed at the end of 2011 on the GNI data of EU-15 Member States for the period 2002 to 2007, EU-10 Member States for 2004-2007, and Bulgaria and Romania for 2007.

2.27. At the beginning of 2011, there were four open specific GNP reservations<sup>(19)</sup> relating to the period 1995 to 2001. The Commission subsequently lifted two reservations concerning the United Kingdom, leaving a balance of two<sup>(20)</sup> at the end of 2011.

*Verification of GNI inventories*

2.28. Based on Eurostat verification of GNI inventories the GNI Committee adopted the assessment reports on the EU-25 Member States, in July and October 2011. No general reservations were lifted or specific reservations put in place in respect of GNI data for the period 2002 onwards until the end of January 2012 (see paragraphs 2.29 and 2.41, fourth indent, of the 2010 Annual Report).

**2.26.** As the Court acknowledges in paragraph 2.28 the situation had changed markedly by January 2012 when general reservations remained in place only for Bulgaria and Romania.

**2.27.** The Commission is making progress via its cooperation with the two countries that still have GNP reservations for the period 1995-2001 (one for Greece and one for the United Kingdom at end 2011) so that these reservations can be lifted.

**2.28.** As a result of conclusions drawn at the two GNI Committee meetings in the second half of 2011 work continued until the end of the year identifying and precisely framing the specific reservations needed to replace the existing general reservations. The administrative processes necessary to provide each of the 25 Member States simultaneously with confirmatory official notification of the lifting of the general reservations and the specific reservations set concerning them were completed in early 2012.

<sup>(18)</sup> Article 10(7) of Regulation (EC, Euratom) No 1150/2000, as amended, 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 by either the Commission or the Member State. These points are known as reservations. A general reservation covers all the data of a Member State.

<sup>(19)</sup> A specific reservation covers discrete elements of GNI (GNP until 2001, GNI thereafter) such as gross value added of selected activities, total final consumption expenditure or gross operating surplus and mixed income.

<sup>(20)</sup> These concerned Greece and the United Kingdom and related to methodological and compilation aspects.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Other revenue: Fines and penalties***Enforced recovery*

2.29. The Financial Regulation's implementing rules<sup>(21)</sup> set out that the Commission should enforce the recovery of amounts receivable by any available means where neither provisional payments have been made nor guarantees lodged by debtors to cover the full amount by the due date. At the end of 2011 around 2 %<sup>(22)</sup> of fines pending were not covered either by a provisional payment or by a guarantee after the due date.

2.30. The Court examined a sample of 14 of such fines and found that in eight cases the Commission had not used all available means to enforce the recovery.

2.31. All of these cases concerned debtors which, the Commission claims, were in a precarious financial condition. DG BUDG states in its 2011 Annual Activity Report that it will not seek to enforce recovery if it assesses that the Union's financial interest is best protected by negotiating a payment plan. The Commission is proposing to modify the Financial Regulation's implementing rules to allow this course of action 'in exceptional circumstances'.

**2.29.** *Enforcing recovery at any price could have irreparable consequences and destroy or make bankrupt companies that are subject to fines. The Commission seeks to obtain coverage of its fines by negotiating with the companies in order to safeguard the fine either through regular down payments or guarantees.*

*It is thanks to such negotiations that a part of the uncovered fines (including default interest) imposed on undertakings in a weak financial situation can be collected or covered by a guarantee and a payment plan covered by a financial guarantee can be agreed under the current rules (see paragraph 2.32). Some fines cannot however be collected because they are imposed on undertakings in bankruptcy, in a precarious financial situation or established outside the Union.*

**2.30.** *As regards the eight cases mentioned by the Court, the Commission is of the opinion that the fines concern either cases where interim measures or ITP (inability to pay under paragraph 35 of the 2006 fining guidelines) requests were pending, and/or cases where enforcement would have caused the immediate insolvency of the company concerned, with the consequence that the Commission would have lost the fine because it is not a preferential creditor.*

*These examples show that the Commission always seeks, with regard to debtors in a precarious financial situation, to obtain coverage of fines by negotiating with the companies in order to safeguard collection of the fine.*

<sup>(21)</sup> Articles 84, 85 and 85a of Commission Regulation (EC, Euratom) No 2342/2002 of 23 December 2002 laying down detailed rules for the implementation of Council Regulation (EC, Euratom) No 1605/2002 on the Financial Regulation applicable to the general budget of the European Communities (OJ L 357, 31.12.2002, p. 1), as last amended by Regulation (EC, Euratom) No 478/2007 (OJ L 111, 28.4.2007, p. 13).

<sup>(22)</sup> About 240 million out of 13 billion euro.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Minimum credit ratings of financial institutions that issue guarantees*

2.32. Under Article 28a of the Financial Regulation <sup>(23)</sup>, the safeguarding of assets is a management objective of the Commission. In order to ensure that the guarantees covering fines are safeguarded, the Commission sets minimum credit rating requirements for the financial institutions providing the guarantees. The Court found cases where these requirements were not respected.

2.33. On 13 May 2011 the Commission made the conditions for such guarantees less stringent to reflect the deteriorating market conditions. The Court found examples where even these updated conditions were not respected.

2.34. In view of the current state of the banking sector, the Commission states in DG BUDG's Annual Activity Report that it is reviewing its risk management policy.

**2.32-2.35.** *The Commission considers that in a very limited number of cases it was impossible to obtain guarantees respecting the set requirements taking into account the deteriorating financial environment.*

**2.33-2.34.** *In view of the current state of the European financial sector, it is inevitable that the Commission reviews on a regular basis its risk management policy concerning the guarantees covering outstanding fines. Indeed, most major banks have now lost their acceptable rating from all three major rating agencies and in a large majority of Member States it is impossible to find a bank with an acceptable rating, which makes it very difficult for a small or medium-sized company, for instance, to obtain such a guarantee. Due to market conditions the Commission was obliged to review requirements for the guarantees on 13 May 2011.*

*In the examples referred to by Court, guarantees concerned respected the risk policy in force, when accepted by Commission. Guarantors were later downgraded, which in view of the reduced number of banks fulfilling the criteria still on the market, led Commission again to reconsider its risk policy for bank guarantees in June 2012. While taking into account the evolution of the financial markets, the new decision also ensures a sufficient degree of diversification in the Commission's overall exposure vis-à-vis individual guarantors.*

**CONCLUSIONS AND RECOMMENDATIONS****Conclusions**

2.35. Based on its audit work <sup>(24)</sup>, the Court concludes that, for the year ended 31 December 2011,

(a) Member States' declarations and payments of TOR;

<sup>(23)</sup> 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), as last amended by Regulation (EU, Euratom) No 1081/2010 of the European Parliament and of the Council (OJ L 311, 26.11.2010, p. 9).

<sup>(24)</sup> For reasons explained in paragraphs 2.13 and 2.14, this conclusion does not provide an assessment of the quality of VAT or GNI data that were received by the Commission from Member States.

## THE COURT'S OBSERVATIONS

- (b) the Commission's calculation of Member States' contributions on the basis of the VAT and GNI data received from Member States;
  - (c) the calculation of the UK correction; and
  - (d) other revenue;
- were free from material error.

2.36. Based on its audit work, the Court found that the examined supervisory and control systems for revenue were effective. However, the Court draws attention to the matters set out below:

- (a) The Court's audits revealed weaknesses in national customs supervision (paragraph 2.20). The Court concludes that the supervisory and control systems of the Member States audited are only partially effective in ensuring that the TOR recorded are complete and correct.
- (b) Long-outstanding reservations still exist in connection with VAT-based own resources (paragraph 2.25).
- (c) At the end of 2011 the Commission had still not lifted general reservations and placed specific GNI reservations in respect of the EU-25 Member States for the period 2002 onwards (paragraph 2.28).
- (d) At the end of 2011 the Commission had not yet lifted the two remaining specific GNP reservations for the period 1995 to 2001 (paragraph 2.27).
- (e) The Court takes note of the reasons for not enforcing recovery in all cases (paragraph 2.31). The Commission is proposing to modify the Financial Regulation's implementing rules to allow this course of action 'in exceptional circumstances'.

## THE COMMISSION'S REPLIES

**2.36.**

- (a) *The Commission will follow up the Court's findings with the Member States concerned.*
- (b) *The number and proportion of reservations long-outstanding according to the Court's definition continues to decrease – it is now less than 10 % of the total. There will always be some long-outstanding reservations as there may be many ramifications for Member States to explore and to remedy.*

*There has been an ongoing improvement in the frequency of consultations with Member States plus enhancement of the levels of cooperation between the Commission and Member States which will continue.*

- (c) *The administrative processes necessary to provide each of the 25 Member States simultaneously with confirmatory official notification of the lifting of the general reservations and the specific reservations set concerning them were completed in early 2012.*
- (d) *The Commission is making progress via its cooperation with the two countries that still have GNP reservations for the period 1995-2001 (one for Greece and one for the United Kingdom at end 2011) so that these reservations can be lifted.*
- (e) *The Commission always seeks to obtain the best coverage of an appealed fine (through a provisional payment or a guarantee) but in some cases where the fined undertaking is in a precarious financial situation, the negotiations of this coverage can be lengthy and involve other stakeholders (shareholders, parent companies or banks). A new rule allowing, in exceptional cases, a deferred payment without guarantee will make it possible to collect some part of a fine even if the undertaking cannot obtain a bank guarantee.*



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

(f) The Commission is also reviewing its risk management policy concerning the reliability of guarantees covering outstanding fines and penalties, in order to reflect the situation in the banking sector (paragraph 2.34).

(f) *The risk management policy has been reviewed and adapted to take into account the current economic and financial environment, while also ensuring that the level of security of the financial assets remains at the highest possible level. Credit ratings provide an indication for the evaluation of risk but are not used uniquely, or without taking into account other criterion for risk management decisions.*

## Recommendations

2.37. *Annex 2.3* shows the result of the Court's review of progress in addressing recommendations made in previous annual reports (2008 and 2009). The following points should be noted:

(a) In its previous annual reports (for example paragraph 4.14 of the 2008 Annual Report and paragraph 2.20 of the 2009 Annual Report), the Court stated that it continued to find problems with the use of the B accounts. In 2011 the Commission was still finding such problems in its inspections.

(b) Concerning GNI-based own resources, the Court has recommended (in, for example, paragraph 2.38 of the 2009 Annual Report) that the Commission should (i) make clear the scope of the opinion it provides in its assessment reports on Member States' GNI data and (ii) take into account its evaluation of supervisory and control systems in the National Statistical Institutes (NSI) for the compilation of national accounts. These recommendations were not implemented by the Commission in its assessment of the GNI data of the EU-25 Member States (see paragraph 2.28).

2.37.

(a) *The Commission examines the B accounts every year in the course of its inspections. The B account in which debts are entered that are not guaranteed and/or which are contested, of its nature, contains matters that may lead to problems and this is the reason why the Commission services examine this account each year. However, it should be noted that the B account is now computerised in most of the Member States and the number of amounts unduly entered in the B account is decreasing. Most of the findings made by the Commission relate to the financial responsibility of the Member State, for example, when an amount cannot be recovered (and is written off) or when a debt is cancelled because of an administrative error. In these cases the management of the B account, as such, is not at issue.*

(b) *The Commission considers that the approach it applies (desk checks of the GNI Questionnaires, the verification of GNI Inventories using the GLAQ supplemented by a direct verification) is appropriate for a final assessment of the Member States' GNI. In this context, the supervisory and control systems (SCS) are of an organisational nature and give no specific indication of the reliability of the accounts, which depends primarily on the statistical sources and methods used, even though SCS may help mitigate the risks of errors in national accounts. The Commission will pursue its efforts to develop SCS guidelines for compilation of their national accounts by Member States, taking into account the observations made by the Court.*

## THE COURT'S OBSERVATIONS

2.38. Following this review, and the findings and conclusions for 2011, the Court recommends that the Commission:

- **Recommendation 1:** encourages Member States to strengthen customs supervision in order to maximise the amount of TOR collected.
- **Recommendation 2:** continues its efforts to ensure that B accounts are correctly used and that accounting systems allow the Member States' A accounts to be demonstrably complete and correct.

## THE COMMISSION'S REPLIES

**2.38.**

*The Commission will continue to verify that the Member States have put in place appropriate control frameworks to protect the financial interests of the EU in the area of traditional own resources.*

*The Commission will continue to verify that B accounts are correctly used and that accounting systems allow Member States' A accounts to be complete and correct.*

## ANNEX 2.1

## RESULTS OF TRANSACTION TESTING FOR REVENUE

	2011				2010	2009	2008
	TOR	VAT/GNI, corrections under budget Title 1	Other revenue	Total			
<b>SIZE AND STRUCTURE OF THE SAMPLE</b>							
Total transactions (of which):	7	42	6	55	55	62	60
Recovery orders	7	42	6	55	55	62	60
<b>RESULTS OF TESTING <sup>(1)</sup> <sup>(2)</sup></b>							
<b>Proportion (number) of transactions tested found to be:</b>							
Free of error	100 % (7)	100 % (42)	83 % (5)	98 % (54)	100 %	95 %	100 %
Affected by one or more errors	0 % (0)	0 % (0)	17 % (1)	2 % (1)	0 %	5 %	0 %
<b>ESTIMATED IMPACT OF QUANTIFIABLE ERRORS</b>							
Most likely error rate				0,8 %			
Upper Error Limit (UEL)				2,4 %			
Lower Error Limit (LEL)				0,0 %			

<sup>(1)</sup> To improve insight into areas with different risk profiles within the policy group, the sample was split up into segments.

<sup>(2)</sup> Numbers quoted in brackets represent the actual number of transactions.

## ANNEX 2.2

## RESULTS OF EXAMINATION OF SYSTEMS FOR REVENUE

## Assessment of the systems examined

System concerned	Commission checks in Member States	Commission calculation / desk checks and revenue management	Commission management of reservations	Key internal controls in Member States audited	Overall assessment
TOR	Effective	Effective	N/A	Partially effective	Effective
VAT/GNI	Effective	Effective	Effective	N/A	Effective
UK correction	N/A	Effective	N/A	N/A	Effective
Fines and penalties	N/A	Effective	N/A	N/A	Effective

## FOLLOW-UP OF PREVIOUS RECOMMENDATIONS FOR REVENUE

Year	Court recommendation	Court's analysis of the progress made	Commission reply
2009	<p>Concerning GNI-based own resources, the Court recommended (in paragraph 2.38 in respect of 2009) that the Commission should</p> <p>(i) make clear the scope of the opinion it provides in its assessment reports on Member States' GNI data; and</p> <p>(ii) that it should take into account an evaluation of supervisory and control systems in the National Statistical Institutes (NSI) for the compilation of national accounts.</p>	<p>(i) in the reports on the EU-25 Member States, the Commission made an assessment on the quality of GNI data and on its conformity with ESA95, without clarifying the scope and objectives of the Eurostat verification work supporting the overall conclusion;</p> <p>(ii) as Eurostat had still not adopted guidelines in 2011 setting out best practices on the functioning of supervisory and control systems for the compilation of national accounts, in the Court's view their evaluation could not be carried out appropriately in the context of the final assessment made on GNI data of EU-25 Member States.</p>	<p><i>The Commission considers that the approach it applies (desk checks of the GNI Questionnaires, the verification of GNI Inventories using the GIAQ supplemented by a direct verification) is appropriate for a final assessment of the Member States' GNI. In this context, the supervisory and control systems (SCS) are of an organisational nature and give no specific indication of the reliability of the accounts, which depends primarily on the statistical sources and methods used, even though SCS may help mitigate the risks of errors in national accounts. The Commission will pursue its efforts to develop SCS guidelines for compilation of their national accounts by Member States, taking into account the observations made by the Court.</i></p>
2009 and 2008	<p>The Court has frequently reported inappropriate use of B accounts (for example paragraph 2.20 of the 2009 Annual Report and paragraph 4.14 of the 2008 Annual Report).</p>	<p>The Commission examines B accounts every year and still finds such inappropriate use.</p>	<p><i>The Commission examines the B accounts each year in the course of its inspections. It will continue to do so.</i></p>



## CHAPTER 3

**Agriculture: market and direct support**

## TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	3.1-3.9
Specific characteristics of the policy group	3.2-3.8
Audit scope and approach	3.9
Regularity of transactions	3.10-3.13
Cross compliance	3.13
Effectiveness of systems	3.14-3.41
Member States' systems relating to regularity of transactions	3.14-3.24
Administrative and control procedures to ensure correct payment including quality of databases	3.18-3.22
Control systems based on physical on-the-spot checks	3.23
Procedures to ensure recovery of undue payments	3.24
The Commission's supervisory system and management representation	3.25-3.41
The Commission's assessment of the proper functioning of management and control systems	3.27-3.39
DG AGRI's management representation — the Annual Activity Report (AAR)	3.40-3.41
Conclusions and recommendations	3.42-3.45
Conclusions	3.42-3.43
Recommendations	3.44-3.45

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

## INTRODUCTION

3.1. This Chapter presents the Court's specific assessment of market and direct support for agriculture, which is part of policy area 05 — Agriculture and rural development. Key information on the activities covered and the spending in 2011 is provided in **Table 3.1**.

**3.1.** *The administrative expenditure referred to in **Table 3.1** also covers non-EAGF activities. The EAGF finances 1 budget line (05 01 04 01) with payments made for 7,7 million euro in 2011 out of the total administrative expenditure of 133,7 million euro (chapter 05 01).*

**Table 3.1 — Market and direct support for agriculture — Key information 2011**

(million euro)

Budget Title	Policy area	Description	Payments	Management mode
05	Agriculture expenditure financed by the European Agricultural Guarantee Fund (EAGF)	Administrative expenditure <sup>(1)</sup>	134	Centralised direct
		Interventions in agricultural markets	3 533	Shared <sup>(2)</sup>
		Direct aids	40 178	Shared
		Other	98	Centralised direct/Shared
			<b>43 943</b>	
Total administrative expenditure <sup>(3)</sup>			<b>134</b>	
Total operational expenditure			<b>43 809</b>	
Of which: — advances			8	
— interim/final payments			43 801	
<b>Total payments for the year</b>			<b>43 943</b>	
<b>Total commitments for the year</b>			<b>43 950</b>	

<sup>(1)</sup> This amount represents the total administrative expenditure for Title 05.

<sup>(2)</sup> This figure includes 1,5 million euro which is centralised management (budget line 05 02 20 02).

<sup>(3)</sup> The audit of administrative expenditure is reported in Chapter 9.

Source: 2011 annual accounts of the European Union.



## THE COURT'S OBSERVATIONS

**Specific characteristics of the policy group**

3.2. The objectives<sup>(1)</sup> of the common agricultural policy (CAP) as set out in the Treaty are to increase agricultural productivity, thus to ensure a fair standard of living for the agricultural community, to stabilise markets, to assure the availability of supplies and to ensure that supplies reach consumers at reasonable prices.

3.3. The EU budget finances CAP expenditure mainly through two funds<sup>(2)</sup>: the European Agricultural Guarantee Fund (EAGF), which fully finances EU direct aid and market measures<sup>(3)</sup>, and the European Agricultural Fund for Rural Development (EAFRD), which co-finances rural development programmes. This Chapter covers EAGF expenditure while rural development expenditure is presented in Chapter 4.

3.4. The main measures financed by EAGF are:

- the *direct aid* 'Single Payment Scheme' (SPS). SPS payments are based on 'entitlements'<sup>(4)</sup> each of which is activated with one hectare of eligible land declared by the farmer. In 2011 SPS represented 31 082 million euro of expenditure (77 % of direct aids),
- the *direct aid* 'Single Area Payment Scheme' (SAPS) provides for the payment of uniform amounts per eligible hectare of agricultural land and is currently applied in 10 of the Member States<sup>(5)</sup> that joined the EU in 2004 and 2007. In 2011 SAPS accounted for 5 084 million euro of expenditure (13 % of direct aids),
- other *direct aid* schemes linked to specific types of agricultural production (such as suckler cows, cotton, etc.). In 2011 those schemes accounted for 4 012 million euro of expenditure (10 % of direct aids),
- *interventions in agricultural markets* covering, e.g. intervention storage, export refunds, food programmes and specific support for the fruit/vegetable and the wine sectors (in total amounting to 3 533 million euro in 2011).

<sup>(1)</sup> Article 39 of the Treaty on the Functioning of the European Union.

<sup>(2)</sup> 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).

<sup>(3)</sup> With the exception of certain measures such as promotion measures and the school fruit scheme, which are co-financed.

<sup>(4)</sup> The number and value of each farmer's entitlement was calculated by the national authorities according to one of the models provided for under EU legislation.

<sup>(5)</sup> Bulgaria, Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Poland, Romania and Slovakia.

## THE COURT'S OBSERVATIONS

3.5. Under all EAGF direct aid schemes <sup>(6)</sup>, beneficiaries of EU aid have a legal obligation to fulfil 'cross compliance' conditions relating to the protection of the environment, public health, animal and plant health, animal welfare (Statutory Management Requirements (SMRs)) and to the maintenance of agricultural land in good agricultural and environmental condition (GAEC) <sup>(7)</sup>. If farmers do not comply with these obligations their aid is reduced <sup>(8)</sup>.

3.6. CAP expenditure is subject to shared management by the Commission and the Member States. Expenditure is channelled through 81 national or regional paying agencies. These paying agencies are responsible for making payments to the beneficiaries and, prior to doing so, they must, either directly or through delegated bodies, check the eligibility of the aid applications. The Integrated Administration and Control System (IACS) is the main management and control system to ensure the regularity of EAGF direct aid transactions. The accounts and payment records of the paying agencies are examined by independent audit bodies (certification bodies) which report to the Commission through annual certificates and reports.

3.7. The Commission has to obtain assurance that the Member States have set up management and control systems which meet the requirements of the regulations, and that the systems function effectively.

3.8. As regards direct aids the main risks to regularity are that area aid is paid for ineligible land or to two or more beneficiaries for the same plot of land, or that animal premiums are paid for more animals than the applicant owns. As regards interventions in agricultural markets the main risks to regularity are that aid is granted for ineligible or overstated costs.

## THE COMMISSION'S REPLIES

**3.5.** *EU legislation provides that where non-compliance with those conditions is noted, a penalty shall be applied on the overall amount of direct payments made in respect of the applications submitted by the farmer in the course of the calendar year of the finding, if the non-compliance is due to an act or omission directly attributable to the farmer and if it is not of a minor nature.*

**3.6.** *According to Article 5 of Commission Regulation (EC) No 885/2006, the certification bodies examine, on an annual basis, the internal control procedures of the paying agencies, in addition to their annual accounts.*

<sup>(6)</sup> Articles 4 to 6 of Council Regulation (EC) No 73/2009 (OJ L 30, 31.1.2009, p. 16).

<sup>(7)</sup> Whilst GAEC standards, as referred to in Annex III to Regulation (EC) No 73/2009, apply in all Member States, Statutory Management Requirements (SMRs) as referred to in Annex II to that Regulation are mandatory only in EU-15. For the EU-10, SMRs are being phased in between 2009 and 2013, and for EU-2 between 2012 and 2014.

<sup>(8)</sup> According to Articles 70 and 71 of Commission Regulation (EC) No 1122/2009 (OJ L 316, 2.12.2009, p. 65), the level of the reduction per SMR or GAEC not complied with can vary between 1 % and 5 % in case of negligence and can lead to full rejection of the aid in case of intentional non-compliance.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Audit scope and approach**

3.9. **Annex 1.1, Part 2**, to Chapter 1 describes the Court's overall audit approach and methodology. For the audit of market and direct support for agriculture the following specific issues should be noted:

- the audit involved the examination of a sample of 180 interim and final payments,
- as regards cross compliance, the Court focused its testing on selected GAEC obligations<sup>(9)</sup> and SMRs<sup>(10)</sup>. Where cross-compliance obligations were not met, the Court treated such cases as errors<sup>(11)</sup>. These errors were included in the calculation of the overall error rate provided that it can be established that the error already existed in the year in which the farmer applied for aid<sup>(12)</sup>. This represents a change from previous years, when the failure to meet cross-compliance obligations was not included in the error rate calculation,
- reductions and exclusions (applied in cases where beneficiaries of EU aid over-claim the actual area or number of animals<sup>(13)</sup>) are not included in the Court's error rate calculation,

3.9.

- *Most of the cross-compliance requirements, i.e. the SMRs, are to be respected by all EU citizens, irrespectively of being a farmer benefiting from EU support under the CAP. The respect of cross compliance does not constitute an eligibility criterion and, therefore, the controls of these requirements do not pertain to the legality and regularity of the underlying transactions. Farmers not respecting the requirements are entitled to receive their payments, but are sanctioned on the basis of the severity, extent, permanence and repetition of the non-compliance found as well as negligence or intent of the farmer concerned. This is also shown by the fact that payments can be made before the cross-compliance controls have been completed and that penalties are not applied on the payments made in respect of the calendar year when the farmer failed to comply with the requirements, but rather on the payments made in respect of the calendar year of the findings by the national authorities. For all these reasons, the Commission does not itself take violations of cross-compliance obligations into account in the calculation of the level of error for its Annual Activity Report.*

<sup>(9)</sup> Avoiding the encroachment of unwanted vegetation, retention of terraces, maintenance of olive groves and respect of minimum livestock stocking rates or mowing obligations.

<sup>(10)</sup> SMR 4 relating to the nitrates Directive.

<sup>(11)</sup> Cross-compliance obligations are substantive legal requirements that must be met by all recipients of direct aid and are the basic and in many cases the only conditions to be respected in order to justify the payment of the full amount of direct payments, hence the Court's decision to treat failure to meet such requirements as errors.

<sup>(12)</sup> For each infringement, the national system for reduction of payments has been used for the quantification of the error.

<sup>(13)</sup> Regulation (EC) No 1122/2009 provides that, where the claimed area is found to be overstated by more than 3 % or two hectares, the aid amount shall be calculated on the basis of the area determined reduced by twice the area claimed irregularly. If the difference is more than 20 % no aid shall be granted for the crop group concerned. Similar provisions apply to animal premiums.

---

THE COURT'S OBSERVATIONS

---

- the assessment of systems covered IACS in five paying agencies in Member States applying the SPS — Austria, Denmark, Finland, Italy (Lombardia) and Spain (Galicia) — and in one paying agency in a Member State applying SAPS (Hungary),
  
- the Court examined the implementation (at national level) of cross-compliance standards and the control systems implemented by Member States. The results of this work are presented in Chapter 4 at paragraphs 4.30 to 4.32 but are also applicable to this Chapter,
  
- the Court reviewed the work carried out by the certification bodies of Romania and Bulgaria under the new reinforcement of assurance procedure <sup>(14)</sup>,
  
- the review of the Commission's management representations covered the annual activity report of DG AGRI concerning EAGF-related issues,
  
- in the context of the Commission's clearance of accounts procedure the Court reviewed 17 of the EAGF certification bodies' certificates and reports relating to 17 paying agencies. The results are presented in Chapter 4 (see paragraph 4.36).

---

<sup>(14)</sup> See paragraphs 3.34 and 3.35.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**REGULARITY OF TRANSACTIONS**

3.10. **Annex 3.1** contains a summary of the results of transaction testing. The Court's testing of its sample of transactions found 39 % to be affected by error. The most likely error estimated by the Court is 2,9 % <sup>(15)</sup>.

3.11. Of the 70 transactions affected by errors 60 (86 %) were affected by quantifiable errors, concerning accuracy 45 (75 %), eligibility 14 (23 %) and occurrence 1 (2 %).

3.12. Illustrations of quantifiable errors found by the Court are in example 3.1 and an illustration of a non-quantifiable error in example 3.2. The most frequent accuracy error relates to area over-declarations, most of which amount individually to less than 5 %. The larger accuracy errors relate to cases where the eligibility of permanent pasture has been incorrectly assessed and recorded in the Land Parcel Identification System (LPIS) (see also paragraph 3.20).

**3.10.** The most likely error determined by the Court for the financial year 2011 represents a slight increase compared to last year but is still within the normal range of statistical variation from one year to another and does not point to a deterioration of the overall quality in the management and control of expenditure by Member States. This is confirmed by the fact that, in the Commission's view, one of the cases which the Court considers to be a 100 % error was of an exceptional nature and does not point to an inherent weakness in the system. The Commission considers that the error rates determined by the Court over the last years taken together provide reliable evidence that the most likely error rate for EAGF is relatively close to the 2 % materiality threshold.

The low error rates indicated in the control statistics which the Commission has received from Member States and which to a very large extent have been verified and validated by the certification bodies, also confirm that EAGF expenditure in financial year 2011 has generally been well managed.

Finally, the risk to the EU budget is adequately covered by the conformity clearance procedures of the Commission.

See also joint reply to points 3.11 and 3.12.

**3.11 and 3.12.** The Commission notes that most of the quantifiable errors are relatively small in financial terms and mainly concern small differences in the re-measurement of parcels carried out by the Court (see paragraph 3.12); indeed, 42 of the errors found by the Court concern very small differences in parcel re-measurement (24 errors at below 2 %).

<sup>(15)</sup> The Court calculates its estimate of error from a representative statistical sample. The figure quoted is the best estimate (known as the MLE). The Court has 95 % confidence that the rate of error in the population lies between LEL 1,1 % and UEL 4,7 % (the lower and upper error limits respectively).

## THE COURT'S OBSERVATIONS

**Example 3.1****Over-declaration of area (example of accuracy error)**

In one Member State, reference parcels classified as permanent pasture are considered to be fully eligible even if substantial parts are covered by rocks or dense bushes rendering the areas ineligible. The Court found in two transactions in this Member State over-declarations of 28 % and 36 % respectively.

**Breach of public procurement rules (example of eligibility error)**

A promotion measure to encourage the consumption of milk was awarded to a domestic market operator without publication of the tendering procedure at EU level as required by EU and national legislation. This restricted the access to the contract for potential operators from other Member States and represents a serious failure to respect public procurement rules rendering the payment of the aid irregular.

**Claim for non-existent animals (example of occurrence error)**

A farmer was granted a special premium for 150 sheep. The Court found that the beneficiary did not have any sheep. The corresponding payment was therefore irregular.

**Example 3.2 — Example of a non-quantifiable error**

In one Member State the total value of entitlements allocated and recorded in the IACS database exceeded the ceiling provided for in EU legislation <sup>(16)</sup>.

## THE COMMISSION'S REPLIES

**Example 3.1****Over-declaration of area (example of accuracy error)**

The Commission is aware of the issues related to the eligibility of pasture areas in this Member State. National authorities were requested to act on this matter and presented the LPIS Improvement Plan in November 2010 including, notably, measures to implement the application of an eligibility coefficient to pasture parcels and to ensure systematic update of LPIS with the results of on-the-spot checks. The Commission will continue to monitor the implementation of this plan by the national authorities.

**Breach of public procurement rules (example of eligibility error)**

The Commission observes that the Member State does not share the Court's finding. The Commission will assess whether and how to pursue the case, if necessary through the conformity clearance procedure, having regard also to the principle of proportionality.

**Claim for non-existent animals (example of occurrence error)**

The national authorities are in the process of recovering the overpaid amounts and the Commission will follow this up. In addition, a clearance procedure will be launched in order to verify the conformity of the Member State's management and control system.

**Example 3.2 — Example of a non-quantifiable error**

The Commission notes that the Member State reduced payments to farmers and thereby respected the ceiling for all direct aid payments established by Council Regulation (EC) No 73/2009.

The Commission will assess information provided by the Court and on this basis decide on any follow-up.

<sup>(16)</sup> The excess was more than 280 million euro, but in the absence of relevant information regarding the basis for allocating the entitlements the Court was unable to quantify the impact on the EU budget.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Cross compliance*

3.13. On the basis of its examination of selected cross-compliance obligations (see paragraph 3.9, second indent) the Court found infringements in 22<sup>(17)</sup> of the 155 payments subject to these obligations<sup>(18)</sup>. The errors found represent around 0,2 percentage points of the total error rate referred to in paragraph 3.10.

**EFFECTIVENESS OF SYSTEMS****Member States' systems relating to regularity of transactions**

3.14. *Annex 3.2* contains a summary of the results of the Court's examination of the Integrated Administration and Control System (IACS)<sup>(19)</sup>. In all the six paying agencies examined, the Court found the IACS systems to be partially effective.

3.15. The Court's audits show that the effectiveness of IACS in the paying agencies audited is adversely affected by inaccurate data in the various databases and incorrect administrative treatment of claims by the paying agencies. Furthermore, some serious systems weaknesses reported in previous annual reports still persist (see paragraphs 3.19 to 3.22).

**3.13.** See reply to point 3.9.

**3.14 and 3.15.** The Commission considers that IACS, which accounts for 91 % of total EAGF expenditure, is generally an effective control system for limiting the risk of error or irregular expenditure.

*The overall effectiveness and constant improvement of the IACS is confirmed by the results of the conformity audits which the Commission has carried out over the past years in all Member States and by the low error rate indicated in the control statistics which it receives from Member States. These statistics are verified and validated by the certification bodies and show a level of undue payments which is below the 2 % materiality threshold.*

*Remaining deficiencies are generally of a lesser nature. Many of these deficiencies pertain to a rather limited scope, e.g. some kind of alpine pastures in Austria, and are not undermining seriously the effectiveness of IACS. All these deficiencies are followed up through conformity clearance procedures which ensure that the risk to the EU budget is adequately covered.*

*Given that the deficiencies the Court detected in Austria are of a minor nature, the Commission considers the supervisory and control system in Austria to be effective.*

<sup>(17)</sup> 14 of the 22 cases affected the payment audited, while the remaining eight cases only affect future payments.

<sup>(18)</sup> The most frequent cross-compliance infringements observed relate to no or insufficient storage capacity for nitrates of animal origin, nitrate output per hectare in excess of the allowed maximum threshold and lack of nutrient balance records.

<sup>(19)</sup> These findings, except those concerning entitlements, apply also to area-related and animal-related rural development measures covered by IACS.

## THE COURT'S OBSERVATIONS

3.16. IACS covers the main schemes financed by EAGF, i.e. SPS, SAPS and all area related coupled aid schemes as well as animal premium schemes. The system consists of databases of holdings and applications, systems for identifying agricultural parcels and registering animals, as well as a register of entitlements in those Member States implementing the SPS. It provides for several eligibility checks including cross-checks between databases.

3.17. The Court's IACS audits covered compliance with the provisions of the relevant regulations and an assessment of the effectiveness of the systems in ensuring the regularity of transactions, notably the following elements:

- (a) administrative and control procedures to ensure correct payment including quality of databases;
- (b) control systems based on physical on-the-spot checks;
- (c) procedures to ensure recovery of undue payments.

*Administrative and control procedures to ensure correct payment including quality of databases*

3.18. The administrative checks<sup>(20)</sup> by paying agencies must include cross-checks wherever possible and appropriate, inter alia with all IACS databases. The Court verified whether databases were complete and reliable, whether checks identified anomalies and whether action was taken to correct errors detected. The major systems weaknesses found are set out below.

3.19. EU legislation provides that after expiry of a specified deadline, farmers can no longer declare additional parcels and that any anomaly detected by the paying agency will lead to a reduction of the aid amount. However, the administration may correct a claim at any time without applying an aid reduction in the case of an obvious error defined as an inconsistency<sup>(21)</sup> which becomes apparent from the data contained in the claim itself. The Court found that four paying agencies (Denmark, Finland, Italy (Lombardia) and Romania) incorrectly applied the obvious error concept, by allowing the replacement of ineligible or double claimed parcels, with the result that the paying agencies did not apply aid reductions (see example 3.3).

## THE COMMISSION'S REPLIES

**3.19.** *As regards Denmark, Finland and Italy, the national authorities have taken or are taking corrective actions by amending their internal instructions and procedures and, where necessary, by recovering overpaid amounts.*

*As regards Romania, the Commission services' own audit found that the national guidelines for the determination of obvious errors were not always applied correctly by the regional paying offices.*

<sup>(20)</sup> Articles 28 and 29 of Regulation (EC) No 1122/2009.

<sup>(21)</sup> Such as clerical error, inconsistency between graphical and alpha-numerical information contained in the application, map reading errors, etc.



## THE COURT'S OBSERVATIONS

**Example 3.3 — Incorrect treatment of the obvious error concept**

In the case of Romania the incorrect application of the obvious error concept was systematic. Parcels affected by over-declarations or double declarations are replaced in a significant number of cases by other parcels in different locations and of a different size or shape. Such replacements cannot be considered as a correction of obvious errors <sup>(22)</sup>.

## THE COMMISSION'S REPLIES

**Example 3.3 — Incorrect treatment of the obvious error concept**

*As from 2010 the Romanian authorities have implemented a web based LPIS (IPA online) which enhances parcel location. As regards the reference to the Court's findings concerning Romania in its 2008 Annual Report (paragraph 5.38), and as already stated in its respective reply, the Commission does not share the view of the Court of Auditors concerning the application of the obvious error concept in case of misplacement of parcels.*

3.20. The LPIS is a database which contains a record of the entire agricultural area (reference parcels) of the Member State and the eligible areas which is of key importance for the quality of administrative cross-checks (see example 3.4).

3.20.

**Example 3.4 — Incorrect data in the LPIS**

In two Member States <sup>(23)</sup> (Italy (Lombardia) and Spain (Galicia)), the Court found cases where 'permanent pasture' reference parcels were recorded in the LPIS as being 100 % eligible despite the fact that they are fully or partially covered with dense forest or other ineligible features. The Court also observed that the LPIS was not updated with the results of on-the-spot inspections performed by paying agencies (Hungary, Italy (Lombardia) and Spain (Galicia)).

**Example 3.4 — Incorrect data in the LPIS**

*According to the Italian authorities, the issue has been rectified as from 2011. The Commission is pursuing this through the conformity clearance procedure of accounts.*

*The Commission is aware of the issues related to the eligibility of pasture areas in Spain. The Spanish authorities were requested to act on this matter and presented the LPIS Improvement Plan in November 2010 including, notably, measures to implement the application of an eligibility coefficient to pasture parcels and to ensure systematic update of LPIS with the results of on-the-spot checks. The Commission will continue to monitor the implementation of this plan by the national authorities.*

*The Commission has also found some cases in Hungary where LPIS was not updated with the results of the on-the-spot checks and has requested the Hungarian authorities in writing to take action in this respect.*

3.21. For SPS aid to be granted, every entitlement held by the farmer needs to be declared together with one hectare of eligible land. The Court has observed that this principle is not respected in certain circumstances in Austria (see example 3.5).

3.21. *The Commission has so far imposed 0,214 million euro in financial corrections on Austria concerning entitlements for alpine pastures in claim years 2005, 2006 and 2007 in the context of the conformity clearance procedure.*

*See also joint reply to points 3.14 and 3.15.*

<sup>(22)</sup> The Court had already observed in its 2008 Annual Report (paragraph 5.38) that in Romania 5 500 farmers had benefited from a total of 2,2 million euro in EU SAPS aid as a result of the incorrect application of the obvious error concept.

<sup>(23)</sup> The Court has already made this observation for Spain in Annual Reports for 2008, paragraph 5.36, for 2009, paragraph 3.38, and for 2010, paragraph 3.31, and for Italy in the 2009 Annual Report, paragraph 3.38.

## THE COURT'S OBSERVATIONS

**Example 3.5 — Incorrect activation of entitlements**

In Austria, when an applicant claiming Alpine pasture areas does not have enough hectares to activate all entitlements the national authorities, contrary to EU legislation, reduce the number of applicant's entitlements (to match it with the number of hectares) and increase their values proportionately <sup>(24)</sup>.

3.22. All payment entitlements should be recorded in the entitlement database the total value of which must not exceed a ceiling laid down in EU legislation. In two Member States the Court found inaccurate information in the entitlements databases due to the incorrect treatment of unused entitlements <sup>(25)</sup> (Denmark) and to differences between regional and central databases (Spain) <sup>(26)</sup>.

*Control systems based on physical on-the-spot checks*

3.23. The quality of the on-the-spot measurements is of key importance for the correct determination of aid amounts. The Court has re-performed a number of measurements carried out by the paying agencies. In three Member States the Court's measurements differed from the results reported by the paying agencies (in Denmark for five out of 18, in both Spain (Galicia) and Finland for four out of 21 measurements).

*Procedures to ensure recovery of undue payments*

3.24. The Court examined the accounting records of the paying agencies audited to establish if the amounts to be recovered are properly accounted for and if these amounts are correctly reported to the Commission. In Denmark the Court could not reconcile the amounts reported with underlying records.

## THE COMMISSION'S REPLIES

**Example 3.5 — Incorrect activation of entitlements**

See reply to point 3.21.

**3.22.** As regards Denmark, the Commission has found similar issues and Danish authorities have agreed to take appropriate corrective measures. The Commission will follow this up in the context of the conformity clearance procedure.

**3.23.** The Commission services share the view of the Court that the quality of on-the-spot checks is important. Audits carried out by the Commission services have identified similar deficiencies in the quality of the on-the-spot checks, and the weaknesses found are followed up through conformity clearance procedures which ensure that the risk to the EU budget is adequately covered.

Following Commission audits, the Spanish authorities presented an LPIS Improvement Plan in November 2010 including measures to improve the quality of on-the-spot checks. These measures are in effect as from claim year 2012.

**3.24.** The Commission shares the Court's assessment that four out of the six systems audited were effective and two partially effective (see **Annex 3.2**). The Commission also considers that the debts management and recovery systems have improved in the last years, not least due to the introduction in 2006 of the so-called 50/50 rule, which gives a strong incentive to Member States to recover undue payments as effectively and as quickly as possible. This is the reason why the Commission has proposed a '100 % rule' for the 2014-2020 period (i.e. 100 % of unrecovered amounts after a four or eight-year delay — depending on whether the case is under administrative or judicial procedure — will be charged to the Member States concerned) <sup>(1)</sup>.

<sup>(24)</sup> The Court has raised this issue already in its 2006 Annual Report (paragraph 5.23).

<sup>(25)</sup> EU legislation provides that entitlements not activated during two consecutive years revert back to the national reserve, see Article 42 of Regulation (EC) No 73/2009.

<sup>(26)</sup> This issue has already been reported by the Court in its 2008 Annual Report (paragraph 5.37).

<sup>(1)</sup> Article 56(2) of SEC(2011) 1153.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*In the specific case of Denmark, the Certifying body also identified some reconciliation issues with regard to recovered amounts or between the reporting to the Commission through the Annex III tables and the paying agency's debtors' ledger. The Commission will review the compliance with the accreditation criteria and the infrastructure and control systems put in place.*

### **The Commission's supervisory system and management representation**

3.25. The Commission bases its assessment of the legality and regularity of expenditure for the policy area on four building blocks:

- an assessment of the proper functioning of management and control systems,
- the results of its own audits,
- the follow-up of previous years' reservations and action plans,
- the assurance received from other authorising officers in cases of sub-delegation.

3.26. The Court has analysed in particular the Commission's assessment of the proper functioning of management and control systems as described in its 2011 Annual Activity Report.

#### *The Commission's assessment of the proper functioning of management and control systems*

3.27. The key elements for the Commission's assessment of the efficiency of the management at Member State level are the statements of assurance given by heads of paying agencies on the legality and regularity of underlying transactions and the audit work performed on them by certification bodies.

3.27. As stated in DG AGRI's Annual Activity Report, the Commission assesses the legality and regularity of the underlying transactions on the basis of findings and indicators which can be summarised in three assurance blocks:

- (1) the functioning of the paying agencies;
- (2) the control results at the level of the final beneficiaries; and
- (3) the Commission's conformity audits on Member States' management and control systems.

## THE COURT'S OBSERVATIONS

3.28. For 2011 the Commission reports that for EAGF all 81 statements of assurance delivered by heads of paying agencies were unqualified and that all but one (Spain (Cantabria)) opinions given by the respective certification bodies were also unqualified<sup>(27)</sup>. The certification bodies perform their audits on the basis of Commission guidelines under a 'standard' or, on a voluntary basis, 'reinforcement of assurance' procedure involving additional checks.

**The standard audit requirements for certification bodies**

3.29. The certification bodies check the accreditation criteria for the paying agencies, assess the internal control system, validate the compilation of inspection statistics and form an opinion on the statement of assurance given by the heads of the paying agencies.

3.30. In its 2011 AAR the Commission states that 91 % of the certification bodies had audited the compilation of inspection statistics for EAGF-IACS and that 92 % of them concluded positively, i.e. that errors in the compilation of statistics amount to less than 2 %. Therefore, only 84 % of paying agencies' statistics have been validated by the certification bodies.

3.31. According to the Commission guidelines, the validation of inspection statistics by the certification bodies is based on a review of a sample of 20 control reports<sup>(28)</sup>. It does not however cover the completeness of the inspection statistics or the correct reporting of the results<sup>(29)</sup>.

3.32. In assessing the quality of on-the-spot inspections the Commission guidelines allow the certification bodies to either accompany or to re-perform on-the-spot inspections. Based on its experience, the Court considers that the quality of inspections would improve if certification bodies were required systematically to re-perform previous inspections<sup>(30)</sup>.

## THE COMMISSION'S REPLIES

**3.30.** *Compared to previous years, DG AGRI adopted a stricter approach in its Annual Activity Report regarding the work done and conclusions drawn from the certification bodies' work: only in case the certification body performed all required work was it considered in the evaluation of the work.*

**3.31.** *On the completeness of the reporting as such, the Commission services are developing the tools that will provide complete information enabling more generalised checks on the on-the-spot checks results. A test run is scheduled for 2012 claim year for area aids claims.*

**3.32.** *Even though the Commission agrees that, if carried out in due time, a re-performance of a previous check provides a better assessment of the quality of on-the-spot checks, it is still possible to evaluate the control environment through inspections accompanied by the certification body. In certain cases it may not even be possible to re-perform a check in due time. These limitations are inherent in many ex post controls performed by external auditors. In such situations, accompanied inspections are a good alternative. They also have the additional benefit of reducing the administrative burden on the farmer by avoiding an accumulation of controls.*

<sup>(27)</sup> No certification body reports have been received for the two Romanian paying agencies.

<sup>(28)</sup> The Commission guidelines provide for a review of a minimum sample of 20 inspection reports for IACS area aid and another sample of 20 for IACS animal premium measures.

<sup>(29)</sup> A full match between random samples selected and reported in the statistics is a prerequisite for any meaningful assessment of the residual error rate in the payments made.

<sup>(30)</sup> See also the 2010 Annual Report, paragraph 3.46.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

3.33. Furthermore, several certification body reports indicate that the Commission requested further clarifications<sup>(31)</sup> by the paying agencies with regard to the inspection statistics initially submitted. Potential amendments to the inspection statistics resulting from these requests are not analysed in the context of certification body audits.

**The new reinforcement of assurance procedure**

3.34. In 2010 the Commission introduced on a voluntary basis<sup>(32)</sup> a new control framework called 'Reinforcement of assurance on the legality and regularity of the transactions at the level of the final beneficiaries through the work of the certification bodies'. The reinforcement exercise requires the certification body to re-perform, for each paying agency and each of the four expenditure populations, EAGF-IACS, EAGF-non-IACS, EAFRD-IACS and EAFRD-non-IACS, the check of a representative sample of transactions which the paying agency has checked on the spot.

3.35. If the Commission considers that Member States apply this procedure correctly, financial corrections in the context of the clearance of accounts will be limited to the error rate derived from the inspection statistics certified.

*Conceptual inconsistencies*

3.36. The ultimate objective of the reinforcement of assurance procedure is to allow the Commission to establish a reliable residual error rate in the various expenditure populations. The Court has analysed the Commission instructions to the certification bodies for the reinforcement of assurance procedure<sup>(33)</sup>. As regards substantive testing, the instructions provide for a sample of between 110 and 180 transactions and for a materiality threshold of 2 %.

3.37. The Commission instructions, however, allow a 2 % tolerance margin between the aid amounts validated by the paying agency and the amounts determined by the certification body and a further 2 % tolerance margin for incorrect compilation of inspection statistics by the paying agency. The two tolerance margins allow the certification body to validate residual error rates which could be understated by up to 4 percentage points thereby undermining the materiality threshold set.

**3.33.** *The Commission notes that the work to be performed by the certification body has to cover the subsequent transmissions of inspection statistics up to the time of preparation of its report.*

**3.37.** *The instructions foresee a 2 % margin for each of the opinions: the compilation of the statistics and the information as such. The financial effect of these two margins is not necessarily cumulative.*

<sup>(31)</sup> The certification body report explains that the control statistics for Germany (Bayern) had been readjusted six times in response to clarification requests by the Commission, the last definite version was received on 7 November 2011.

<sup>(32)</sup> For the financial year 2011 only Luxembourg, Bulgaria and Romania opted to apply the reinforcement of assurance procedure.

<sup>(33)</sup> AGRI/D(2010) 248617Rev1, Part A — Audit Strategy and AGRI/D(2010) 251540Rev1, Part B — Reporting.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Implementation errors*

3.38. The Court noted substantial deficiencies in the implementation of the reinforcement of assurance procedure in both Member States audited (Bulgaria and Romania, see example 3.6).

**Example 3.6 — Deficiencies in the work carried out by certification bodies**

In Bulgaria, the re-performance of the on-the-spot checks was outsourced by the certification body to a service provider. In several cases re-performed by the Court the service provider had incorrectly assessed the eligibility of land. Furthermore, the certification body did not observe that the paying agency did not offset area surpluses found on one parcel against deficits found on another parcel, as required by EU legislation. Another shortcoming undetected by the certification body was that where the same area was claimed by two farmers (multiple-claims) the paying agency, contrary to EU legislation, replaced the area claimed by one of the farmers concerned by an equivalent unclaimed area in another part of the reference parcel.

In Romania, the paying agency withheld all payments selected by the certification body and presented to that body payment simulations based on lists of parcels which excluded all ineligible parcels. However, after the completion of the audit and the validation of the payment simulations by the certification body, the paying agency added new parcels to the list by way of incorrect application of the obvious error concept<sup>(34)</sup> and paid higher amounts than those validated by the certification body. As a result, the certification body issued an unqualified opinion on the legality and regularity of payments despite the weaknesses highlighted by the Court.

3.39. Overall, the Court considers that the quality of the work performed by the certification bodies audited under reinforcement of assurance is insufficient.

**3.38.**

**Example 3.6 — Deficiencies in the work carried out by certification bodies**

*See reply to point 3.39.*

**3.39.** *The Commission would like to point out that in none of the case the certification body certified the statistics. Consequently, they will not be used for the purposes indicated in point 3.35.*

*As regards the Court's findings, the Commission will raise them with the Member States concerned and will address these issues in any future guidance it will provide.*

<sup>(34)</sup> See also example 3.3.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*DG AGRI's management representation — the Annual Activity Report (AAR)*

3.40. DG AGRI's 2011 AAR contains a reservation in respect of serious deficiencies in IACS in Bulgaria and Portugal. However, the Commission lifted its previous reservation for IACS expenditure in Romania. In the light of the observations referred to in paragraph 3.19 and example 3.6 the Court considers that this was premature.

3.41. Furthermore, DG AGRI considers that the anomalies found by paying agencies during randomly selected on-the-spot inspections reflect the residual error rates. The Court reiterates its criticism of this approach already made in its 2010 Annual Report because:

- it is based on inspections, the quality of which the Commission's own audits <sup>(35)</sup> and the Court's audits (see paragraph 3.23) have shown to be insufficient, in the case of a number of paying agencies,
- it relies on inspection statistics which, according to certification body reports, are affected by compilation errors (see paragraph 3.30), and
- it is incomplete because it disregards the residual errors in the administrative management of claims which the Court's (see paragraphs 3.19, 3.21 and 3.22) and the Commission's own audits have shown to be deficient <sup>(36)</sup>.

**3.40.** It should be recalled that the reservation for Romania was issued purely on a reputational basis due to serious deficiencies in the IACS which is the single most important control system for the CAP and did not entail a financial risk above the 2 % materiality threshold at EU level. In February 2012 Commission audits have determined that the Romanian action plan was completed, properly implemented and the system was operational at sufficient quality for claim year 2011. Therefore the Commission considers that it was justified to lift the reservation independently of the question whether the error rate was above materiality in Romania. An audit of the implementation of the revised IACS system will be carried out as part of the normal audit programme in 2012.

**3.41.** The Member States' control statistics are verified and validated to a large extent by the certification bodies, as recommended as an option by the Court in its annual report for 2005, and the results of this work are disclosed in DG AGRI's Annual Activity Report.

- In order to address the risk that the error rates derived from these control statistics could have been understated due to inaccuracies in the databases or inadequate follow up of anomalies, as referred to by the Court, DG AGRI applied a safety margin of a 25 % increase which it considers largely sufficient to cover the risks referred to by the Court.
- See reply above.
- See reply above.

<sup>(35)</sup> Clearance of accounts reports AA/2011/15 (Portugal), paragraph 3.2, AA/2011/09 (Finland), paragraph 3.2.1, AA/2011/05 (Germany, Mecklenburg-Vorpommern), paragraph 6.2, AA/2011/12 (Italy, Emilia-Romagna), paragraph 3.4.2, AA/2010/16 (Romania), paragraph 3.3, AA/2011/17 (Slovenia), paragraph 3.2, AA/2011/06 (Spain, Navarra), paragraph 3.4, AA/2011/07 (Spain, Castilla y Leon), paragraph 3.4.

<sup>(36)</sup> For example, clearance of accounts reports AA/2011/01 (Bulgaria), paragraph 3.3, AA/2010/15 (Portugal), paragraph 3.3, AA/2011/12 (Italy), paragraph 3.2, AA/2011/06 (Spain), paragraph 3.2 and AA/2011/13 (Lithuania), paragraph 3.3.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**CONCLUSIONS AND RECOMMENDATIONS****Conclusions**

3.42. Based on its audit work, the Court concludes that the payments for the year ended 31 December 2011 of market and direct support for agriculture were affected by material error.

3.43. Based on its audit work, the Court found that the examined supervisory and control systems for market and direct support for agriculture were partially effective.

**3.42.** *The most likely error determined by the Court for the financial year 2011 represents a slight increase compared to last year but is still within the normal range of statistical variation from one year to another and does not point to a deterioration of the overall quality in the management and control of expenditure by Member States. This is confirmed by the fact that, in the Commission's view, one of the cases which the Court considers to be a 100 % error was of an exceptional nature and does not point to an inherent weakness in the system. The Commission considers that the error rates determined by the Court over the last years taken together provide reliable evidence that the most likely error rate for EAGF is relatively close to the 2 % materiality threshold.*

*The low error rates indicated in the control statistics which the Commission has received from Member States and which to a very large extent have been verified and validated by the certification bodies, also confirm that EAGF expenditure in financial year 2011 has generally been well managed.*

*Finally, the risk to the EU budget is adequately covered by the conformity clearance procedures of the Commission.*

*See also reply to paragraph 3.12.*

**3.43.** *The Commission considers that the IACS is generally an effective control system for limiting the risk of error or irregular expenditure and that, based on the control statistics from Member States and its own audit findings, the level of undue direct payments covered by the IACS in 2011 was below the 2 % materiality threshold. See, also, reply to paragraph 3.15. Moreover, the remaining risk for the EU budget is adequately covered by the conformity clearance procedure.*



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Recommendations**

3.44. **Annex 3.3** shows the result of the Court's review of progress in addressing recommendations made in previous annual reports (2008 and 2009). The Court recognises that the Commission has taken remedial action as regards the reliability and completeness of information recorded in the LPIS, such as introducing mandatory quality assessments by all paying agencies and action plans in Member States affected by major deficiencies. However, the Court noted that the Commission did not ensure that certain Member States remedied the LPIS and administrative weaknesses reported by the Court in previous annual reports (see paragraph 3.15).

3.45. Following this review and the findings and conclusions for 2011, the Court recommends for the current programming period that the Commission and Member States take appropriate action to ensure that:

- **Recommendation 1:** the eligibility of permanent pasture is properly assessed, especially in cases where areas are partly covered with bushes, shrubs, dense trees or rocks (see paragraphs 3.12 and 3.20).
- **Recommendation 2:** paying agencies take immediate remedial action where their administrative and control systems and/or IACS databases are found to be deficient (see paragraphs 3.19 to 3.22).
- **Recommendation 3:** on-the-spot inspections are of the quality necessary to identify the eligible area in a reliable manner (see paragraph 3.23).

**3.44.** As from 2010, Member States are required to perform an annual quality assessment of the LPIS according to determined procedures, the results of which the Commission will continue to monitor in the following years. Moreover, in 2010 the Commission introduced on a voluntary basis a new control framework called 'Reinforcement of assurance on the legality and regularity of the transactions at the level of the final beneficiaries through the work of the certification bodies'. Finally, several Member States have developed action plans and the Commission will monitor their completion.

**3.45.** See joint reply to paragraphs 1.12 and 1.13.

The Commission is aware of this issue and is has made proposals aimed at clarifying the eligibility criteria in the context of the ongoing CAP reform towards 2020.

For the current period, where the Commission finds such weaknesses, recommendations for rectification are made to the Member State and financial corrections are imposed through conformity clearance procedures in order to protect the EU's financial interests.

The Commission agrees with the Court and systematically recommends Member States to improve the control systems and ensure a more vigorous implementation thereof.

Moreover, the Commission services have identified similar deficiencies in the quality of the on-the-spot checks, and the weaknesses found are followed up through conformity clearance procedures which ensure that the risk to the EU budget is adequately covered.

## THE COURT'S OBSERVATIONS

- **Recommendation 4:** the design and quality of the work performed by the certification bodies provides a reliable assessment of the legality and regularity of operations in the paying agencies (see paragraphs 3.29 ff).

## THE COMMISSION'S REPLIES

*The Commission considers the overall structure and reporting requirements with regards to the review of on-the-spot controls by the certification bodies to be appropriate. Consequently, no changes in the Commission's guidelines to certification bodies are foreseen for financial year 2012. The Commission will, however, continue to monitor the quality of the work of the certification bodies.*

*However, the certification bodies are not presently required to give an opinion on the legality and regularity of operations. Such work is possible on a voluntary basis only at the moment. The Commission's proposals for both the financial regulation and the horizontal regulation on the financing, management and monitoring of the CAP require the certification bodies<sup>(2)</sup>, from the start of the new programming period, to deliver an opinion on legality and regularity of transactions.*

<sup>(2)</sup> Article 9 of the Commission's proposal for a Regulation of the European Parliament and of the Council on the financing, management and monitoring of the common agricultural policy — COM(2011) 628 final/2.

## ANNEX 3.1

## RESULTS OF TRANSACTION TESTING FOR AGRICULTURE: MARKET AND DIRECT SUPPORT

	2011	2010	2009	2008
<b>SIZE AND STRUCTURE OF THE SAMPLE</b>				
Total transactions ( <i>of which</i> ):	180	146	148	151
Advances	0	0	0	0
Interim/Final payments	180	146	148	151
<b>RESULTS OF TESTING <sup>(1)</sup></b>				
<b>Proportion (number) of transactions tested found to be:</b>				
Free of error	61 % (110)	73 %	76 %	72 %
Affected by one or more errors	39 % (70)	27 %	24 %	28 %
<b>Analysis of transactions affected by error</b>				
<b>Analysis by type of error</b>				
Non-Quantifiable errors:	14 % (10)	26 %	31 %	29 %
Quantifiable errors:	86 % (60)	74 %	69 %	71 %
Eligibility	23 % (14)	3 %	13 %	10 %
Occurrence	2 % (1)	0 %	0 %	0 %
Accuracy	75 % (45)	97 %	87 %	90 %
<b>ESTIMATED IMPACT OF QUANTIFIABLE ERRORS</b>				
Most likely error rate	2,9 %			
Upper Error Limit (UEL)	4,7 %			
Lower Error Limit (LEL)	1,1 %			

<sup>(1)</sup> Numbers quoted in brackets represent the actual number of transactions.

## ANNEX 3.2

## RESULTS OF EXAMINATION OF SYSTEMS FOR AGRICULTURE: MARKET AND DIRECT SUPPORT

## Assessment of selected supervisory and control systems — EAGF

Member State (Paying agency)	Scheme	IACS related expenditure (national ceiling, Annex VIII to Regulation (EC) No 73/2009) (1 000 euro)	Administrative and control procedures to ensure correct payment including quality of databases	On-the-spot inspection method- ology, selection, execution, quality control and reporting of individual results	Procedures for the recovery of undue payments	Overall assessment
Austria	SPS	745 235	Partially effective 1, 9	Effective	Effective	Partially effective
Denmark	SPS	1 030 478	Partially effective 1, 4, 7, 8	Partially effective b	Partially effective A	Partially effective
Finland	SPS	565 520	Partially effective 3, 5, 7, 8	Partially effective b, c	Effective	Partially effective
Hungary	SAPS	1 073 824	Partially effective 2, 6, 9	Partially effective a, b	Partially effective B	Partially effective
Italy (Lombardia)	SPS	4 227 177	Partially effective 2, 5, 8	Effective	Effective	Partially effective
Spain (Galicia)	SPS	5 108 650	Partially effective 1, 2, 3, 4	Partially effective b, c	Effective	Partially effective

1 Weaknesses regarding the LPIS.

2 Failure to update LPIS after on-the-spot checks.

3 Insufficient audit trail in IACS databases.

4 Inaccuracies in the entitlements databases.

5 SPS claims do not contain information allowing the location of the agricultural parcels to be determined.

6 Only limited retroactive checks of potential over-declaration in previous years.

7 Weaknesses in the claim registration procedure.

8 Obvious error corrections do not meet the obvious error concept.

9 Incorrect basis of payment calculation.

a No off-setting of area over-declarations and area under-declaration found within one crop group.

b Insufficient quality of area measurements during on-the-spot controls.

c Incorrect or incomplete information in the on-the-spot inspection reports.

A Inaccuracies in the debtors accounts.

B Weaknesses concerning the use of enforcement procedures.

## FOLLOW-UP OF PREVIOUS RECOMMENDATIONS FOR EAGF

Year	Court recommendation	Court's analysis of the progress made	Commission reply
2009	As regards IACS the Court concluded that significant improvements were necessary especially in three out of the eight paying agencies audited (namely Cyprus, Greece, Malta) (paragraph 3.72).	<p>In the three paying agencies the following corrective actions have been taken:</p> <ul style="list-style-type: none"> <li>— Greece: an action plan to overcome deficiencies was implemented by the authorities. A new LPIS-GIS system and a revised claim procedure were put in place.</li> <li>— Cyprus: a five year renewal plan was implemented. As of 2011 there was a redefinition of the reference parcels based on the most recent images.</li> <li>— Malta: the paying agency updated the LPIS in 2009 using 2008 ortho-photos and planned to finalise a full LPIS update with 2010 imagery for the 2011 claim year.</li> </ul>	
	The Court considered that the Commission guidelines as regards the work to be performed by certification bodies must be reviewed concerning the nature, coverage and reporting obligations, especially as regards the work related to the validation of Member States' control and inspection statistics (paragraph 3.75).	<p>The Commission put forward a new system for the validation of Member States' control and inspection statistics from 2010 called 'reinforcement of assurance procedure' (see paragraphs 3.34 and 3.35).</p> <p>The Court during its audits of two out of the three paying agencies that opted to apply this procedure showed that due to conceptual and implementation deficiencies no or only very limited assurance can be gained from these audits for the two paying agencies audited (see paragraphs 3.36 ff).</p>	<i>The Commission does not share the view that the 'reinforcement of assurance procedure' is affected by conceptual deficiencies. The Commission has also checked the work performed by the certification bodies in relation to the control statistics of the two paying agencies concerned and shares the view that only limited assurance can be gained in these two specific cases.</i>
2009 and 2008	<p>The Court recommended that the systems weaknesses identified were resolved. In this regard, the most urgent deficiencies to be addressed for the SPS and SAPS are (paragraph 3.73 <sup>(1)</sup>):</p> <p>(a) to overcome the systems weaknesses leading to errors relating to ineligible land or over-declarations of land as well as inaccurate entitlements, notably by improving the reliability and completeness of the data recorded in the LPIS (e.g. most recent ortho-photos);</p> <p>(b) to ensure that all IACS databases provide a reliable and full audit trail for all modifications made;</p>	<p>(a) As from claim year 2010 Commission Regulation (EU) No 146/2010 introduced the requirement for Member States to perform a quality assessment of the LPIS-GIS on an annual basis according to determined procedures.</p> <p>(b) No specific corrective actions were taken to address the Court's recommendation.</p>	<p>(a) <i>The Commission shares the Court's evaluation. It will continue to monitor the results in the following years.</i></p> <p>(b) <i>As part of its audits, the Commission makes recommendations to Member States so as to improve the situation on a continual basis. Over the years, the results of audits show progress as regards the quality of information in the databases.</i></p>

Year	Court recommendation	Court's analysis of the progress made	Commission reply
2009 and 2008	(c) to clarify and enforce further the rules so that EU direct aid is not paid to claimants who have neither used the land for farming nor maintained it in GAEC;	<p>(c) In the framework of the Health Check, the Commission gave Member States the possibility to exclude natural or legal persons whose principal business objects do not consist of agricultural activities or whose agricultural activities are insignificant.</p> <p>The Court considers that the risk of payments to claimants who have neither used the land for farming nor maintained it in GAEC still exists.</p> <p>In its proposal for the CAP post-2013, the Commission clarified the definition of a farmer. The Court considers that the risk persists that payments may continue to be made to beneficiaries who do not exercise any agricultural activity.</p>	<p>(c)</p> <p><i>Following a recommendation by the Court, the Commission put forward a definition of 'active farmer' in the framework of its proposal for the CAP post-2013, which is currently still under negotiation among the legislative authority.</i></p>
	(d) to set at EU level minimum annual maintenance requirements for grassland to be eligible for EU direct aid.	(d) No progress has been made in the current programming period.	(d) <i>The current system provides for a common legal framework within which the Member States are responsible for defining the maintenance criteria under the GAEC. This allows for the diversity of agricultural areas and traditions in the EU to be taken into account.</i>
2008	The Court, based on the level of errors in transaction testing and its systems assessment, reiterated that IACS generally is an effective control system for limiting the risk of error or irregular expenditure. Nevertheless, the audit found that significant improvements are necessary in selected paying agencies in three Member States (namely UK (Scotland), Bulgaria, Romania) (paragraph 5.64).	<p>The Commission took the following corrective actions:</p> <ul style="list-style-type: none"> <li>— Bulgaria: an action plan for the period 2009-2011 was developed with the aim of mainly addressing a high level of negligent errors in farmers' aid application, the acquisition of new ortho-imagery and the update of LPIS-GIS with information from new ortho-photo and the results of on-the-spot checks.</li> <li>— Romania: an action plan for the years 2009-2011 was established in order to address the acquisition of new ortho-imagery, the update of LPIS-GIS with information from new ortho-photo and results of on-the-spot checks.</li> <li>— UK (Scotland): the national authorities have been reviewing and updating the information in the LPIS-GIS.</li> </ul>	<p><i>The action plans for Romania and Bulgaria were completed in November 2011 and February 2011 respectively.</i></p>

(1) Similar recommendations were made in paragraph 5.65 of the 2008 Annual Report.

## CHAPTER 4

**Rural development, environment, fisheries and health**

## TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	4.1-4.9
Specific characteristics of the policy group	4.2-4.8
Rural development	4.2-4.5
Environment and climate action, maritime affairs and fisheries, health and consumer protection	4.6-4.8
Audit scope and approach	4.9
Regularity of transactions	4.10-4.19
Rural development	4.12-4.18
Cross-compliance	4.16-4.18
Environment and climate action, maritime affairs and fisheries, health and consumer protection	4.19
Effectiveness of systems	4.20-4.50
Rural development	4.20-4.44
Member States' systems related to regularity of transactions	4.20-4.32
The Commission's clearance of accounts system and management representation	4.33-4.44
Environment and climate action, maritime affairs and fisheries, health and consumer protection	4.45-4.50
Internal Control System of DG MARE	4.46
Other DGs' management representation — the annual activity reports (AARs)	4.47-4.50
Conclusions and recommendations	4.51-4.55
Conclusions	4.51-4.52
Recommendations	4.53-4.55

## THE COURT'S OBSERVATIONS

## INTRODUCTION

4.1. This Chapter presents the Court's specific assessment of rural development, environment, fisheries and health which comprises rural development (which is part of policy area 05 — Agriculture and rural development) and policy areas 07 — Environment and climate action, 11 — Maritime affairs and fisheries and 17 — Health and consumer protection. Key information on the activities covered and the spending in 2011 is provided in **Table 4.1**.

Table 4.1 — Rural development, environment, fisheries and health — Key information 2011

(million euro)

Budget Title	Policy area	Description	Payments	Management mode
05	Rural development	Rural development	12 292	Shared
		Pre-accession measures	102	Decentralised
		International aspects of 'agriculture and rural development' policy area	5	Centralised direct
			<b>12 399</b>	
07	Environment and climate action	Administrative expenditure	92	Centralised direct
		Operational expenditure	240	Centralised direct/Centralised indirect
			<b>332</b>	
11	Maritime affairs and fisheries	Administrative expenditure	41	Centralised direct
		Operational expenditure	731	Centralised/Shared
			<b>772</b>	
17	Health and consumer protection	Administrative expenditure	117	Centralised direct
		Operational expenditure	506	Centralised direct/Centralised indirect
			<b>623</b>	

Total administrative expenditure <sup>(1)</sup>	<b>250</b>
Total operational expenditure	<b>13 876</b>
Of which: — advances	566
— interim/final payments	13 310
<b>Total payments for the year</b>	<b>14 126</b>

**Total commitments for the year** **16 779**

<sup>(1)</sup> The audit of administrative expenditure is reported in Chapter 9.

Source: 2011 annual accounts of the European Union.



## Specific characteristics of the policy group

### *Rural development*

4.2. Rural development is part of the common agricultural policy (CAP), for which the overall objectives and the sources of funding are presented in Chapter 3 (see paragraphs 3.2 and 3.3).

4.3. The European Agricultural Fund for Rural Development (EAFRD) co-finances at varying rates rural development expenditure through Member States' rural development programmes. The expenditure covers 45 measures which include both area-related measures (such as agri-environment payments and compensatory payments to farmers in areas with natural handicaps) and non-area-related measures (such as modernisation of agricultural holdings and the setting up of basic services for the economy and rural population) (12 394 million euro) <sup>(1)</sup>.

4.4. The management and control of CAP expenditure is described in Chapter 3 (see paragraphs 3.6 and 3.7). Under certain EAFRD aid schemes <sup>(2)</sup>, beneficiaries of EU aid have a legal obligation to fulfil 'cross-compliance' conditions, as described in paragraph 3.5.

4.5. In its 2010 Annual Report, the Court noted that rural development expenditure is particularly prone to error <sup>(3)</sup>. The main risk to regularity is caused by the often complex rules and eligibility conditions. In addition, as some programmes have low implementation rates <sup>(4)</sup>, there is a risk, especially towards the end of the programming period, that ineligible expenditure is declared to avoid decommitments.

4.4. See reply to paragraph 3.5.

4.5. The Commission shares the Court's view that some areas of rural development expenditure are affected by a higher incidence of errors, as compared to the first pillar of the CAP. However, the relatively higher error rates for rural development must also be seen in context of the rural development policy objectives which can only be achieved by the more complex rules and eligibility conditions referred to by the Court.

<sup>(1)</sup> This amount includes expenditure for completion of earlier (2000-2006) programmes (500 million euro) and pre-accession measures in the field of agriculture and rural development (102 million euro).

<sup>(2)</sup> As set out in Article 50a of Council Regulation (EC) No 1698/2005 (OJ L 277, 21.10.2005, p. 1).

<sup>(3)</sup> See paragraph 3.18 of the Court's 2010 Annual Report.

<sup>(4)</sup> Five years after the start of the 2007-2013 programming period, execution rates (i.e. payments/financial plan) were still very low for Bulgaria (29,1 %), Romania (34,3 %) and Italy (36,2 %) (based on data from DG AGRI as at 31.12.2011).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Environment and climate action, maritime affairs and fisheries, health and consumer protection*

4.6. The Union's policy on the environment is designed to contribute to protecting and improving environmental quality, the life of its citizens, and the rational utilisation of natural resources, including at international level. The financial instrument for the environment (LIFE) <sup>(5)</sup> is the most important programme in terms of funding (184 million euro expenditure in 2011) for co-financing projects in the Member States relating to nature and biodiversity; environment policy and governance; and information and communication.

4.7. The common fisheries policy of the policy area maritime affairs and fisheries pursues the same overall objectives as the common agricultural policy (see paragraph 3.2). The European Fisheries Fund <sup>(6)</sup> (EFF) is the main instrument (441 million euro expenditure in 2011).

4.8. Concerning health and consumer protection, the EU contributes both to human, animal and plant health protection and to consumer welfare. The majority of payments are made for animal disease eradication programmes and European agencies <sup>(7)</sup> (186 million euro and 171 million euro respectively in 2011).

**Audit scope and approach**

4.9. **Annex 1.1, Part 2**, of Chapter 1 describes the Court's overall audit approach and methodology. For the audit of rural development, environment, fisheries and health, the following specific issues should be noted:

- the audit involved the examination of a sample of 178 interim and final payments, comprising 160 payments for rural development and 18 concerning environment and climate action, maritime affairs and fisheries, and health and consumer protection;

**4.9.**

<sup>(5)</sup> Regulation (EC) No 614/2007 of the European Parliament and of the Council (OJ L 149, 9.6.2007, p. 1).

<sup>(6)</sup> The Financial Instrument for Fisheries Guidance (FIFG) has been replaced by the EFF for the current programming period (2007-2013) — Council Regulation (EC) No 1198/2006 (OJ L 223, 15.8.2006, p. 1).

<sup>(7)</sup> European Centre for Disease Prevention and Control, European Food Safety Authority, European Medicines Agency.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

- with respect to cross-compliance, the Court focused its testing on compliance with GAEC (good agricultural and environmental condition) obligations and selected statutory management requirements (SMRs) <sup>(8)</sup> for which evidence could be obtained and a conclusion reached at the time of the audit visit;
- reductions and exclusions (to be applied by Member States in cases where beneficiaries of EU aid over-claim the actual area, number of animals or eligible expenditure <sup>(9)</sup>) are not included in the Court's error rate calculation <sup>(10)</sup>;
- the assessment of systems for rural development covered one paying agency in each of six Member States: Denmark, Spain (Galicia), Italy (Lombardia), Hungary, Austria and Finland. For maritime affairs and fisheries the Court tested the internal control system of DG MARE;
- the review of the Commission's management representations covered the annual activity reports of DGs AGRI (concerning rural development), CLIMA, ENV, MARE and SANCO;
- in addition, in order to assess the basis for the Commission's financial clearance decisions the Court reviewed DG AGRI's clearance of accounts audit work and the EAFRD certification bodies' certificates and reports related to 15 paying agencies.

- See replies to paragraphs 4.16 to 4.18.

<sup>(8)</sup> All requirements for SMRs 6-8 (concerning the identification and registration of animals) and obvious non-compliance with SMRs 4 (nitrates Directive) and 18 (animal welfare).

<sup>(9)</sup> Articles 16, 17 and 30 of Commission Regulation (EU) No 65/2011 of 27 January 2011 laying down detailed rules for the implementation of Council Regulation (EC) No 1698/2005, as regards the implementation of control procedures as well as cross-compliance in respect of rural development support measures (OJ L 25, 28.1.2011, p. 8).

<sup>(10)</sup> Except in cases where Member States had already found the irregularity without applying the due reductions/exclusions.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**REGULARITY OF TRANSACTIONS**

4.10. **Annex 4.1** contains a summary of the results of transaction testing. The Court's testing of its sample of transactions found 57 % to be affected by error. The most likely error estimated by the Court is 7,7 % <sup>(1)</sup>.

4.11. With regard to rural development expenditure, of 160 transactions sampled, 93 (58 %) were affected by errors, of which 61 (66 %) were quantifiable errors. As regards environment and climate action, maritime affairs and fisheries, and health and consumer protection, of 18 transactions sampled, 8 (44 %) were affected by errors, of which 2 (25 %) were quantifiable errors.

**Rural development**

4.12. For EAFRD, the Court's transaction testing resulted in auditing 26 different measures. 75 transactions concerned area-related and 85 non-area-related measures. The major part of the most likely error reported in paragraph 4.10 concerned the eligibility of non-area-related measures. The Court also found a high incidence of errors when beneficiaries were public bodies, such as municipalities or the paying agency itself: in the 34 transactions audited involving public beneficiaries, there were 17 errors (50 %) concerning issues such as declaring ineligible VAT or not complying with public procurement rules.

4.13. The sample of 160 rural development transactions included 43 payments for agri-environment schemes. The Court found that in 10 cases (23 %), the farmers had not respected the agri-environmental commitments they had given. A description of such an error found by the Court is provided in example 4.1. For the measure 'modernisation of agricultural holdings', 21 payments were audited, in which the Court detected 8 cases (38 %) of ineligible expenditure.

**4.10 and 4.11.** *The Commission takes note of the most likely error rate estimated by the Court. Although it does not share the Court's assessment in certain cases, the Commission's own estimate of the level of undue payments on the basis of the control statistics provided by the Member States in 2011, also shows a deterioration of the situation, albeit of a more limited magnitude. Therefore, the Director-General for DG AGRI has made a reservation, concerning rural development expenditure, in his declaration of assurance for 2011.*

*This reservation is accompanied by a number of corrective actions to be determined by the Commission together with the Member States in order to address the situation.*

*However, the relatively higher error rates for rural development compared to the first pillar of the CAP must also be seen in context of the rural development policy objectives which can only be achieved by the more complex rules and eligibility conditions referred to by the Court in paragraph 4.5.*

*The Commission notes that half of the quantifiable errors are rather small in financial terms (below 5 %).*

**4.12.** *The Commission takes note of the Court's findings, although they do not always coincide with the control statistics from the Member States, and will take them into account in the implementation of its action plan for rural development, if deemed necessary.*

**4.13.**

<sup>(1)</sup> The Court calculates its estimate of error from a representative statistical sample. The figure quoted is the best estimate (known as the MLE). The Court has 95 % confidence that the rate of error in the population lies between LEL 4,5 % and UEL 10,9 % (the lower and upper error limits respectively).

## THE COURT'S OBSERVATIONS

**Example 4.1 — Non-respect of agri-environment commitments (example of eligibility error)**

The beneficiary applied for support for two agri-environment schemes. For the first scheme, he had committed on 14 parcels to refrain from cultivating crops in a one metre buffer strip and to leave this area uncultivated, unploughed, unfertilised and unsprayed. The audit found that this requirement was not respected on any of the 14 parcels. For the second scheme, the farmer committed to carry out appropriate orchard management techniques and good agricultural practices, including pruning and thinning of fruit trees. The audit found that the trees were not pruned and that the parts of the parcels where the trees grew were covered with waste matter. According to the applicable national rules, this significant breach of requirements for the two schemes should result in a 100 % reduction of the payment.

4.14. In 31 of the transactions audited, the beneficiary was required to respect public procurement rules. The Court found that in 12 cases (39 %), one or more of these rules were not respected (see example 4.2).

**Example 4.2 — Breach of public procurement rules (example of eligibility error)**

The beneficiary of 5,1 million euro EU aid was the paying agency itself. The amount was paid for the measure 'technical assistance' and concerned a part of the larger operation of the paying agency's service and maintenance of the IT system. The Court found that the two contracts for this larger operation, with a value of around 58 million euro, were awarded to a company through negotiated procedures without notice. The paying agency did not provide the necessary analysis or required justification for awarding these contracts through such procedures, rather than through open or restricted procedures.

4.15. The Court found in more than one third of the cases that the error identified as part of the transaction testing was systematic, i.e. that it affected more payments than the one audited (see example 4.3).

## THE COMMISSION'S REPLIES

**Example 4.1 — Non-respect of agri-environment commitments (example of eligibility error)**

*The Commission considers that the finding of the Court concerns a non-systematic case of non-compliance with a commitment entered under an agri-environment measure.*

*The Commission will request the relevant certification body to monitor the recovery of the amount unduly paid.*

4.14. *The Commission notes that some observations of the Court concern national rules on public procurement and that certain Member States have a different interpretation of those rules to that of the Court.*

**Example 4.2 — Breach of public procurement rules (example of eligibility error)**

*The Commission notes that, had an appropriate justification been made for this procedure, it would in principle have been legally possible for the beneficiary to award the contracts through negotiated procedure. In such a case, the Commission would possibly not exclude the entire expenditure from EU financing in the context of its conformity clearance procedure in order to respect the principle of proportionality.*

4.15.

## THE COURT'S OBSERVATIONS

**Example 4.3 — Ineligible VAT included (example of a systematic eligibility error)**

One payment audited concerned the services provided to a public body for a training and information programme. The public body declared the full amount of the payment, including ineligible VAT, which was fully paid and charged to the EU budget. This systematic error affected all expenditure for the rural development measure concerned in this Member State totalling 0,8 million euro.

## THE COMMISSION'S REPLIES

**Example 4.3 — Ineligible VAT included (example of a systematic eligibility error)**

*In the framework of the financial clearance procedure, the Commission services will follow up the Court's findings vis-à-vis the national authorities in view of recovery of any undue payments.*

*Cross-compliance*

4.16. As noted in Chapter 3 (see paragraph 3.9), cross-compliance errors are included for the first time in the Court's error rate calculation.

4.17. For the 2011 DAS the Court found, on the basis of its examination (see paragraph 4.9, second indent), one or more cross-compliance infringements in 26<sup>(12)</sup> of the 73 payments subject to cross-compliance (36 %). For each infringement, the Court used the national system for reducing payments to quantify the error. In all cases, this reduction was between 0 % and 5 %. The errors found represent around 0,2 percentage points of the total error rate referred to in paragraph 4.10.

4.18. The Court noted in particular significant problems concerning the implementation of cross-compliance requirements for the identification and registration of animals. For the 46 farms with animals included in the sample, non-compliance with the requirements was detected in 16 cases (35 %).

**Environment and climate action, maritime affairs and fisheries, health and consumer protection**

4.19. An error found in the policy areas of environment and climate action, maritime affairs and fisheries, and health and consumer protection is outlined in example 4.4.

**4.16 to 4.18.** Most of the cross-compliance requirements, i.e. the SMRs, are to be respected by all EU citizens, irrespectively of being a farmer benefiting from EU support under the CAP. The respect of cross-compliance does not constitute an eligibility criterion and, therefore, the controls of these requirements do not pertain to the legality and regularity of the underlying transactions. Farmers not respecting the requirements are entitled to receive their payments, but are sanctioned on the basis of the severity, extent, permanence and repetition of the non-compliance found as well as negligence or intent of the farmer concerned. This is also shown by the fact that payments can be made before the cross-compliance controls have been completed and that penalties are not applied on the payments made in respect of the calendar year when the farmer failed to comply with the requirements, but rather on the payments made in respect of the calendar year of the findings by the national authorities. For all these reasons, the Commission does not itself take violation of cross-compliance obligations into account in the calculation of the level of error for its own statement of assurance.

**4.19.**

<sup>(12)</sup> 17 of the 26 cases affected also the payment audited, while the other 9 cases will only affect future payments.

## THE COURT'S OBSERVATIONS

**Example 4.4 — Expenditure declared after eligibility period**

Member States' national authorities have to submit declarations of expenses relating to animal disease eradication programmes to the Commission by 30 April, for the previous calendar year. A declaration from one Member State for 2010 amounting to 12,4 million euro included 0,3 million euro expenses paid after 30 April 2011.

## THE COMMISSION'S REPLIES

**Example 4.4 — Expenditure declared after eligibility period**

The Commission decided to pay a first instalment in advance of fixing the final financial contribution, as the Member State's cost declaration could not be approved in 2011 due to an on-going on-the-spot control (C(2011) 9743, Articles 1 and 2). Checks whether the declared costs were paid after 30 April are foreseen in the standard check list for on-the-spot controls.

**EFFECTIVENESS OF SYSTEMS****Rural development***Member States' systems related to regularity of transactions*

4.20. **Annex 4.2** contains a summary of the Court's examination of Member States' supervisory and control systems. Concerning the six rural development supervisory and control systems audited, the Court found that one of the control systems implemented was not effective (Denmark), four were partially effective (Spain (Galicia), Italy (Lombardia), Hungary and Finland) and one was effective (Austria) in ensuring the regularity of payments.

4.21. For area-related rural development measures, such as agri-environment, verification of certain key elements such as eligible area is made through the Integrated Administration and Control System (IACS), described in Chapter 3 (paragraph 3.16). Other eligibility requirements are governed by specifically designed controls<sup>(13)</sup>. As described in Chapter 3 (paragraphs 3.14 to 3.17), for 2011 the Court found the IACS systems to be partially effective in all paying agencies examined.

4.22. The Court's audit covered compliance with the provisions of the relevant regulations and an assessment of the effectiveness of the systems in ensuring the regularity of transactions. In particular the following elements were examined:

- (a) administrative and control procedures to ensure correct payment.
- (b) control systems based on physical on-the-spot checks;

4.20. The Commission takes note that the results presented are similar to the results of last year.

4.21. The Commission considers that IACS is generally an effective control system for limiting the risk of error or irregular expenditure.

See also Commission replies to paragraphs 3.14 and 3.15.

4.22. See joint replies to paragraphs 4.16 to 4.18.

<sup>(13)</sup> For rural development measures under the 2007-2013 programming period, the detailed requirements are defined by Regulation (EU) No 65/2011.

## THE COURT'S OBSERVATIONS

(c) systems to ensure implementation and control of cross-compliance.

**Administrative and control procedures to ensure correct payment**

4.23. The administrative checks by paying agencies should cover the correctness of the declarations made by the claimant and the fulfilment of the eligibility requirements for the granting of the aid.

4.24. The Court identified weaknesses in the implementation of administrative checks related to eligibility conditions and commitments in five of the six Member States audited (Denmark, Italy (Lombardia), Hungary, Austria and Finland). An illustration of this is given in example 4.5. In one Member State (Denmark), the Court examined a sample of five randomly selected projects for non-area-related measures. The audit identified ineligible expenditure in four of the projects, which had not been detected by the paying agency.

4.25. In addition, the Court found that three of the six Member States audited (Denmark, Italy (Lombardia) and Finland) did not correctly apply the reductions as stipulated in the legislation.

4.26. One of the key administrative checks<sup>(14)</sup> of measures for improving the competitiveness of the agricultural sector, such as modernisation of farms, and improvement and development of rural infrastructure, is to assess whether the costs claimed are reasonable. Member States are therefore required to implement suitable systems for evaluating the amounts claimed by beneficiaries. The Court found that this regulatory requirement was not effectively implemented by four of the six national authorities audited (Denmark, Spain (Galicia), Italy (Lombardia) and Hungary). This situation is confirmed by the sample of transactions, where errors were reported for 21 out of the 70 transactions (30 %) examined. A similar finding was already reported last year but for other paying agencies (see paragraph 3.35 of the Court's 2010 Annual Report).

**Control systems based on physical on-the-spot checks**

4.27. Member States must carry out on-the-spot checks covering, depending on the aid scheme, at least 5 % of all beneficiaries or of the expenditure<sup>(15)</sup>. The Court's audit focussed on the adequacy of procedures to select beneficiaries for such checks, the quality and reporting of the checks and the adequacy of the corrections made.

## THE COMMISSION'S REPLIES

**4.25.** *Whenever in the framework of its audits the Commission identifies weaknesses in administrative checks, it pursues them through the conformity clearance procedure to protect the EU's financial interests.*

**4.26.** *The Commission shares the view that administrative checks of the reasonableness of costs are essential for ensuring the effectiveness of the whole control system. These essential checks are systematically examined during Commission audit missions. However, the Commission notes that in the case of Italy the Court's finding concerns amounts (general costs) which are usually paid on a flat rate basis of maximum 10 % or even fixed or outside the influence of the beneficiary (taxes, cost for quality system certification, etc.).*

**4.27 to 4.29** *The issues mentioned by the Court of Auditors are also systematically examined during the Commission audits missions. When weaknesses are found, they lead to financial corrections imposed on Member States through the conformity clearance of accounts procedure as well as recommendations for improving the control systems.*

<sup>(14)</sup> Referred to in Article 24 of Regulation (EU) No 65/2011.

<sup>(15)</sup> Articles 12 and 25 of Regulation (EU) No 65/2011.



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

4.28. The Court found in five of the six Member States audited (Denmark, Spain (Galicia), Italy (Lombardia), Hungary and Finland) that the checks implemented did not cover all the commitments and obligations of a beneficiary which can be checked at the time of the visit, as required by the legislation.

4.29. In each of the six Member States visited, the Court carried out four randomly selected 're-performance' checks. This involved the Court re-performing all checks originally carried out by the paying agency, including all administrative and on-the-spot checks. When re-performing on-the-spot checks carried out by paying agencies, the Court found that checks had not always been properly executed. An illustration of such a case is in example 4.5.

**Example 4.5 — Insufficient quality of Member State's administrative and on-the-spot checks**

One of the Court's re-performance checks in Italy (Lombardia) was of a project to construct a two-storey building on a farm including a laboratory for the processing of fruit and other farm products, a storage area and a terrace for drying fruits.

The paying agency approved the full amount of the final payment claim of 221 205 euro following both administrative and on-the-spot checks.

However, the Court found that the building had predominantly the characteristics of a private residence and not of an agricultural building and that thus the related costs were not eligible. The fact that the national authorities accepted the full amount of expenditure declared indicates a material system weakness in the administrative and on-the-spot checks.

**Example 4.5 — Insufficient quality of Member State's administrative and on-the-spot checks**

*The Commission will, in the context of the conformity clearance procedure, follow up the case with the Italian authorities.*

**Systems to ensure implementation and control of cross-compliance**

4.30. The Court's examination of the design and implementation of the systems for cross-compliance revealed a number of important weaknesses which are also relevant to Chapter 3. None of the six Member States audited had established or were carrying out checks for the complete set of applicable requirements defined by the legislation.

4.30. *The Commission has carried out cross-compliance audits in the six Member States audited by the Court (although not the same regions in Spain and Italy) and has also observed serious weaknesses in the definition and control of the GAEC standards and SMRs. Whenever in these six Member States a risk for the Funds had been clearly established, the Commission has applied a financial correction in the framework of several of these enquiries (Denmark, Hungary, Austria and other regions of Italy and Spain) or clearance of accounts procedure is ongoing in relation to enquiries concerning these six Member States.*

## THE COURT'S OBSERVATIONS

4.31. Furthermore, the planning and timing of the checks showed weaknesses in five of the six Member States audited (Denmark, Spain (Galicia), Italy (Lombardia), Hungary and Finland). For instance, one Member State (Italy (Lombardia)) carried out all checks for three SMRs<sup>(16)</sup> between October and December. Hence the requirements which had to be respected outside these months, such as the ban on spreading manure and other substances containing nitrates on the fields until 28 February in nitrate vulnerable zones, were not effectively checked.

4.32. The Court also found in three of the Member States audited (Italy (Lombardia), Hungary and Finland) that, when the checks were carried out, non-compliance did not always lead to the required reductions. In one Member State (Italy (Lombardia)), for the six SMRs relating to animals, no reductions on the basis of the criteria set by the legislation (extent, severity and permanence of the non-compliance) were set. Instead, this Member State evaluated whether the error was correctable and whether this was the first time that an error was identified for the beneficiary checked. Consequently, the majority of non-compliance cases were treated as minor for which no reduction was applied.

## THE COMMISSION'S REPLIES

**4.31.** During the cross-compliance audits, the Commission systematically verifies the compliance with the planning and timing of on the spot checks requirements (whether appropriate level of control is achieved by the Member States during the year, whether inspections are carried forward to the following year, the respect of the notification deadlines, etc.). The Commission has also observed these weaknesses in Hungary, Italy and other Member States and follows them up through the conformity clearance procedure.

**4.32.** The Commission pays particular attention to the evaluation and sanctioning system established by the Member States for cross-compliance (leniency of the system, adequate use and follow-up of minor non-compliances, non-compliances not leading to a reduction because of the incorrect use of tolerances, etc.). These weaknesses have also been observed by the Commission in the Member States mentioned by the Court and the consequent risk for the Funds is being followed up through the conformity clearance procedure.

The Commission has also observed specific serious deficiencies in relation to the cross-compliance controls on animal SMRs in Italy and is following this up through the conformity clearance procedure.

<sup>(16)</sup> SMR 1 (Council Directive 79/409/EEC of 2 April 1979 on the conservation of wild birds (OJ L 103, 25.4.1979, p. 1)); SMR 4 (Council Directive 91/676/EEC of 12 December 1991 concerning the protection of waters against pollution caused by nitrates from agricultural sources (OJ L 375, 31.12.1991, p. 1)) and SMR 5 (Council Directive 92/43/EEC of 21 May 1992 on the conservation of natural habitats and of wild flora and fauna (OJ L 206, 22.7.1992, p. 7)).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*The Commission's clearance of accounts system and management representation***The Commission's clearance of accounts procedure**

4.33. Management of most expenditure on agriculture is shared between Member States and the Commission. Aid is paid by the Member States, which are then reimbursed (on a quarterly basis for EAFRD and on a monthly basis for EAGF) by the Commission. The final recognition of expenditure is determined through a two-stage procedure called the clearance of accounts procedure. The two stages consist of an annual financial decision and multiannual conformity decisions taken by the Commission <sup>(17)</sup>.

4.34. In previous annual reports as well as in Special Report No 7/2010 'Audit on the clearance of accounts procedure' <sup>(18)</sup> the Court has criticised the fact that the Member States, and not the final beneficiaries, are charged with the financial corrections and that the conformity adjustments involve considerable use of flat-rate corrections which are not directly related to the real amount of irregular payments. The conformity clearance system remained unchanged in 2011.

**4.34.** What the Court criticises in the conformity clearance system is inherent to this system. The conformity clearance is designed to exclude expenditure from EU financing which has not been effected in compliance with EU 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 with recovery actions against these beneficiaries. However, even where recoveries from beneficiaries are not needed because the financial correction relates only 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 use of flat rates has been accepted by the Court of Justice as being in conformity with the legal rules governing the conformity work and endorsed, under certain circumstances, by the European Parliament in its 2007 discharge resolution <sup>(1)</sup>.

Finally, the Commission has indicated <sup>(2)</sup> to Member States that if their certification bodies fully re-perform a representative sample of transactions which the paying agency has checked on the spot and, on this basis, confirm the reliability of a Member State's control statistics, then the Commission will accept that the resulting error rate represents the maximum risk possible and that any financial corrections for the year in question will not exceed that level.

<sup>(17)</sup> The accounts and payments of a paying agency are examined by an independent body (the certification body) which reports to the Commission in February of the following year. By 30 April of that year, the Commission must decide on whether to accept the accounts (financial clearance decision) or to ask for more work to be performed or for additional information. The Commission also carries out audits aiming to verify that Member States have applied EU rules for checking the legality and regularity of the expenditure (conformity audits). Based on these audits, the Commission can impose a correction to the Member States, who have the right to invoke a conciliation procedure. When this procedure has run its course, the Commission is in a position to include a financial correction in a conformity decision.

<sup>(18)</sup> <http://eca.europa.eu>

<sup>(1)</sup> See paragraph 83 of the European Parliament's 2007 discharge resolution.

<sup>(2)</sup> Document D/413722/2009.

## THE COURT'S OBSERVATIONS

4.35. The first stage of the clearance of accounts procedure is based on audits carried out by independent certification bodies in the Member States. These bodies submit to the Commission a certification report on the accounts and the internal control system of the paying agency and an opinion on the statement of assurance issued by the director of the paying agency.

4.36. The Court's review of a sample of 32 of these audits for EAGF and EAFRD showed that the certification bodies generally follow closely the model report prescribed by DG AGRI. In their audits, certification bodies have to apply international standards on auditing, which includes the use of other sources, such as previous audits <sup>(19)</sup>. However, the Court found that the certification bodies rarely consider observations raised by the Commission's or the Court's previous audits, such as reporting if the paying agency implemented sufficient remedial action regarding the observations identified.

4.37. The Court reviewed DG AGRI's audit work on the certification body reports and found that this was based on detailed checklists which addressed the most important issues. However, DG AGRI does not check if certification bodies' reports follow up previously detected observations, even if they were identified as part of the Commission's conformity clearance procedure. Currently, the Commission guidelines do not specify that certification bodies should include in their audit strategy and report information from other sources such as previous audits by the Commission or the Court. Therefore, the certification bodies do not have to assess either the risk of previously detected observations or their financial implications or if the paying agencies have remedied these findings.

## THE COMMISSION'S REPLIES

**4.36.** *The DG AGRI guidelines recall that the International standard on auditing (ISA) No 315 'Identifying and assessing the risks of material misstatement through understanding the entity and its environment' requires the certification bodies to assess the design and implementation of controls and look at an organisation's ability to identify risks and assess the impact which this may have on the accounts.*

*Therefore the Commission considers that EU auditors' findings, irrespective of whether they come from the Court of auditors or the Commission audit services, might be a very valuable source of information for the certification bodies to understand and evaluate the paying agencies' internal control systems. The certification bodies are reminded of the relevance to consider such findings in the certification bodies' expert group meeting.*

**4.37.** *The certification bodies have to report on the paying agency's follow-up of their previous own findings, be it financial errors or recommendations to address systems weaknesses. When reviewing the certification bodies' reports, the Commission systematically ensures that the certification bodies adequately address the follow-up of their own findings from previous years.*

*For what concerns other auditors' findings, the Commission considers that these might be a useful source of information to be considered by the certification body when planning its audit strategy (see reply to paragraph 4.36).*

*It is however not in the certification bodies' mandate to report systematically in detail on the follow-up of the Commission, Court of auditors or any other external audit body's finding.*

<sup>(19)</sup> International Standard on Auditing (ISA) No 200 (Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing) includes under A28: 'Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits [...]'.  
[...]

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

4.38. The Court also reviewed the work done by the certification body concerning EAFRD in the Member State (Denmark) where it had identified the most serious weaknesses in the supervisory and control systems. The Court found that this certification body:

- (a) was not fully independent as legally required, as the firm which carried out the certification work was also involved in pre-payment eligibility checks in 35 % of the 65 files audited;
- (b) relied to a significant extent on the work carried out by the internal audit unit of the paying agency, without documentation showing that this work was sufficiently reviewed;
- (c) had not sufficiently checked that the expenditure complied with all eligibility conditions. In seven of 11 files selected which had been checked by the certification body, the Court identified ineligible expenditure representing 8 % of the EAFRD amount checked.

4.39. The second stage of the clearance of accounts procedure is based on audits performed by the Commission. The Court reviewed all 27 audits carried out by DG AGRI in 2011 for EAFRD and found that these audits were generally a sufficient basis for the conformity clearance procedure subject to the weaknesses reported below. In its audits, the Commission found similar weaknesses as reported by the Court, e.g. concerning a lack of verification of the reasonableness of costs, public procurement and eligibility of expenditure.

4.40. The Commission's conformity audit work is systems based, and is not aimed at checking the legality and regularity of underlying transactions. Samples are selected on a judgemental or random basis, and cover expenditure relating to several budgetary years. The Commission's audit work is thus not intended to calculate an annual error rate.

4.41. The Court found that the Commission did not always have adequate records of the checks carried out. For instance, no standardised checklists were used for the 11 audits carried out for non-area-related measures. In addition, the audit work was generally not reviewed by an independent party.

**4.38.**

**(a) and (b)** *In the framework of the financial clearance procedure, the Commission will follow up the issue with the Danish authorities, notably with a view to reinforcing the operational independence of the certification body.*

**(c)** *The work that the certification bodies have to do in relation to the financial clearance procedure is mostly aimed at checking that the accounts are complete, accurate and true.*

**4.40.** *See joint replies to paragraphs 1.12 and 1.13.*

**4.41.** *The Commission has adequate records of the checks carried out, although not in a standardised form in all cases. This is due to measures being very heterogeneous and, in addition, implemented by Member States in very different ways. The Commission services will consider using suitable standardised checklists in all cases.*

*All audit findings and the resulting reports are reviewed and approved by team leaders and head of unit before being finalised.*

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**DG AGRI's management representation — the Annual Activity Report (AAR)**

4.42. DG AGRI's AAR contains a reservation for the total EAFRD expenditure for 2011 (11,8 billion euro) with a total residual amount at risk of 278 million euro<sup>(20)</sup>. The Court considers that, in principle, this reservation corroborates the Court's observations on substantive testing and systems audit as presented above.

4.43. DG AGRI's main argument for including a reservation for EAFRD is because the residual error rate reported by DG AGRI of 2,36 % is above the 2 % materiality threshold. The Court noted that DG AGRI in its AAR<sup>(21)</sup>:

— does not analyse nor explain why the residual error rate for EAFRD reported by DG AGRI has 'increased significantly compared to the previous year';

— reports that it has put in place a plan with corrective actions envisaged to address the situation.

4.44. The Court notes in addition that the error rate reported by DG AGRI is based on figures reported by the Member States for 2010. One of the reasons why the Court has identified a much higher error rate than the one reported by DG AGRI is that as part of its audit the Court found that Member States do not detect and report all non-eligible expenditure due to weaknesses in the administrative and the on-the-spot checks of the paying agency, as illustrated in example 4.2, example 4.5 and analysed in paragraphs 4.24, 4.28, 4.29 and 4.39.

**4.43.**

— *The higher error rate for rural development measures, as compared to measures under the first pillar of the CAP financed by the EAGF, is mainly due to the fact that support for certain of these measures such as, for example, agri-environmental measure is subject to a high number of conditions often of a very specific nature, which may increase the risk of errors by the beneficiaries and may render the controls by the national authorities more difficult.*

*As a consequence of the reservation on rural development expenditure made by the Director-General of DG AGRI in his declaration of assurance in the Annual Activity Report 2011, the Commission services have started in cooperation with the Member States (June 2012), an in depth analysis of the situation in order to diagnose the underlying reasons for the higher error rates and determine specific corrective actions.*

**4.44.** *In order to address the risk that the error rates derived from these control statistics could have been understated due to inaccuracies in the databases or inadequate follow-up of anomalies, as referred to by the Court, DG AGRI applied a safety margin of 25 % when calculating the residual risk to the Fund. The Commission considers this largely sufficient to cover the risks referred to by the Court.*

*It should also be noted that the Member States' control statistics are verified and validated to a large extent by the certification bodies, as recommended as an option by the Court in its Annual Report for 2005, and the results of this works are presented in DG AGRI's Annual Activity Report.*

*The Commission notes that some observations of the Court concern national rules on public procurement and that certain Member States have a different interpretation of those rules to that of the Court.*

<sup>(20)</sup> The reservation does not cover expenditure for completion of earlier (2000-2006) programmes (500 million euro) and pre-accession measures in the field of agriculture and rural development (102 million euro).

<sup>(21)</sup> Pages 58, 59 and 79 to 81 of DG AGRI's AAR.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

## Environment and climate action, maritime affairs and fisheries, health and consumer protection

4.45. The policy areas of environment and climate action, maritime affairs and fisheries as well as health and consumer protection are managed by the Commission under specific control systems. The Court examined the internal control system of DG MARE.

### *Internal Control System of DG MARE*

4.46. 30 randomly selected payments concerning the main budget areas of DG MARE were tested. The audit found that key controls were not always fully documented with the risk that such controls are not performed. Furthermore, there was insufficient monitoring of fish catches under an international fisheries agreement that resulted in unforeseen expenditure for the Commission, as illustrated in example 4.6.

#### **Example 4.6 — Insufficient monitoring of fish catches**

The Fisheries Partnership Agreement between the European Union and a third country, the Islamic Republic of Mauritania, for the four-year period ending 31 July 2012, allows EU registered fishing vessels to catch up to 300 000 tonnes of fish each year (ending 31 July), in exchange for an EU contribution of 40 euro per tonne caught. The protocol to this agreement provides that if the EU wishes to have an additional quota, it shall inform the national authorities no later than 15 February of each year, and pay at the same rate per tonne. In the year ending 31 July 2010, there was insufficient monitoring of fish catches under the partnership agreement by the Commission services, and the national authorities were not informed before 15 February 2010 that additional quota was sought. In October 2010, the national authorities informed the Commission that the 300 000 tonne quota for the year ending 31 July 2010 was exceeded. The Commission paid 1,9 million euro to the Islamic Republic of Mauritania for 47 346 tonnes caught in excess of the quota. Better monitoring of fish catches would have allowed the Commission services to consider taking preventive action to avoid making additional payments.

4.46. *The monitoring of catches has been strengthened and an alert mechanism now prevents overshooting.*

#### **Example 4.6 — Insufficient monitoring of fish catches**

*The Commission acknowledges that there was some delay in the monitoring of pelagic catches during the protocol year 2009/2010 (1 August to 31 July) and that this had certain consequences in terms of additional payments to be made to Mauritania in 2010.*

*This issue has now been fully addressed by specifically deducting the exceeded quantity (and of course the related payment) from the additional pelagic quota for 2011/2012. In other words, what was caught and paid for in 2009/2010 was taken off in 2011/2012. Thus, both sustainability and sound financial management were respected.*

*Moreover, to further strengthen monitoring of catches, general working methods have improved substantially from 2010 onwards. An alert mechanism (pelagic catches which are close to the catch limits are being monitored on a weekly basis) was introduced to prevent the overshooting. In 2011, following the exhaustion of the quota, the Commission closed the pelagic fishery 16 days before the end of the Protocol year, after having monitored pelagic catches on a weekly and in the last period also on a daily basis. The same precautionary approach prevailed in 2012 (closing of the pelagic fishery already on 23 April 2012).*

## THE COURT'S OBSERVATIONS

*Other DGs' management representation — the annual activity reports (AARs)*

4.47. The Court examined the AARs and declarations by Directors-General for Commission DGs ENV, CLIMA, MARE and SANCO.

4.48. DG ENV did not create a reservation, because its residual error rate was under the 2 % materiality threshold. The Court notes that the calculation of the residual error rate by DG ENV is based on assumptions that are not fully supported by representative testing.

4.49. DG CLIMA maintained its reservation from 2010 on reputational grounds related to a significant security breach identified in the national registries of the EU Emissions Trading System. There were no reservations relating to expenditure, most of which relates to procurement.

4.50. DG SANCO's only reservation related to the food and feed policy area, on the basis that the residual error rate was 4,3 %. All 2011 payments in the public health policy area (except for the contributions to regulatory agencies) relate to procurement. DG SANCO did not perform *ex-post* controls on this expenditure and assumed that, due to its *ex-ante* controls, the error rate for procurement related expenditure is approximately 0 %.

**CONCLUSIONS AND RECOMMENDATIONS****Conclusions**

4.51. Based on its audit work, the Court concludes that the payments for the year ended 31 December 2011 for rural development, environment, fisheries and health were affected by material error.

## THE COMMISSION'S REPLIES

4.48. In line with the guidance in the AAR Standing Instructions, DG ENV complemented the results of the *ex-post* controls with an analysis of 245 on-site monitoring visits of LIFE projects performed in 2011. This testing provides a realistic and reasonably sound basis for estimating the likely error rate.

4.49. The Commission considers the procurement procedures currently in place to be adequate for limiting the risk of error or irregular expenditure.

4.50. DG SANCO concludes procurement contracts for which the prices fixed in the contract have to be paid when the good and services are delivered as requested. Once DG SANCO achieves a good price-quality ratio in the contractor's offer and ensures that the requested quality is delivered, it checks that the contractor's invoice complies with the prices agreed in the contract. Adequate procurement procedures as well as the technical and financial checks prior to payment are sufficient to give reasonable assurance that error rates are very low. Thus, additional checks after the final payment (*ex-post*) are unlikely to find significant errors and are thus an excessive administrative burden.

4.51. The Commission takes note of the most likely error rate estimated by the Court. Although it does not share the Court's assessment in certain cases, the Commission's own estimate of the level of undue payments on the basis of the control statistics provided by the Member States in 2011 also shows a deterioration of the situation, albeit of a more limited magnitude. Therefore, the Director-General for DG AGRI has made a reservation, concerning rural development expenditure, in his declaration of assurance for 2011.

This reservation is accompanied by a number of corrective actions to be determined by the Commission together with the Member States in order to address the situation.

However, the relatively higher error rates for rural development compared to the first pillar of the CAP must also be seen in context of the rural development policy objectives which can only be achieved by the more complex rules and eligibility conditions referred to by the Court in paragraph 4.5.



## THE COURT'S OBSERVATIONS

4.52. Based on its audit work, the Court found that the examined supervisory and control systems for rural development, environment, fisheries and health were partially effective.

### Recommendations

4.53. **Annex 4.3** shows the result of the Court's review of progress in addressing recommendations made in previous annual reports (2008 and 2009). It should be noted that the Court's recommendation to further simplify the rules and conditions for rural development remains valid.

4.54. Following this review and the findings and conclusions for 2011, the Court recommends in the area of rural development for the current programming period that:

- **Recommendation 1:** the Member States carry out administrative and on-the-spot checks in a more rigorous manner so as to mitigate the risk of declaring ineligible expenditure to the EU;
- **Recommendation 2:** the Commission and the Member States ensure that the existing rules are better enforced concerning:
  - public procurement and VAT rules when public bodies are beneficiaries of the aid,
  - agri-environment commitments and eligibility rules for modernisation of holdings;
- **Recommendation 3:** the Commission analyses the reasons for the material error rate;

## THE COMMISSION'S REPLIES

**4.52.** *The Commission takes note that the results presented are similar to the results of last year.*

**4.53.** *The Commission proposals for the legal framework governing the future programming period (CAP towards 2020; COM(2012) 627 final/2) include a number of proposals for simplification. The Commission is also proposing to further increase the responsibility of Member States authorities in respect to ensure verifiability and controllability of measures in the rural development programmes.*

**4.54.** *See joint replies to paragraphs 1.12 and 1.13.*

*The Commission agrees with the Court and systematically recommends Member States to remedy any such deficiencies in framework of its conformity clearance procedures.*

*The enforcement of existing rules is at the core of the clearance of accounts system. The Commission imposes financial corrections on Member States when risks to the fund have been identified, and recommendations for improvements are addressed to the national authorities. This will continue with particular focus on the issues highlighted by the Court of Auditors as these have also been found by the Commission during its own audits.*

*The Director-General for DG AGRI has stated a reservation concerning rural development in his annual statement of assurance for 2011 due to the residual error rate communicated by the Member States exceeding the materiality threshold when taking into account a safety margin of 25 %. The reservation is accompanied by corrective actions aiming at identifying, in collaboration with the Member States concerned, the root causes for the higher error rates along with specific actions to be implemented in the current and the future programming period.*

*It should in this context also be recalled that according to Article 4(5), of Commission Regulation (EU) No 65/2011, Member States are obliged to identify the causes for problems encountered during controls and to implement corrective and preventive actions.*

## THE COURT'S OBSERVATIONS

- **Recommendation 4:** the Commission takes account of the findings identified by the Court when establishing the audit strategy of DG AGRI's clearance of accounts audits;
- **Recommendation 5:** the Commission extends the guidelines for the certification bodies with the requirement that these bodies include, in their audit strategy and reports, findings from previous audits by the Commission and the Court;
- **Recommendation 6:** regarding cross-compliance, the Member States should ensure the respect of the requirements concerning animal identification and registration and improve the spread of checks throughout the year so that all relevant requirements are properly checked.

4.55. In the policy areas of environment, maritime affairs and fisheries, health and consumer protection, the Court recommends that:

- **Recommendation 7:** the Commission improves the monitoring of fish catches under fisheries partnership agreements with countries outside the EU.

## THE COMMISSION'S REPLIES

*The Commission takes into duly account the findings of the Court and considers them as one of the elements to be taken into account in its central risk analysis for establishing its audit programme.*

*Although it is not in the certification bodies' mandate to report in detail on the follow-up of the Commission, Court of auditors or any other external audit body's findings, the findings from previous audits by the Commission and the Court are useful for the certification bodies at a planning stage when setting-up its audit strategy.*

*The Commission has reminded the certification bodies to consider such findings in the next certification bodies' expert group meeting*

*The Commission, in the framework of cross-compliance audits, systematically verifies that the Member States ensure the respect of the requirements concerning animal identification and registration as well as the timing of the on the spot checks.*

**4.55.**

*To further strengthen monitoring of catches, general working methods have improved substantially from 2010 onwards. An alert mechanism (pelagic catches which are close to the catch limits are being monitored on a weekly basis) has been introduced to prevent the overshooting.*

## ANNEX 4.1

## RESULTS OF TRANSACTION TESTING FOR RURAL DEVELOPMENT, ENVIRONMENT, FISHERIES AND HEALTH

	2011			2010	2009	2008
	Rural development	Env., fish. and health	Total			
<b>SIZE AND STRUCTURE OF THE SAMPLE</b>						
Total transactions (of which):	160	18	178	92	93	53
Advances	0	0	0	0	0	0
Interim/Final payments	160	18	178	92	93	53
<b>RESULTS OF TESTING <sup>(1)</sup></b>						
<b>Proportion (number) of transactions tested found to be:</b>						
Free of error	42 % (67)	56 % (10)	43 % (77)	48 %	67 %	55 %
Affected by one or more errors	58 % (93)	44 % (8)	57 % (101)	52 %	33 %	45 %
<b>Analysis of transactions affected by error</b>						
<b>Analysis by type of error</b>						
Non-quantifiable errors:	34 % (32)	75 % (6)	38 % (38)	48 %	42 %	38 %
Quantifiable errors:	66 % (61)	25 % (2)	62 % (63)	52 %	58 %	62 %
Eligibility	69 % (42)	50 % (1)	68 % (43)	56 %	22 %	40 %
Occurrence	0 % (0)	50 % (1)	2 % (1)	0 %	6 %	7 %
Accuracy	31 % (19)	0 % (0)	30 % (19)	44 %	72 %	53 %
<b>ESTIMATED IMPACT OF QUANTIFIABLE ERRORS</b>						
Most likely error rate				7,7 %		
Upper error limit (UEL)				10,9 %		
Lower error limit (LEL)				4,5 %		

<sup>(1)</sup> To improve insight into areas with different risk profiles within the policy group, the sample was split up into segments.

## ANNEX 4.2

## RESULTS OF EXAMINATION OF SYSTEMS FOR RURAL DEVELOPMENT

## Assessment of selected supervisory and control systems

Member State (Paying agency)	Administrative and control procedures	On-the-spot inspection methodology, selection, execution, quality control and reporting of results	Implementation and control of cross- compliance	Overall assessment
<b>Denmark</b>	Not effective 1, 2, 3, 4, 5	Partially effective A, B, C	Partially effective 2, A, D, a	<b>Not effective</b>
<b>Spain (Galicia)</b>	Partially effective 2, 3	Partially effective A, C, D	Partially effective 2, C, D, a	<b>Partially effective</b>
<b>Italy (Lombardy)</b>	Partially effective 1, 2, 3, 4	Partially effective A, C, D	Not effective 4, A, B, C, D, a, b	<b>Partially effective</b>
<b>Hungary</b>	Partially effective 1, 3	Partially effective B, C, D	Not effective 2, 4, B, D, a, b	<b>Partially effective</b>
<b>Austria</b>	Partially effective 1, 2	Effective A	Effective a	<b>Effective</b>
<b>Finland</b>	Partially effective 1, 2, 4	Partially effective 2, C, D	Partially effective 2, 4, A, D, a	<b>Partially effective</b>

1 Ineffective checks related to eligibility conditions and commitments (e.g. ineligible VAT included, double financing).

2 Shortcomings in the administrative organisation and internal control of the checks.

3 Absence of a suitable system to evaluate the reasonableness of the costs proposed in the application for support.

4 Incorrect calculations and payments (e.g. reduction not applied).

5 Systematic weaknesses in Title II (i.e. non-area-related) measures resulting in the acceptance of ineligible expenditure.

A Insufficient details on the extent of the checks carried out.

B Inconsistencies concerning the number of checks carried out.

C Insufficient quality of the checks: non-compliances not detected and/or not all commitments and obligations covered.

D Deficiencies in the planning and timing of the checks (e.g. checks carried out after the farming year).

a Incomplete set of requirements (e.g. insufficient national GAEC standards, missing requirements for certain SMRs).

b Incorrect national implementation of the Nitrates Directive.

## ANNEX 4.3

## FOLLOW-UP OF PREVIOUS RECOMMENDATIONS FOR RURAL DEVELOPMENT, ENVIRONMENT, FISHERIES AND HEALTH

Year	Court recommendation	Court's analysis of the progress made	Commission reply
2009	The Court recommended to take effective measures, together with the concerned national authorities, to avoid payment of ineligible expenditure for fisheries projects (DG MARE; paragraph 3.76 of the 2009 Annual Report).	The controls over eligible expenditure under the European Fisheries Fund have been strengthened compared with the controls carried out under the previous Financial Instrument for Fisheries Guidance.	
	The Court recommended a clear segregation of functions between the Commission services and the development of appropriate formal control procedures for internal controls on payments for animal disease eradication and monitoring programmes to Member States (DG SANCO; paragraph 3.76 of the 2009 Annual Report).	The Commission services clarified the segregation of functions and took a number of mitigating actions such as the simplification of the legal base for the 2012 programmes.	
2009 and 2008	The Court reiterated that further efforts are required in the area of rural development to further simplify the rules and conditions (paragraph 3.74 <sup>(1)</sup> ).	<p>The Commission recast Regulation (EC) No 1975/2006 and replaced it by Regulation (EU) No 65/2011 per 1 January 2011.</p> <p>The new regulation clarifies to a certain extent provisions on control procedures, cross-compliance as well as reductions, exclusions and recoveries.</p> <p>The Commission considers that this initiative has been pursued by the CAP post-2013 where a set of simplifications in respect of rural development has been laid down.</p> <p>In its Opinion No 1/2012 on the Commission's legislative proposals for the reform of the common agricultural policy as of 2014, the Court recognised the efforts made by the Commission to simplify the provisions of the CAP, but considered that the legislative framework of the policy remained too complex.</p>	
2008	The Court recommended to take effective measures so that the issues identified in the policy areas of environment, fisheries, health and consumer protection are resolved (DGs ENV, MARE and SANCO; paragraph 5.67 of the 2008 Annual Report).	The Commission took several initiatives to resolve the issues identified by the Court (see analysis concerning 2009).	

(1) Similar recommendations were made in paragraph 5.66 of the 2008 Annual Report.



## CHAPTER 5

**Regional policy; energy and transport**

## TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	5.1-5.27
Specific characteristics of the policy group	5.4-5.26
Policy objectives	5.4-5.5
Policy instruments	5.6-5.21
Risks to regularity	5.22-5.26
Audit scope and approach	5.27
Regularity of transactions	5.28-5.34
Effectiveness of systems	5.35-5.69
Audit authorities	5.35-5.51
The Court's examination of seven AAs	5.39-5.43
Assessment of the Commission's supervision of AAs	5.44-5.51
Assessment of programme closure for the 2000-2006 programming period	5.52-5.64
Reliability of Commission management representations	5.65-5.69
DG Regional Policy	5.66-5.67
DG Mobility and Transport and DG Energy	5.68-5.69
Conclusions and recommendations	5.70-5.73
Conclusions	5.70-5.72
Recommendations	5.73

## THE COURT'S OBSERVATIONS

## INTRODUCTION

5.1. This Chapter presents the Court's specific assessment of regional policy, energy and transport, which comprises policy areas 06 — Mobility and transport, 13 — Regional policy and 32 — Energy. Key information on the activities covered and spending in 2011 is provided in **Table 5.1**.

**Table 5.1 — Regional policy; energy and transport — Key information 2011**

(million euro)

Budget Title	Policy area	Description	Payments made	Management mode
06	Mobility and transport	Administrative expenditure	71	Centralised direct
		Inland, air and maritime transport	150	Centralised direct and indirect
		Trans-European Networks (TENs)	833	Centralised direct and indirect
		Research related to transport	59	Centralised direct
		<b>1 113</b>		
13	Regional policy	Administrative expenditure	84	Centralised direct
		European Regional Development Fund (ERDF) and other regional operations	25 841	Shared
		Cohesion Fund (CF)	6 450	Shared
		Pre-accession operations related to structural policies	351	Decentralised
		Solidarity Fund	269	Centralised indirect
<b>32 995</b>				
32	Energy	Administrative expenditure	74	Centralised direct
		Trans-European Networks (TENs)	18	Centralised direct
		Conventional and renewable energies	591	Centralised direct/centralised indirect/joint
		Nuclear energy	121	Centralised direct/centralised indirect/joint
		Research related to energy	159	Centralised direct
<b>963</b>				
		Total administrative expenditure <sup>(1)</sup>	229	
		Total operational expenditure	34 842	
		<i>Of which: — advances</i>	1 469	
		<i>— interim/final payments</i>	33 373	
		<b>Total payments for the year</b>	<b>35 071</b>	
		<b>Total commitments for the year</b>	<b>42 964</b>	

<sup>(1)</sup> The audit of administrative expenditure is reported in Chapter 9.

Source: 2011 annual accounts of the European Union.



THE COURT'S OBSERVATIONS

---

5.2. Regional policy is mostly financed through the European Regional Development Fund (ERDF) and the Cohesion Fund (CF). These funds are governed by the same rules (subject to exceptions in the specific regulations of each fund) and are often managed by the same authorities as the European Social Fund (ESF). The ESF, which is the subject of Chapter 6, is referred to in this Chapter where issues common to all the funds are discussed.

5.3. Regional policy accounts for 94 % of spending in this policy group while the remaining 6 % concerns the energy and transport areas.

### **Specific characteristics of the policy group**

#### *Policy objectives*

##### **Regional policy**

5.4. Regional policy aims at strengthening economic and social cohesion within the European Union by reducing development disparities between different regions.

##### **Energy and transport**

5.5. Energy and transport policies aim to provide European citizens and businesses with secure, sustainable and competitive energy and transport systems and services and to develop innovative solutions that contribute to the formulation and implementation of these policies.

#### *Policy instruments*

##### **Regional policy**

5.6. The ERDF and CF are the main tools for the implementation of regional policy<sup>(1)</sup>. The ERDF finances infrastructure works, the creation or preservation of jobs, regional economic development initiatives and activities supporting small and medium-sized enterprises<sup>(2)</sup>. In Member States whose gross national income per capita is below 90 % of the EU average, the CF finances investments in infrastructure in the fields of environment and transport.

---

(<sup>1</sup>) Other regional policy instruments include the Instrument for Pre-Accession Assistance which supports regional and cross-border cooperation measures in the Western Balkan countries, Turkey and Iceland, and the EU Solidarity Fund, which provides support in the event of natural disasters in the Member States.

(<sup>2</sup>) The ERDF and ESF provide support for SMEs through grants and Financial Engineering Instruments. See Special Report No 2/2012, 'Financial instruments for SMEs co-financed by the European Regional Development Fund' (<http://eca.europa.eu>).

---

THE COURT'S OBSERVATIONS

---

5.7. The ERDF (with payments of 26 billion euro) and the CF (with payments of 6 billion euro) accounted for 98 % of the expenditure under budget Title 13 in 2011 <sup>(3)</sup>.

**Management and control of spending by ERDF, CF and ESF**

5.8. The ERDF, the CF and the ESF <sup>(4)</sup> are governed by common rules and are subject to shared management by the Commission and the Member States. Additional provisions for each fund are set in specific regulations. These funds are spent in multiannual programmes.

5.9. For each programming period, on the basis of Member States' proposals, the Commission approves operational programmes (OPs) together with indicative financial plans which include the EU and national contributions <sup>(5)</sup>. Projects implemented under the OPs are carried out by private individuals, associations, private or public undertakings or local, regional and national public bodies.

5.10. In the Member States responsibility for day-to-day administration lies with designated managing authorities and intermediate bodies <sup>(6)</sup>. This includes selecting individual projects, implementing controls to prevent, detect and correct errors within the declared expenditure and verifying that projects are actually implemented ('first level checks'). Certifying authorities verify that 'first level checks' are effectively carried out and, where appropriate, undertake additional checks prior to declaring expenditure to the Commission.

---

<sup>(3)</sup> In 2011, 29,9 billion euro or 93 % related to the 2007-2013 programming period, while 2,4 billion euro (7 %) were for the 2000-2006 period.

<sup>(4)</sup> For the Court's findings and conclusions on ESF see Chapter 6.

<sup>(5)</sup> In total, 434 OPs have been approved by the Commission for the 2007-2013 programming period: 317 for ERDF/CF (out of which 24 OPs contain CF projects) and 117 for ESF.

<sup>(6)</sup> Intermediate Bodies are public or private bodies acting under the responsibility of a managing authority and carrying out duties on their behalf.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

5.11. Audit authorities (AAs) in the Member States play a key role in ensuring that the expenditure reimbursed under the ERDF, ESF and CF is regular. They are responsible for carrying out system audits and audits of operations (i.e. projects or group of projects) in order to provide reasonable assurance on the effective functioning of the management and control systems of the programmes and on the regularity of the expenditure certified for each OP. They report on these audits to the Commission through annual control reports (ACRs) and annual opinions <sup>(7)</sup>.

5.12. At the start of each programming period the Commission makes pre-financing payments to the Member States <sup>(8)</sup>. The financing of a project generally takes the form of the reimbursement of costs on the basis of expenditure declarations by the project promoters. These individual declarations are aggregated into periodic expenditure declarations per OP certified by the Member State authorities and submitted to the Commission. The share cofinanced by the EU is then reimbursed from the EU budget.

5.13. The eligibility rules are laid down at national or sometimes regional level, subject to exceptions in the specific regulations for each fund. Member States bear primary responsibility for preventing or detecting and correcting irregular expenditure, and for reporting on this to the Commission.

5.14. The Commission has to obtain assurance that the Member States have set up management and control systems which meet the requirements of the regulations, and that the systems function effectively <sup>(9)</sup>. If the Commission finds that a Member State has failed to correct irregular expenditure which had been certified and declared or that there are serious failings in the management and control systems, it may interrupt or suspend payments <sup>(10)</sup>. If the Member State does not withdraw the irregular expenditure (which may be substituted by expenditure which is eligible) or does not remedy any detected system failures, the Commission may apply financial corrections, leading to a net reduction in EU funding <sup>(11)</sup>.

*5.13. The establishment of eligibility rules at national level (Article 56 of Council Regulation (EC) No 1083/2006) was one of the main elements of simplification introduced in the 2007-2013 programme period. It aimed at providing Member States with more flexibility in adapting eligibility rules to the specific needs of regions or programmes and to harmonise them with rules in force for other, national public schemes.*

*5.14. The Commission provided a detailed assessment of its assurance on the set up and subsequent functioning of management and control systems for each co-financed programme, as well as an overall assessment of national control systems in its 2011 Annual Activity Report.*

*In case of systems deficiency, the Commission in its supervisory role does interrupt and/or suspend payments. It reports on the exercise of this responsibility in the annual activity report. For 2011, DG Regional Policy reports 70 interruptions of payment deadlines and initiation of suspension procedures for 10 programmes. DG Employment reports for 2011 the interruption of 21 interim payment requests and 3 further suspension decisions.*

<sup>(7)</sup> In addition, AAs are required to submit copies of system audit reports to the Commission. For audits on operations, generally, no audit reports are sent to the Commission.

<sup>(8)</sup> See Article 82 of Council Regulation (EC) No 1083/2006 (OJ L 210, 31.7.2006, p. 25).

<sup>(9)</sup> Article 72 of Regulation (EC) No 1083/2006.

<sup>(10)</sup> Article 39(2) of Council Regulation (EC) No 1260/1999 (OJ L 161, 26.6.1999, p. 1); Articles 91 and 92 of Regulation (EC) No 1083/2006.

<sup>(11)</sup> Article 99 of Regulation (EC) No 1083/2006.

## THE COURT'S OBSERVATIONS

**Energy and transport**

5.15. The European Union's energy policy aims at contributing to provide citizens and business with affordable energy, competitive prices and technologically advanced energy services. It promotes sustainable energy production, transport and consumption, and a secure energy supply within the EU and its Member States. The main financial instrument is the European Energy Programme for Recovery (EPR) which provides financing for projects, largely in the form of grants and subsidies.

5.16. Transport policies aim at developing the internal market, increasing competition and innovation and integrating transport networks. In this area, EU policies promote mobility, sustainable development and transport security. The Trans-European Network Programme for Transport (TEN-T) is the main financial instrument which provides funding for large infrastructure projects.

5.17. Payments in the field of energy and transport under budget Titles 06 and 32 were in the order of 2 billion euro in 2011 <sup>(12)</sup>.

**Management and control of energy and transport spending**

5.18. The Commission (DG Mobility and Transport and DG Energy) implements energy and transport expenditure under direct and indirect centralised management (through two executive agencies and a joint undertaking <sup>(13)</sup>), and also through joint management arrangements (such as nuclear decommissioning funds or the European energy efficiency finance facility).

5.19. The Commission generally finances projects following formal calls for project proposals. Payments for approved projects are made directly by the Commission to beneficiaries, based on grant agreements or Commission financing decisions. The beneficiaries are usually Member State authorities but may also be public or private companies. Nearly all payments are made in instalments: an advance or pre-financing payment upon signature of the grant agreement or financing decision, followed by interim and final payments to reimburse eligible expenditure reported by beneficiaries.

<sup>(12)</sup> Around 41 % of energy and transport expenditure is for Trans-European Networks (TEN), 28 % is for conventional and renewable energy projects and another 11 % for research projects mainly funded by the research framework programmes. The other two main categories of expenditure is for projects concerning inland, air and maritime transport 7 % and nuclear energy 6 %.

<sup>(13)</sup> TEN-Transport Executive Agency, Executive Agency for Competitiveness and Innovation and SESAR (Single European Sky Air Traffic Management Research) joint undertaking.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

5.20. The principal elements of control of the expenditure by the Commission include the evaluation of proposals against specified selection and award criteria, the provision of information and guidance to beneficiaries, and the monitoring and verification of the implementation of projects based on financial and technical progress reports submitted by beneficiaries. Where required by financing agreements, expenditure claims have to be certified by an independent external auditor or a relevant national body.

5.21. In addition, the Commission carries out ex-post audits in order to detect and correct errors which may not have been prevented by earlier controls and to provide reasonable assurance on the regularity of the expenditure.

*Risks to regularity***Regional policy**

5.22. For ERDF and CF expenditure the main risks relate to the funding of projects which do not comply with EU and national public procurement rules or which do not fulfil the eligibility conditions specified in the EU regulations or the OPs. In addition, the risk also exists that beneficiaries declare specific costs that are ineligible.

5.23. In implementing the OPs, Member State authorities face competing priorities. On the one hand, spending has to be subject to appropriate controls of regularity, whilst, on the other hand, there is a need to ensure the timely absorption of the EU funds made available. In practice, the desire to implement the programme on a timely basis may militate against the consistent application of robust controls.

5.24. If cases of non-compliance are neither detected nor corrected by the different layers of control in a Member State or by the Commission, this results in ineligible expenditure being reimbursed from the EU budget.

5.22. *The Commission shares this assessment, as detailed in its Staff Working Document 'Analysis of errors in the Cohesion Policy for the years 2006-2009' (SEC(2011) 1179 of 5 October 2011). In this document, the Commission indicates specific actions to mitigate these risks (in particular additional guidance and training to managing authorities on the identified risks, timely implementation of financial corrections, interruptions and suspensions procedures, more targeted audit activity on the most risky areas).*

5.23. *The Commission agrees that a sound management and control system is a system that allows certification of legal and regular expenditure while ensuring timely absorption of funds.*

5.24. *Since the management and control system has a multi-annual character, an overpayment detected in a payment claim reimbursed by the Commission may not have been yet subject to the entire control chain at national and EU level at the time of certification.*

## THE COURT'S OBSERVATIONS

**Energy and transport**

5.25. For energy and transport expenditure the main risk is that ineligible costs declared by beneficiaries are not detected by the Commission before reimbursement. As under ERDF and CF, there are also risks related to non-compliance with public procurement rules. For TEN-T the potential impact of these risks on the EU budget is mitigated by the fact that eligible expenditure often exceeds the ceiling defined by the financing agreements.

5.26. A concentration of a significant proportion of payments in a limited period may adversely affect the effectiveness of supervisory and control systems and increase the risk of error (see paragraph 1.35). In 2011, 32 % of the EEP payments by value occurred in the month of December. Moreover, the programme aims at rapidly disbursing funds which may also be detrimental to the application of adequate controls.

**Audit scope and approach**

5.27. **Annex 1.1, part 2**, of Chapter 1 describes the Court's overall audit approach and methodology. For the audit of regional policy, energy and transport, the following specific issues should be noted:

- (a) the audit involved the examination of a sample of 180 interim and final payments<sup>(14)</sup> in Member States and at the Commission;
- (b) the assessment of systems covered:
  - audit authorities for ERDF, ESF and CF in the 2007-2013 programming period<sup>(15)</sup>,

<sup>(14)</sup> This sample comprises 180 payments made to 129 ERDF, 39 CF, 8 Energy and 4 Transport projects. 148 of the payments to ERDF/CF projects relate to the 2007-2013 programming period and 20 to the 2000-2006 period. The sample was drawn from all payments, with the exception of advances which amounted to 1,4 billion euro in 2011.

<sup>(15)</sup> The Court's audit work regarding AAs consisted of: (a) an examination of a sample of seven AAs (and, where applicable, delegated audit bodies) in seven Member States (Czech Republic, Greece, Italy (Sicily), Latvia, Hungary, Portugal and Romania); and (b) a review of the Commission's supervisory activities of AAs as a whole. See the 2010 Annual Report, paragraphs 4.37 to 4.44.

## THE COURT'S OBSERVATIONS

- the procedures implemented at Commission and Member State level with regard to the programme closure for the 2000-2006 programming period,
- a review of the Commission's management representations contained in the Annual Activity Reports of DG Regional Policy, DG Mobility and Transport and DG Energy.

## THE COMMISSION'S REPLIES

## REGULARITY OF TRANSACTIONS

5.28. **Annex 5.1** contains a summary of the results of transaction testing. The Court's testing of its sample of transactions found 59 % of the 180 payments audited to be affected by error. The most likely error estimated by the Court is 6,0 % <sup>(16)</sup>.

5.29. For 62 % of the regional policy transactions affected by error, the Court considers that sufficient information was available for the Member State authorities to have detected and corrected at least some of the errors prior to certifying the expenditure to the Commission.

5.30. In regional policy, weaknesses in verifications by national authorities were detected in particular in the 'first level checks' carried out by managing authorities and intermediate bodies.

**5.28.** *The Commission notes that for the third consecutive year, the level of error (MLE 6,0 %) remains well below those reported by the Court in the period 2006-2008. This positive development derives from the reinforced control provisions of the 2007-2013 programming period and its strict policy of interruptions/suspensions when deficiencies are identified, in line with its 2008 Action Plan.*

*As shown in **Table 1.3** of Chapter 1, the combined most likely error for regional policy, transport, energy and employment and social affairs also decreased considerably compared to 2010, from 7,7 % to 5,1 %.*

*The Commission will continue to focus its actions on the most risky programmes and/or Member States.*

**5.29.** *The Commission is strictly following up these cases to ensure that the concerned systems better prevent errors before certification in the future.*

*Managing authorities are required to perform documentary checks on all claims submitted by beneficiaries, before certification of expenditure. However, on-the-spot verifications on operations may also intervene at a later stage of project implementation, after certification and up to closure, which explains why part of the errors in the Court's sample could not be detected (see also Commission replies to paragraphs 5.22 and 5.24). The impact of the control system in reducing error rates is usually only seen in subsequent years, after all layers of controls have been implemented.*

<sup>(16)</sup> The Court calculates its estimate of error from a representative statistical sample. The figure quoted is the best estimate (known as the MLE). The Court has 95 % confidence that the rate of error in the population lies between LEL 3,0 % and UEL 9,0 % (the lower and upper error limits respectively).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Failures to respect public procurement rules identified in one quarter of transactions**

5.31. Previous years' audits have shown that public procurement procedures are particularly prone to error<sup>(17)</sup>. In 2011, the Court audited 298 public procurement procedures for works and services underlying the expenditure for the 180 transactions certified to the Commission<sup>(18)</sup>. The combined estimated contract value for the public procurements audited amounts to 6,7 billion euro<sup>(19)</sup>.

5.32. The Court identified instances of non-compliance with EU and national public procurement rules in 25 % of the 180 transactions audited. Serious failures to respect these rules were identified in 9 % of the transactions audited (see example 5.1). These errors account for 44 % of all quantifiable errors and make up approximately 58 % of the estimated error rate for this policy group.

**5.31.** Public procurement errors relate to non-compliance with internal market rules, and are not specific to cohesion policy, as shown in other chapters of this report.

**5.32.** While the Commission and the Court audit compliance with public procurement rules in the same way, the Commission applies proportionate flat-rate corrections in cohesion policy thereby addressing the risk of damage to the EU budget and taking into account the nature and gravity of the irregularities.

These flat rates are applied by the Commission and by most national authorities when imposing financial corrections for infringements of public procurement rules, including when following up all public procurement errors reported by the Court.

**Example 5.1 — Serious failures to respect public procurement rules**

- (a) *Use of direct award without justification:* In the case of an EEPR project concerning the construction of a gas pipeline, the contracts related to the works in the second and third stage of the project were awarded without tendering to the consortium that had been awarded a contract for the first stage of the pipeline five years earlier. This is not in line with the applicable EU and national public procurement laws.
- (b) *Direct award of additional works in the absence of unforeseeable circumstances:* In the case of a CF project related to road construction, additional works relating to amendments made subsequent to the approval of the original plan were awarded directly to the same contractor. These additional works were not due to unforeseeable circumstances, therefore a breach of public procurement rules occurred.

<sup>(17)</sup> See European Commission: 'Analysis of errors in the Cohesion Policy for the years 2006-2009' (SEC(2011) 1179, 5.10.2011).

<sup>(18)</sup> For 41 % of the 298 public procurement procedures audited by the Court the contract value was above the threshold which made them subject to EU public procurement rules as transposed into national law.

<sup>(19)</sup> This amount represents the total expenditure for the contracts awarded, part of which has been certified under the audited expenditure declarations.



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

- (c) *Contract awarded to single bidder without obtaining intended price reduction during negotiations:* In the case of a CF project related to the construction of a sludge treatment facility, only one offer was received. The beneficiary judged the offer to be unacceptable due to its high price, which was more than double the estimated budget. The beneficiary then initiated negotiations with the sole bidder. Following these negotiations, the contract was awarded with only a 1 % decrease in the offered price. Given the lack of success of the negotiations to secure a better price, the beneficiary should have concluded that the tender procedure had been unsuccessful.
- (d) *Artificial split of tenders:* In the case of an ERDF project related to the provision of advisory services to a national ministry, several small-scale contracts were directly awarded for similar or identical services. In accordance with EU and national procurement laws, these services should have been procured together as a single service and, because the aggregate value would then have exceeded a certain threshold, a contract should only have been awarded following a public tendering procedure, allowing more bidders the possibility to submit an offer.
- (e) *Significant changes in scope of the contracted works:* In the case of a CF project related to the construction of a new metro line, the scope and budget of a related service contract was changed significantly through the involvement of experts who initially had not been foreseen. The additional tasks to be carried out were not due to unforeseeable circumstances, but rather to the way the contracting authority had planned the project.

5.33. Moreover, the Court found other non-quantifiable errors related to tendering and contracting procedures in a further 16 % of the 180 transactions audited. These errors include cases of non-compliance with the information and publicity requirements (such as late publication of award notices), shortcomings in the tender specification and procedural weaknesses in the evaluation of offers. These errors do not contribute to the error rate estimated by the Court (see paragraph 5.28) <sup>(20)</sup>.

**5.33.** *The Commission will follow up all errors reported by the Court and will apply financial corrections where appropriate and legally possible.*

<sup>(20)</sup> Further information regarding the Court's approach to the quantification of public procurement errors is set out in **Annex 1.1**, points 10 and 11.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Ineligible costs account for more than half of all quantifiable errors detected by the Court**

5.34. The Court found that ineligible costs had been declared in 12 % of the transactions audited. These account for 56 % of all quantifiable errors and make up approximately 42 % of the estimated error rate for this policy group (see example 5.2).

**5.34.** *The Commission seeks to ensure that beneficiaries and programmes managing authorities are well aware of eligibility rules. This can be through training and guidance and, for regional policy, managing authorities should carry over this knowledge to all bodies in charge of managing the funds. For regional policy, when the Commission identifies complex rules at programme level, it also makes recommendations to the Member State to simplify the rules.*

*The Commission will continue to focus its actions on programme authorities where risks have been identified (see also replies to paragraphs 5.24 and 5.28).*

**Example 5.2 — Ineligible costs**

- (a) *Non-compliance with project approval decision:* A Financial Engineering Instrument funded by the ERDF to grant financial support to SMEs provided also funding to large enterprises. This was not permitted under the national approval decision for this project.
- (b) *Revenue from the sale of old machinery that was replaced using ERDF funding was not taken into account:* In the case of an ERDF project related to the purchase of metal processing machines, the revenue resulting from the disposal of the old machines that were replaced should have been taken into account and this would have reduced the expenditure declared for the purchase of the new machines.
- (c) *Non-compliance with specific provisions in national eligibility rules:* In the case of a CF project related to the construction of a motorway, costs related to financial and insurance services were reimbursed. Such costs are, however, not eligible according to the national eligibility rules.
- (d) *Declaration of multiple ineligible costs for a project:* In the case of a TEN-T project related to preparatory studies for the building of a tunnel, an invoice had been declared twice. In addition, key documentation relating to public procurement procedures (such as the report by the evaluation committee and the applicant's winning offer) was missing. Nevertheless, since the overall costs declared were significantly higher than the maximum EU contribution, this over-declaration had no impact on the EU budget (see paragraph 5.25).

## EFFECTIVENESS OF SYSTEMS

### Audit authorities

5.35. The regulations defining the rules for the ERDF, ESF and CF for the 2007-2013 programming period introduced important changes with regard to the role and responsibilities of audit authorities (AAs) in the Member States <sup>(21)</sup>.

5.36. Within the 27 Member States, 112 AAs have been set up for the 434 OPs of the 2007-2013 programming period. More than half of these AAs are responsible for auditing OPs for all three funds within their region (i.e. ERDF, CF and ESF), whilst the remaining AAs audit specific OPs <sup>(22)</sup> under one fund.

5.37. ACRs and annual opinions provide information on the regularity of EU spending under the ERDF, ESF and CF for the 2007-2013 programming period <sup>(23)</sup>. An effective verification of the accuracy and reliability of the information is necessary so that the results reported by the AAs in the ACRs can be used by the Commission as one of the main sources of assurance. In 2011, a total of 204 ACRs and annual opinions <sup>(24)</sup> for ERDF and CF and 117 ACRs and annual opinions for ESF were submitted to the Commission.

*5.35. The audit authorities indeed play a central role in the assurance building process, as from the beginning of the programming period and set-up of systems. Thereafter, they report each year an audit opinion on the functioning of management and control systems to the Commission, based on audits on management and control systems and on statistical samples of operations carried out in accordance with an audit strategy. For this reason the Commission is closely cooperating and coordinating with them, and has started reviewing their methodologies and audit results as early as 2009, as described below. This contributed to capacity building by providing advice, guidance and recommendations to audit authorities through the Commission's reperformance work. The regulation provides the Commission the possibility to rely on the work of an audit authority for its assurance under certain conditions (Article 73).*

*5.37. In their 2011 Annual Activity Report, DG Regional Policy and DG Employment, provided a detailed assessment of the accuracy and reliability of the audit information and results reported by audit authorities in their 2011 annual control reports, (see pages 63 to 66 of DG Regional Policy's 2011 AAR and pages 42 to 45 of DG Employment's 2011 AAR).*

<sup>(21)</sup> The AAs replaced the control authorities in charge of 'Article 10 checks' and 'Article 15 winding-up declarations'. See Article 10 and 15 of Commission Regulation (EC) No 438/2001 (OJ L 63, 3.3.2001, p. 21).

<sup>(22)</sup> 63 of these AAs are common for all three funds. 18 AAs are only for ERDF/CF OPs and 31 AAs are only for ESF OPs.

<sup>(23)</sup> Each AA may produce one or more ACRs which in turn may relate to one or more OPs.

<sup>(24)</sup> The ACRs and annual opinions are based on the findings of the AAs' audits relating to expenditure certified to the Commission in the previous EU financial year (see Article 62(1)(d) of Regulation (EC) No 1083/2006).

## THE COURT'S OBSERVATIONS

5.38. For 2011, the Court carried out its own examination of seven AAs and assessed the work done by the Commission to supervise AAs <sup>(25)</sup>.

*The Court's examination of seven AAs*

5.39. **Annex 5.2** contains the results of the individual key requirements tested and the overall assessment of the AAs examined. In drawing an overall conclusion, the Court paid particular attention to the ACRs and annual opinions and the parts of the AAs' work which had a direct and important effect on the conclusions reported in them <sup>(26)</sup>.

5.40. For each of the seven AAs sampled the Court reviewed:

- (a) their organisational arrangements and audit methodology;
- (b) their working documents for up to four system audits;
- (c) their working documents for a sample of up to 25 audits of operations, including a re-performance of at least five of those 25 audits; and
- (d) their 2011 annual control reports and annual opinions, together with the related working papers.

5.41. Of the seven AAs examined, the Court assessed four to be 'effective'. For these four AAs, the annual control report and annual opinion is considered to be reliable and all or most of the key requirements were fulfilled.

5.42. For the three other AAs:

- (a) two AAs were assessed as 'partially effective' because problems were observed with some key requirements and the error rate reported in the annual control report was understated; and

## THE COMMISSION'S REPLIES

**5.38.** *In the area of regional policy, the Commission carried out audits fully or partially to review the work of 34 audit authorities by end of 2011 (29 AA completed, 5 on-going) following a 2009 risk analysis that is updated every year.*

**5.39.** *The Commission takes the Court's findings into account for its assessment of the national audit authorities, with a view to encourage improvements, where still necessary and in order to ensure conditions for single auditing in the coming years.*

**5.40.** *The Commission notes that its audit methodology to review the work of the audit authorities is consistent with that of the Court.*

**5.41.** *The Commission shares the Court's assessment for these four audit authorities and reached similar conclusions through its own audits.*

**5.42.** *The Commission agrees with the Court's assessment and is taking corrective and preventive actions.*

- (a) *For the two AAs assessed as partially effective, the Commission accepted in one case the reported audit opinion for its own assurance as it was qualified. In the other case the Commission identified and corrected the incorrect extrapolation of errors for its assurance process, as indicated in the Annual Activity Reports.*

<sup>(25)</sup> The Commission's assessment is based on an internal risk scoring and the total amount of EU co-financing for the OPs audited by the AA. In 2010, eight AAs were subject to detailed assessment by the Court. See the 2010 Annual Report, paragraphs 4.37 to 4.44.

<sup>(26)</sup> In particular, as indicated in **Annex 5.2**, AAs were assessed to be 'not effective' if the Court identified significant shortcomings in the ACR and/or the annual opinion or if there were pervasive weaknesses in essential elements of the AAs' work which undermined the reliability of the ACRs and annual opinions.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

(b) one AA was assessed as 'not effective' because important problems were observed for nearly all the key requirements and, as a result, the error rate reported in the annual control report is considered to be unreliable. The Commission has observed the same problems for this AA as well as other aspects of the management and control systems for the operational programmes covered by the AA (see paragraph 5.49(b)).

5.43. The Court identified the following areas for improvement:

(a) for four AAs, the audit checklists used did not sufficiently cover the main risks to the regularity of expenditure. This concerns in particular the scope of verifications and the extent of checks with regard to public procurement, state aid rules, revenue generating projects and project selection procedures. For financial engineering instruments, guidance issued by the Commission had not yet been incorporated into the AAs' audit checklists;

(b) for two AAs, the quality control of audits of systems and/or operations was not in line with their own audit manual and for another two AAs it was not documented; and

(c) for two AAs, the methodology used to sample projects to be audited was not appropriate in view of the guidance specified by the Coordination Committee of the Funds <sup>(27)</sup> (COCOF) or the sampling methodology had been incorrectly applied by the AA, which meant that the results of their audits could not be extrapolated as required.

5.43.

(a) *The Commission also identified as a result of its extensive review of audit authorities during 2009-2011 the need to reinforce, in some cases and on particular issues, the existing checklists used by national audit authorities for the audit of operations. As a follow-up, the Commission shared its own checklist for audits on operations with the Member States audit authorities in October 2011.*

*These check lists cover the issues raised by the Court: public procurement, state aid rules, revenue generating projects and project selection procedures. As far as public procurement is concerned, the Commission has shared with Member States an analysis of the types of errors detected in cohesion by EU audits in the previous years and has launched an exercise to collect best practices and possible answers by Member States to remedy such errors and reduce their occurrence (see also paragraph 6.29(a)).*

(c) *The Commission has found similar weaknesses during its audits and is intensifying its efforts to provide guidance on sampling.*

<sup>(27)</sup> The COCOF is a standing committee of the European Commission. Its function is to discuss subjects relating to the application of regulations governing the ERDF, ESF and CF. Its meetings are chaired by the European Commission and attended by officials from Member States.

## THE COURT'S OBSERVATIONS

*Assessment of the Commission's supervision of AAs*

5.44. In 2011, the Commission carried out enquiries for a sample of AAs <sup>(28)</sup> and assessed, through a desk review, the implementation of their audit strategy and the reliability of the error rates reported in ACRs.

*Assessment of the Commission's enquiries for a sample of AAs*

5.45. The Court reviewed the Commission's working papers and supporting documentation for DG Regional Policy in relation to 14 AAs covering 39 OPs and for DG Employment, Social Affairs and Inclusion in relation to seven AAs covering seven OPs <sup>(29)</sup>.

5.46. The Commission found similar weaknesses to those observed by the Court in its own audits of AAs (see paragraphs 5.42 and 5.43).

5.47. The Court found that in all cases where the Commission identified specific weaknesses the Member States were notified about the corrective action to be taken.

## THE COMMISSION'S REPLIES

**5.44.** During the period 2009-2011 the Commission has carried out 127 audit missions covering 34 ERDF/CF AAs and 78 audit missions covering 67 ESF AAs. At the end of 2011 the audit work both desk review and on the spot work covering review of systems audits, audit methodology, reperformance of systems audits and of audits on operations on the spot had been completed for 29 ERDF/CF audit authorities and 67 ESF audit authorities.

The Commission has also assessed, through desk review completed by on-the-spot fact-finding missions where necessary, the implementation of the audit strategy and the reliability of the error rates reported in ACRs for all audit authorities.

**5.46.** The Commission shares the Court's assessment on the compliance and effectiveness of the work of audit authorities.

**5.47.** In the course of its extensive review of audit authorities, the Commission indeed notified targeted recommendations to audit authorities to remedy the identified weaknesses, when needed.

This contributed to an extensive capacity building exercise that allowed to improve the work and to raise the quality of audit results overall for the audited audit authorities, thus allowing in some cases the Commission to enter into Article 73 agreements and to draw further lessons and disseminate good practices for all audit authorities.

<sup>(28)</sup> In 2011, DG Regional Policy completed enquiries for 14 AAs with regard to ERDF and CF. DG Employment, Social Affairs and Inclusion undertook specific examinations of 42 OPs for the ESF. This also included a review of the AAs in charge of the OPs examined.

<sup>(29)</sup> These 14 AAs for DG Regional Policy and seven AAs for DG Employment, Social Affairs and Inclusion are additional to those reviewed by the Court in 2010 (see the 2010 Annual Report, paragraph 4.42).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Assessment of the Commission's desk reviews of ACRs*

5.48. For all 112 AAs, the Commission checked that the ACRs and annual opinions complied with the requirements of the regulation in terms of content and format. It did this by analysing relevant information reported by the AAs on the functioning of the management and control systems and by checking the calculation of the reported error rate. This review also took account of other information regarding the supervisory and control systems for OPs which was available to the Commission.

5.49. For 2011, the Commission considered that the error rates reported in the ACRs by the AAs are:

- (a) reliable for 363 of the 434 OPs (84 %). These 363 OPs account for 67 % of the estimated expenditure under the 2007-2013 programming period;
- (b) not reliable for 71 OPs (16 %). These 71 OPs account for 33 % of the estimated expenditure under the 2007-2013 programming period. For these OPs, on the basis of its own assessment of the functioning of the management and control systems, the Commission recalculated the error rate or applied a fixed error rate. These adjusted error rates were then used for the estimation of the amount of 'payment at risk' disclosed by DG Regional Policy and DG Employment, Social Affairs and Inclusion in their AARs <sup>(30)</sup> (see paragraphs 5.66 and 6.24).

5.50. Overall, the Court considers that the approach applied by the Commission is in principle appropriate. The possibility for the Commission to validate and, where necessary, adjust the error rates disclosed by national AAs in their ACRs is however limited since the AAs are not required by the regulations to provide information about their audits of operations to the Commission. For the 2011 ACRs, DG Regional Policy therefore organised fact-finding missions to 12 AAs in 11 Member States to clarify how the error rate reported in the ACR was calculated. Similarly, DG Employment, Social Affairs and Inclusion carried out additional examinations for 12 OPs following its review of ACRs.

**5.48.** *The analysis of annual control reports (ACR) and audit opinions is an extensive exercise at the beginning of each year. It takes indeed into account all national audit results received by audit authorities during the year, as well as other Commission and ECA audit results. In addition, in 2012 the Commission services carried out fact finding missions on the spot in 11 Member States, to collect further evidence/obtain clarifications on the submitted ACR and in particular on the methodology for calculating the error rates. The results of this analysis is a main source of the assurance building process, as explained in the AAR.*

**5.49.**

- (b) *When the Commission could recalculate the error rate, it means that it obtained additional, reliable information either in the text of the ACR itself or after communicating with the audit authority. The Commission communicated these recalculated rates to the concerned audit authorities that will thus be able to provide more reliable information in the next exercise.*

*For this reason the Commission presents separately in the respective Annual Activity Reports the error rates that it could recalculate and the ones that it considered unreliable. Only for these unreliable error rates the risk was estimated based on flat rates. This represented 9 % and 7 % of payments made in 2011 in total respectively for DG Regional Policy and DG Employment.*

**5.50.** *The Commission welcomes the Court's assessment for the second consecutive year, since the analysis of ACR and audit opinions constitute a key part of the assurance building process in the Annual Activity Reports. The fact-finding missions organised by DG Regional Policy and DG Employment, on the basis of doubts or risks identified, allowed to improve reliance on error rates reported, or in some cases to provide a sound basis for a recalculation of the error rates jointly agreed with the Audit Authority.*

<sup>(30)</sup> See AAR for DG Regional Policy, table on 'Shared management: assessment of national control systems', p. 121, and AAR for DG Employment, Social Affairs and Inclusion, p. 76.

## THE COURT'S OBSERVATIONS

5.51. The Court is of the opinion that the Commission drew appropriate conclusions from its reviews of ACRs and that the Commission, based on its assessment, had adjusted the reported error rates where necessary.

**Assessment of programme closure for the 2000-2006 programming period**

5.52. Payments relating to each programming period usually continue for some years beyond the end of the period. For the programming period 2000-2006, final beneficiaries were permitted to incur expenditure up to the end of June 2009 (with some exceptions).

5.53. The closure of an OP is the financial settlement of any outstanding EU budgetary commitments towards the programme, through payment of the final balance due to the Member State or by decommitment of any unused balance or by recovery of any amount unduly paid.

5.54. The Court noted in a recent special report that, for those programmes where the Commission cannot fully rely on the effective functioning of the management and control systems, the final assessment of the remaining risk of error in programmes has to be made by the Commission during the ongoing closure process <sup>(31)</sup>.

5.55. Member States are required to submit three documents to the Commission for the closure of each programme:

- (a) a *final implementation report* provided by the managing authority on the extent to which the programme met its objectives and on the financial resources used;
- (b) a *declaration by the winding-up body*, summarising the conclusions of checks carried out during the programming period, and assessing the validity of the application for final payment and the regularity of the transactions covered by the certified statement of expenditure;
- (c) a *certified statement of expenditure*, drawn up by the paying authority, together with an application for final payment if the final balance is in favour of the Member State.

## THE COMMISSION'S REPLIES

**5.54.** *The Commission's assurance for 2000-2006 programmes was built up over the years namely through substantial audit work carried out by the Commission services.*

*As a result, the Commission services acquired an extensive knowledge of the audit results and risks related to each Member state, which provides a substantive basis for analysing the winding-up declarations.*

<sup>(31)</sup> Paragraph 65 of Special Report 3/2012: 'Structural Funds — Did the Commission successfully deal with deficiencies identified in the Member States management and control systems?' (<http://eca.europa.eu>).



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

5.56. After approval of the final implementation report and review of the winding-up documents, the Commission decides the final amount to be paid, recovered or decommitted. Where the final error rate validated by the Commission exceeds 2 % of total eligible expenditure, the Commission imposes financial corrections before paying the final balance or requesting a recovery.

5.57. If closure is to be effective, winding-up declarations should be reliable and the Commission should address any significant weaknesses in these documents. The Court assessed whether the closure documents submitted by Member States were reliable and whether the Commission dealt appropriately with the documents.

5.58. The Court's examination covered the initial phase of the closure process and was based on:

- (a) a review of procedures, manuals, checklists, monitoring and reporting tools within DG Regional Policy and DG Employment, Social Affairs and Inclusion;
- (b) an examination of the Commission's assessment of closure documents for a sample of 31 OPs (both ERDF and ESF) in eight Member States<sup>(32)</sup>, none of which had been formally closed at the time of the audit;
- (c) visits to nine winding-up bodies in two Member States, covering 14 of the 31 sampled programmes, and including analysis of the data underlying the information reported in their closure documents.

5.59. The Court found that the Commission, in cooperation with the Member States, had taken steps such as the early issue of guidelines and regular discussion of closure issues, which meant that the closure process was better prepared than in previous programming periods.

**5.56.** *In the 2000-2006 regulatory framework, the Member States had to audit a sample of operations based on risks and ensuring representativity of the main bodies and beneficiaries.*

*Therefore, the error rate reported at closure by the winding-up body has to be carefully analysed: all corrective actions taken by the Member States and the Commission during implementation have to be taken into account to conclude on the frequency of errors and residual risks, before evaluating possible additional corrections (see Commission Guidelines on Closure, paragraphs 3.6, 3.7 and 4.2 of Annex 2).*

*If based on this analysis the Commission determines a residual risk above 2 %, a financial correction is applied.*

**5.57 and 5.58.** *The Court examined the initial assessment the Commission made on closure documents submitted by Member States in the sample of the Court, as the closure process for those programmes was only starting at the time of the Court's audit. The weaknesses in winding up declarations reported by the Court had been identified and analysed by the Commission before the Court's audit. These weaknesses were addressed by the Commission during the closure process subsequently to the Court's audit and additional audit work has been or is currently being performed after the initial assessment of the closure documents, where necessary, to conclude on the residual risk. Financial corrections were applied where appropriate.*

**5.59.** *The Commission also closely monitored the management and control systems and audit work during implementation of the 2000-2006 programming period up to the closure process.*

<sup>(32)</sup> Germany, Ireland, Spain, France, Italy, Netherlands, Austria and United Kingdom. For Italy, the audit was carried out in coordination with the Italian Supreme Audit Institution (Corte dei Conti Italiana) on the basis of a Memorandum of Understanding and a Joint Declaration signed by the Presidents of the Corte dei Conti and of the European Court of Auditors. For this audit, the coordinated activities essentially covered the collection of audit evidence.

## THE COURT'S OBSERVATIONS

5.60. However, the Court identified weaknesses undermining the reliability of some of the closure documents submitted by Member States to the Commission and highlighted weaknesses in the Commission's procedures for the initial assessment of the closure documents. The submission of unreliable documents by Member States places additional pressure on the Commission by increasing the work which it has to carry out in order to ensure that programmes are closed without remaining material error.

5.61. Some of the closure documents audited by the Court were affected by the following problems:

- (a) the second level checks in the Member States, which are fundamental to the winding-up declarations, were affected by a number of specific weaknesses;
- (b) winding-up declarations contained incomplete information;
- (c) the winding-up bodies in some Member States submitted declarations which contained unjustified reductions of final error rates and opinions, which were not in line with the results of checks (see **Table 5.2**).

## THE COMMISSION'S REPLIES

With a view to improving the closure process for 2000 to 2006 programmes, the guidelines to Member States on the closure of Structural Funds were published in August 2006, in due time for the beginning of the closure process. The Commission discussed closure issues with the control authorities of the Member States during their regular annual bilateral meetings. The Commission organised closure seminars with the Member States in September 2008 and December 2009, developed a list of 'frequently asked questions' and held technical meetings with the bodies responsible for drawing up the closure declarations.

**5.60.** The Commission considers to have assessed all cases according to international auditing standards before the Court's audit and addressed appropriately all risks identified.

**5.61.**

- (a) The Commission agrees with the Court's assessment regarding 5 cases out of 10 cases underlying the Court's observation.

The Court's observation was generally based on the Commission's analysis of the winding up declarations at the time of the audit. The Commission subsequently took appropriate actions to tackle the issues and mitigate the residual risks in these cases. In the remaining cases, the Commission considers that second level checks were adequately performed and reported in the winding up declarations.

- (b) The Commission identified the same issues for two cases underlying the Court's observation in its audits. Appropriate financial corrections will be proposed at closure.

For the two remaining cases, the Commission services assessed the completeness of information in the winding-up declaration after a thorough analysis.

- (c) For three cases quoted in **Table 5.2**, the Commission considers that the reductions of error rates have been duly justified.

The Commission services assessed the audit opinions provided by the winding-up bodies according to International Auditing Standards, taking into account all available audit results and evidence, as well as the application of self-corrections by Member States going beyond individual errors detected in the audited sample. In all cases, the Commission services took the necessary measures to address the issues including the interruption of the closure process, the request of additional information and the launch of a process leading to the application of financial corrections where necessary.

Table 5.2 — Effect of unjustified reductions of final error rates reported in winding-up declarations

Operational Programme	Total certified amount (euro)	Error rate before withdrawing atypical errors	Error rate reported
Steiermark, Objective 2, ERDF	1 643 131 021	2,9 %	0,7 %
West Midlands, Objective 2, ERDF	2 131 670 207	10,6 %	6,47 %
Merseyside, Objective 1, ERDF	2 495 941 228	2,8 %	1,1 %
Sicily, Objective 1, ERDF	5 557 834 587	11,0 %	1,2 %
Spain Local Development, Objective 1, ERDF	1 644 137 526	6,7 %	1,2 %

Note: In two further cases (France, Objective 3, ESF and UK West Wales and the Valleys, Objective 1, ERDF), the impact of the decrease could not be quantified from the information in the closure documents. The reduction in the Spanish ERDF programme concerns the part implemented by the local administration, representing around 25 % of the total programme expenditure.

---

 THE COURT'S OBSERVATIONS
 

---

5.62. The problems identified by the Court in the winding-up declarations submitted by the Member States make it difficult for the Commission to assess the declarations and the underlying information. For the audited cases, the Commission's assessment was affected by procedural weaknesses regarding in particular the use of interservice liaison and the monitoring and reporting of the closure process, as well as by some shortcomings in the Commission's checks.

5.63. The Court also noted that in four out of six audited programmes that were subject to financial corrections in the course of the programming period, error rates continued to be high afterwards, thus showing the persistence of weak management and control systems. This would require the Commission to perform additional work in order to obtain sufficient assurance at closure.

---

 THE COMMISSION'S REPLIES
 

---

5.62. The Commission considers that its closure procedure has allowed identifying remaining material risks at closure, and addresses it by performing additional audit work and/or by applying appropriate financial corrections.

Consultations between Commission services, in line with agreed established procedures, were consistently carried out with the exception of a few cases where non-disclosure identified to other services did not entail any risk. The Commission underlines that the quality of reporting increased with time, as more qualitative information on the ongoing analysis was available. The Commission notes that the checks reported as missing by the Court were actually carried out by different services within the directorates-general.

5.63. The Commission regrets that, for the four programmes mentioned, despite financial corrections during the programming period, the residual risk at closure might remain high. Therefore, regardless of financial corrections already implemented, the Commission systematically assesses the residual risk at closure for all programmes and performs additional checks to mitigate this risk.

Furthermore, the Commission has included in its closure audits programmes for which some issues remain, thus allowing to reach high assurance at closure for these programmes as well.

## THE COURT'S OBSERVATIONS

5.64. In view of the problems found by the Court, in particular with regard to the unjustified reductions of final error rates, the Court considers that for five of the 31 programmes audited there is a risk that, unless the Commission takes the necessary action during subsequent stages, the closure might be based on unreliable closure documents.

**Reliability of Commission management representations**

5.65. The Court assessed the 2011 annual activity reports (AARs) and accompanying declarations of the Directorates-General for Regional Policy, Mobility and Transport, and Energy. In particular, with regard to the regularity of payments authorised during 2011, the Court:

- (a) assessed the reservations made in the AARs;
- (b) checked the consistency and accuracy of the Commission's calculation of the residual error rate and the amounts of 'payments at risk'.

*DG Regional Policy*

5.66. DG Regional Policy estimated that between 3,1 % and 6,8 % of the interim payments for the 2007-2013 programming period authorised during 2011 (the latter amounted to approximately 29,8 billion euro in total) were at risk of error. This assessment of the 'payments at risk' includes all OPs; those under reservation as well as those not under reservation. The number of OPs subject to reservation by DG Regional Policy increased in 2011 compared to 2010 from 98 to 123. This was due to a stricter assessment by the Commission. In total, the scope of the financial reservations made by DG Regional Policy represented 31 % of the total payment appropriations authorised during the year. According to the AAR, the impact of these reservations represented between 1,9 % and 4,3 % of the payments authorised by DG Regional Policy during 2011.

## THE COMMISSION'S REPLIES

**5.64.** *The Commission considers that in all cases referred to quoted by the Court's assessment the remaining risks are being adequately covered during the ongoing closure process. The Commission services have made a thorough assessment of the closure documents and have taken the necessary measures to address the issues identified, including the interruption of the closure process, the request of additional information, the performance of closure audits and eventually for some programmes the application of financial corrections (see also Commission reply to paragraph 5.61(c)).*

**5.66.** *The Commission welcomes the Court's reference to the Commission's stricter assessment of the amounts at risk, which was intended to address observations made by the Court in its former Annual Reports.*

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

5.67. The Court notes that DG Regional Policy issued reservations for those OPs of the 2000-2006 programming period for which the Member State had not yet adequately corrected weaknesses identified during the closure process. The Commission did not quantify these reservations (which are referred to by the Commission as reservations for 'reputational reasons'). As shown by the Court's work there remains a risk that the closure might be based on unreliable closure documents leading to insufficient financial corrections (see paragraphs 5.60 to 5.61 and Special Report No 3/2012, paragraphs 65 to 67).

*DG Mobility and Transport and DG Energy*

5.68. DG Mobility and Transport and DG Energy estimated that approximately 4,5 % of payments authorised during 2011 in relation to the sixth and the seventh framework programmes for research and technological development were affected by errors. Accordingly, reservations were issued for each of these two expenditure programmes by both DGs. In total, the reservations made by DG Mobility and Transport and DG Energy cover respectively 25,7 % and 18,8 % of the total payment appropriations authorised during the year. The combined impact of these two reservations represented 0,9 % and 0,8 % of the payments authorised by DG Mobility and Transport and DG Energy, respectively.

5.69. The Court noted the following issues:

- (a) for both DG Mobility and Transport and DG Energy the Court considers that the amount of 'payments at risk' is understated for the part of expenditure related to the seventh framework programme. In both cases the reservation concerning the seventh framework programme (FP7) is based on the results of the audits carried out by DG Research and DG Information Society. Audits by DG Mobility and Transport and DG Energy for FP7 projects had however shown error rates significantly above the estimated error rate for the framework programme as a whole;
- (b) for DG Energy, the Court considers that the scope of the audit work carried out in relation to the EEPR in 2011 is insufficient concerning public procurement.

5.67. As indicated in its reply to paragraph 5.62, the Commission considers that its closure procedure has allowed identifying remaining material risks at closure. The Commission has mitigating actions in place to address the risks identified at closure. Based on its risk assessment, the Commission carries out specific closure audits to verify and validate the quality of the winding-up declaration.

*The information provided by the winding-up body (WUB) is based on the cumulative audit information originating from all audit sources (national, Court and Commission audits), including from additional audits carried out at closure by the winding-up body when necessary.*

5.69.

- (a) *The Commission considers that both Directorates-General followed the standing instructions when quantifying the amount at risk for FP7 by using the best information available.*

*Since Energy DG and Mobility and Transport DG manage a small number of FP7 projects, they conducted a small number of FP7 audits. As this was found to be not sufficiently representative, the Commission considered it appropriate to use the results of the considerably larger number of random, representative FP7 audits conducted by Research and Innovation DG and Information Society and Media DG.*

*From 2012, the Commission DGs managing research projects will have a Common Representative Audit Sample for FP7.*

- (b) *The Commission will take into account the Court's observation in its audit of each of the 65 beneficiaries of EEPR funds during the lifetime of the EEPR.*

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**CONCLUSIONS AND RECOMMENDATIONS****Conclusions**

5.70. Based on its audit work, the Court concludes that the interim and final payments for the year ended 31 December 2011 for the policy group regional policy, energy and transport were affected by material error.

5.71. Based on its audit work on the examined supervisory and control systems, the Court found that:

(a) audit authorities were partially effective in ensuring the regularity of operations for the ERDF, ESF and CF of the 2007-2013 programming period;

(b) the procedures of the Commission and Member States have been partially effective in carrying out the initial phase of the closure process for the 2000-2006 programming period.

5.72. The Court's audits have shown that there is no assurance that financial correction mechanisms compensate for all OPs in an adequate manner the errors uncovered and that all material issues are resolved. There is equally no evidence that financial correction mechanisms necessarily translate into lasting improvements to systems which will prevent recurrence of the errors uncovered<sup>(33)</sup>.

**5.70.** *The Commission notes the considerable decrease in the error rate compared to last year which confirms a positive development for the third consecutive year.*

*The Commission considers that this is in particular a result of its strict policy of interruptions/suspensions when deficiencies are identified, in line with its 2008 Action Plan.*

*The Commission is taking measures to correct the errors detected by the Court including by applying financial corrections where appropriate, and focuses its actions on the most risky programmes and/or Member States<sup>(1)</sup>.*

**5.71.**

(a) *The Commission underlines that the effectiveness and quality of the work of audit authorities differs by programme and Member State, as shown by the Court's assessment in paragraph 5.41 and by the results of the Commission's audit work. In accordance with Article 73 of Regulation (EC) No 1083/2006, the Commission is as from July 2012 formally relying on the work of 13 audit authorities for ERDF/CF and 9 audit authorities for ESF. The Commission will continue to review the work of the remaining audit authorities and to monitor the situation for programmes for which an Article 73 letter was granted.*

(b) *The Commission considers to have established robust procedures and guidance for the closure process, and considers that most Member States have carried out important and professional work to enable the closure of programmes and to increase assurance at closure. The Commission also considers to have made a comprehensive work at closure, analysing thoroughly all closure documents, carrying out additional audits and enquiries where necessary, which has led in many cases to additional financial corrections being applied at closure to address remaining risks.*

**5.72.** *The multiannual nature of expenditure and control cycle includes the closure process, where final checks are performed on the legality and regularity of expenditure and final corrections are made where necessary.*

*The closure process for 2007-2013 programmes will be further strengthened compared to the 2000-2006 period considering in particular reinforced requirements for the audit of a representative statistical sample on a yearly basis and the annual opinions.*

<sup>(33)</sup> See the 2010 Annual Report, paragraph 1.25; and Special Report No 3/2012.

<sup>(1)</sup> As demonstrated in the Staff Working Document 'Analysis of errors in the Cohesion Policy for the years 2006-2009' (cf SEC(2011) 1179 of 5.10.2011) and in DG Regional Policy's AAR for 2011.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Recommendations**

5.73. The Court recommends that the Commission:

— **Recommendation 1:** makes sanction systems more effective by increasing the impact of financial corrections and by reducing the possibility of replacing the ineligible expenditure with other expenditure, as proposed by the Commission in the area of cohesion for the next programming period. There should be a presumption that any irregularity detected subsequent to presentation of the annual accounts will lead to a net financial correction.

— **Recommendation 2:** requires strict compliance with the eligibility requirements for EU funding, in particular the correct application of EU and national public procurement rules.

Moreover, for a limited number of OPs, the Commission's audits also demonstrated that programmes authorities still need to improve their management and control systems despite corrections applied. In such cases additional actions by the Commission, such as interruptions or suspensions are applied.

The Commission has proposed in the 2014-2020 legal framework to increase the possibility to make net financial corrections.

See joint reply to paragraphs 1.12 and 1.13.

**5.73.**

The Commission considers that Member States should have the right to substitute ineligible expenditure they detect with legal and regular one in order to optimise the use of Cohesion spending, which contributes to its added value and to ensure efficient controls at Member State level. The Commission's proposal for the 2014-2020 regulatory framework provides that 'Where irregularities affecting annual accounts sent to the Commission are detected by the Commission or by the European Court of Auditors, the resulting financial correction shall reduce support from the Funds to the operational programme (Article 137(6))' thereby limiting the possibilities of withdrawal/replacement to the ongoing financial year. This provision is intended as an incentive for expenditure included in the annual certified accounts to be legal and regular.

The Commission has made considerable efforts to ensure strict compliance with eligibility requirements and the correct application of public procurement rules. For example:

— For regional policy, it has provided training and guidance on eligibility rules to programme managing authorities to ensure they transmit this knowledge to all bodies in charge of managing the funds. Moreover, when it identifies complex rules at programme level, the Commission makes recommendations to simplify the rules. It has also shared with Member States an analysis of the types of procurement errors detected by EU audits in cohesion policy during previous years and has launched an exercise to collect best practices and possible answers by Member States to remedy such errors and reduce their occurrence.

## THE COURT'S OBSERVATIONS

- **Recommendation 3:** addresses weaknesses in 'first level checks' at the level of managing authorities and intermediate bodies for ERDF and CF, where appropriate through training measures and specific guidance material.
  
- **Recommendation 4:** regarding the control system for audit authorities in the cohesion area:
  - provides further guidance to AAs for the current programming period, in particular on sampling, the scope of verifications to be undertaken for audits of projects and quality control,
  
  - encourages AAs to carry out specific system audits concerning 'first level checks' done by managing authorities and intermediate bodies.

## THE COMMISSION'S REPLIES

- For the TEN-T programme, strict compliance with the eligibility requirements is insisted upon throughout the funding process, for example, the guide for applicants contains clear instructions on the respect of these requirements. The respect of these rules is then checked through the sampling controls when making intermediate and final payments.

The Commission has been giving guidelines to the Member States on the way managing authorities should define and implement their management verifications.

Moreover, the Commission developed in 2009 comprehensive guidelines for the first level checks and a self-assessment tool for managing authorities, which they can use to improve their functioning. The Commission has also developed and disseminated in 2011 to audit authorities checklists for the audit of management verifications which can be used by the managing authorities themselves, as a benchmark.

- Since the beginning of the programming period, the Commission has provided detailed and technical guidance, offered training and conducted technical meetings with auditors of national audit authorities. Furthermore, guidance on the scope and extent of audits on operations that was delivered under the 2000-2006 programming period is still valid since such audits do not differ significantly between both programming periods. As far as sampling is concerned, a specific workshop was organised by the Commission in June 2012.
  
- The Commission is actively implementing this recommendation and will continue to do so. When the Commission identifies weaknesses in management verifications (through various audit results at national or Community level), it requests the audit authority to review its audit strategy and audit plan to include targeted audits on management verifications or, alternatively, following revised risk assessments, it carries out directly such audits (under its audit enquiry 'bridging the assurance gap'). Moreover, based on an assessment of the functioning of management verification across all co-financed programmes based on all audit results available, the Commission has encouraged audit authorities in October 2011 to pay particular attention in their systems audits to first level checks (cf. Homologues Group, dedicated workshop on the role of audit authorities to contribute to improvement of management verifications).



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

— **Recommendation 5:** in order to make the procedure for closing multiannual programmes in the area of cohesion more efficient:

- reminds the Member States to ensure that the final declarations submitted for the 2007-2013 programmes are reliable,
- examines the specific weaknesses identified by the Court in the winding-up declarations for closures of 2000-2006 programmes,
- considers whether these problems have also occurred for other OPs, and apply financial corrections where necessary,
- ensures that ongoing closure audits adequately address the issues raised by the Court.

— *The 2007-2013 regulatory framework foresees quite different requirements for the audit of representative, statistical sample on a yearly basis, that support formal audit opinions of the audit authorities. This will form a more solid basis for closure declarations, which will allow identifying the residual risk after all corrections were taken during programme implementation. It should also be noted that guidelines for closure 2007-2013 were already presented to Member States during the COCOF meeting in June 2012.*

— *These weaknesses were identified and addressed by the Commission.*

— *More generally, the Commission analyses thoroughly each winding-up declaration and draws conclusions, including application of financial corrections where necessary.*

— *The Commission is confident that its closure process will allow applying appropriate financial corrections at closure, when needed, once its services will have carried out the required assessments of all closure documents received and additional information requested, and taking into account the evidence gathered during the closure audits.*

## ANNEX 5.1

## RESULTS OF TRANSACTION TESTING FOR REGIONAL POLICY, ENERGY AND TRANSPORT

	2011					2010	2009	2008
	ERDF	CF	Energy	Transport	Total			
<b>SIZE AND STRUCTURE OF THE SAMPLE</b>								
Total transactions (of which):	129	39	8	4	<b>180</b>	177	165	140
Advances	0	0	0	0	<b>0</b>	0	20	9
Interim/Final payments	129	39	8	4	<b>180</b>	177	145	131
<b>RESULTS OF TESTING <sup>(1)</sup> <sup>(2)</sup></b>								
<b>Proportion (number) of transactions tested found to be:</b>								
Free of error	49 % (63)	18 % (7)	38 % (3)	0 % (0)	<b>41 % (73)</b>	43 %	64 %	49 %
Affected by one or more errors	51 % (66)	82 % (32)	62 % (5)	100 % (4)	<b>59 % (107)</b>	57 %	36 %	51 %
<b>Analysis of transactions affected by error</b>								
<b>Analysis by type of expenditure</b>								
Advances	N/A	N/A	N/A	N/A	<b>N/A</b>	N/A	3 %	0 %
Interim/Final payments							97 %	100 %
<b>Analysis by type of error</b>								
Non-quantifiable errors:	58 % (38)	81 % (26)	20 % (1)	75 % (3)	<b>64 % (68)</b>	60 %	59 %	41 %
Quantifiable errors:	42 % (28)	19 % (6)	80 % (4)	25 % (1)	<b>36 % (39)</b>	40 %	41 %	59 %
Eligibility	96 % (27)	100 % (6)	100 % (4)	0 % (0)	<b>94 % (37)</b>	97 %	71 %	93 %
Occurrence	0 % (0)	0 % (0)	0 % (0)	100 % (1)	<b>3 % (1)</b>	0 %	0 %	0 %
Accuracy	4 % (1)	0 % (0)	0 % (0)	0 % (0)	<b>3 % (1)</b>	3 %	29 %	7 %
<b>ESTIMATED IMPACT OF QUANTIFIABLE ERRORS</b>								
Most likely error rate						<b>6,0 %</b>		
Upper Error Limit (UEL)						9,0 %		
Lower Error Limit (LEL)						3,0 %		

<sup>(1)</sup> To improve insight into areas with different risk profiles within the policy group, the sample was split up into segments.

<sup>(2)</sup> Numbers quoted in brackets represent the actual number of transactions.

## RESULTS OF EXAMINATION OF SYSTEMS FOR COHESION (REGIONAL POLICY AND EMPLOYMENT, SOCIAL AFFAIRS AND INCLUSION)

## Assessment of selected supervisory and control systems: Audit authorities (AA) — compliance with key regulatory requirements and effectiveness in ensuring the regularity of operations

Key requirements tested by the Court		Czech Republic AA for ERDF/CF/ESF	Greece AA for ERDF/CF/ESF	Italy-Sicily AA for ERDF/CF/ESF	Latvia AA for ERDF/CF/ESF	Hungary AA for ERDF/CF/ESF	Portugal AA for ERDF/CF/ESF	Romania AA for ERDF/CF/ESF
General aspects	The set up of the management and control systems of the operational programme provides for an appropriate definition, allocation and separation of functions within the AA and between the AA and other competent management and control bodies	Not compliant	Compliant	Compliant	Compliant	Compliant	Compliant	Compliant
Audit manual coverage	Existence of audit manual (for both audits on systems and audits on operations), which is in accordance with internationally accepted audit standards and clearly describes the audit procedures	Partially compliant	Compliant	Compliant	Compliant	Compliant	Compliant	Compliant
Audit methodology for systems audit	The audit work carried out by the AA to evaluate the effective functioning of the management and control system is based on a checklist that contains questions that verify key requirements of the applicable regulations (specified for MAs, IBs and CAs) and appropriate assessment criteria for each of these key requirements	Partially compliant	Compliant	Compliant	Compliant	Compliant	Compliant	Compliant
Review of audits on systems	The AA's audit plan had been implemented in accordance with the approved audit strategy for the period, audits on systems were carried out in accordance with the methodology established by the AA and all phases of the audits on systems were properly documented	Not effective	Effective	Effective	Effective	Effective	Effective	Effective

Key requirements tested by the Court		Czech Republic AA for ERDF/CF/ESF	Greece AA for ERDF/CF/ESF	Italy-Sicily AA for ERDF/CF/ESF	Latvia AA for ERDF/CF/ESF	Hungary AA for ERDF/CF/ESF	Portugal AA for ERDF/CF/ESF	Romania AA for ERDF/CF/ESF
Sampling methodology for audits of operations	An appropriate sampling methodology for audits of operations has been specified to draw the sample of operations to be audited for the period under review	Partially compliant	Compliant	Partially compliant	Compliant	Compliant	Compliant	Compliant
Drawing of sample for audits of operations	The sampling methodology for audits of operations has been used as specified to draw the sample of operations to be audited for the period under review	Partially effective	Effective	Partially effective	Effective	Effective	Effective	Effective
Audit methodology for audits of operations	The audit work carried out to examine the regularity of operations is based on a checklist that contains questions that verify the requirements of the applicable regulation at a sufficient level of detail to address the associated risks	Not compliant	Partially compliant	Compliant	Compliant	Partially compliant	Compliant	Partially compliant
Review of audits of operations	The audits of operations had been implemented in accordance with the sample selected for the period, were carried out in accordance with the methodology established by the AA and all phases of the audits of operations were properly documented	Partially effective	Effective	Effective	Effective	Effective	Effective	Partially effective
Re-performance of audits on operations	A re-performance by the Court of the AA's audits of operations resulted in findings similar to those of the AA, as reported to the Commission	Not effective	Effective	Effective	Effective	Effective	Effective	Effective

Key requirements tested by the Court		Czech Republic AA for ERDF/CF/ESF	Greece AA for ERDF/CF/ESF	Italy-Sicily AA for ERDF/CF/ESF	Latvia AA for ERDF/CF/ESF	Hungary AA for ERDF/CF/ESF	Portugal AA for ERDF/CF/ESF	Romania AA for ERDF/CF/ESF
Annual control report and audit opinion	The annual control report and audit opinion were established in accordance with the regulatory requirements and the guidance agreed between the Commission and the Member States, and the report and opinion are consistent with the results of the audits on systems and audits on operations carried out by the AA	Not compliant	Compliant	Partially compliant	Compliant	Compliant	Compliant	Partially compliant
Overall assessment <sup>(1)</sup>		Not effective	Effective	Partially effective	Effective	Effective	Effective	Partially effective

- <sup>(1)</sup> As for last year's examination of AAs (see the 2010 Annual Report, Annex 4.2), the following criteria are applied to obtain the overall assessment of the AA on the basis of the assessment of the specific key requirements tested:
- (a) *Effective*: the assessment of the key requirement 'Annual control report and audit opinion' is 'Compliant' and the assessments of the key requirements 'Review of audits on systems', 'Drawing on sample', 'Review of audits of operations' and 'Re-performance of audits on operations' are 'Effective'.
  - (b) *Partially effective*: the assessment of the key requirement 'Annual control report and audit opinion' is at least 'Partially compliant' and the assessments of the key requirements 'Review of audits on systems', 'Drawing on sample', 'Review of audits of operations' and 'Re-performance of audits on operations' are at least 'Partially effective'.
  - (c) *Not effective*: the assessment of the key requirement 'Annual control report and audit opinion' is 'Not compliant' or the assessments of at least one of the key requirements 'Review of audits on systems', 'Drawing on sample', 'Review of audits of operations' and 'Re-performance of audits on operations' is 'Not effective'.



## CHAPTER 6

**Employment and social affairs**

## TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	6.1-6.12
Specific characteristics of the policy group	6.3-6.11
Policy objectives	6.3
Policy instruments	6.4-6.9
Risks to regularity	6.10-6.11
Audit scope and approach	6.12
Regularity of transactions	6.13-6.18
Effectiveness of systems	6.19-6.26
In-depth examination of two audit authorities (AAs)	6.19-6.20
Assessment of the Commission's supervision of AAs	6.21-6.23
Reliability of Commission management representations	6.24-6.26
Conclusions and recommendations	6.27-6.30
Conclusions	6.27-6.28
Recommendations	6.29-6.30

## THE COURT'S OBSERVATIONS

## INTRODUCTION

6.1. This Chapter presents the Court's specific assessment of policy group 04 — Employment and social affairs. Key information on the activities covered and the spending in 2011 is provided in **Table 6.1**.

6.2. Employment and social affairs policy is mostly financed through the European Social Fund (ESF), which is governed by the same rules as the European Regional Development Fund (ERDF) and the Cohesion Fund (CF) as described in Chapter 5. Additional provisions for the ESF are set out in a specific regulation. For issues common to all three funds, reference is made in this Chapter to Chapter 5.

**Table 6.1 — Employment and social affairs — Key information 2011**

(million euro)

Budget Title	Policy area	Description	Payments	Management mode
04	Employment and social affairs	Administrative expenditure	93	Centralised direct
		European Social Fund	9 966	Shared
		Working in Europe — Social dialogue and mobility	59	Centralised direct
		Employment, social solidarity and gender equality	132	Centralised direct
		European Globalisation Adjustment Fund	114	Shared
		Instrument for Pre-Accession Assistance	28	Decentralised
			<b>10 392</b>	
Total administrative expenditure <sup>(1)</sup>			93	
Total operational expenditure			10 299	
<i>Of which: — advances</i>			128	
<i>— interim/final payments</i>			10 171	
<b>Total payments for the year</b>			<b>10 392</b>	
<b>Total commitments for the year</b>			<b>11 638</b>	

(1) The audit of administrative expenditure is reported in Chapter 9.

Source: 2011 annual accounts of the European Union.



## Specific characteristics of the policy group

### *Policy objectives*

6.3. The employment and social affairs policy group forms part of EU cohesion policy, which aims to reinforce economic, social and territorial cohesion within the EU by reducing the gap in the level of development between regions. Specifically, the main objectives of EU employment and social policy are to combat unemployment, to develop human resources and to promote integration in the labour market.

### *Policy instruments*

6.4. The European Social Fund (ESF) is the main tool for the implementation of employment and social policy, accounting for 97 % of the policy area spending in 2011. The ESF funds investments in human capital through training and other employment measures.

6.5. Other spending takes the form of subsidies and grants to organisations implementing and coordinating social and employment actions. This includes funding for the European Employment Services (EURES) network, which develops cooperation between the Commission and the Member States in the implementation of the European Employment Strategy, and the progress programme, which supports policy implementation in the Member States through studies, analysis and other measures.

6.6. Funding is also provided to EU Agencies: the European Institute for Gender Equality, the European Foundation for the Improvement of Living and Working Conditions, and the European Agency for Safety and Health at Work.

6.7. The European Globalisation Adjustment Fund (EGF) supports workers in the EU made redundant as a result of major structural changes in world trade patterns and of the financial and economic crisis. The Instrument for Pre-Accession Assistance (IPA) provides support to candidate countries in human resources development.

### **Management and control of spending**

6.8. ESF expenditure is subject to shared management by the Commission and the Member States. The ESF is governed by the management and control systems for cohesion spending as a whole, as described in the previous chapter (paragraphs 5.8 to 5.14).

6.9. The EGF is also implemented through shared management. For EGF, the budgetary authority decides on the appropriations and, the Commission reviews the applications for funding submitted by Member States and approves the payments. The IPA instrument is implemented through decentralised management while the other social and employment expenditure is implemented under direct centralised management.

**6.8.** *Although, as mentioned in paragraph 5.8, management and control systems for ESF, ERDF and CF are governed by common rules, in practice most ESF operational programmes have their own specific authorities and control systems.*

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Risks to regularity*

6.10. The main risks for ESF expenditure are related to the intangible nature of the investments in human capital (such as training courses), the diversity of the co-financed activities and the involvement of multiple, often small-scale, partners in the implementation of projects. These factors lend themselves to ineligible costs being accepted or calculation errors affecting the accuracy of claims, which are then not detected by the systems in place.

6.11. For EGF, the principal risk is that the applications contain inaccurate information, which is not detected by the Commission during approval or in subsequent checks. For IPA, the main risk is related to the ability of the candidate countries to set up and operate the necessary structures and controls. For the other social and employment spending, the main risk is that beneficiaries may include ineligible costs in their cost claims.

**Audit scope and approach**

6.12. **Annex 1.1, Part 2**, of Chapter 1 describes the Court's overall audit approach and methodology. For the audit of employment and social affairs, the following specific issues should be noted:

- (a) the audit involved examination of a sample of 180 interim and final payments;
- (b) the assessment of systems focused on two audit authorities (AAs) for the 2007-2013 programming period in cohesion;
- (c) the review of Commission management representations covered the Annual Activity Report of DG Employment, Social Affairs and Inclusion (DG EMPL).

**REGULARITY OF TRANSACTIONS**

6.13. **Annex 6.1** contains a summary of the results of transaction testing. The Court's testing of its sample of transactions found 40 % of the 180 payments audited to be affected by error. The most likely error estimated by the Court is 2,2 % <sup>(1)</sup>.

**6.10.** *The Commission has taken specific actions in order to mitigate the risks identified, which include in particular preventive and corrective measures, such as guidance, training, and interruptions of payments.*

**6.13.** *The most likely error rate estimated by the Court in 2011 is in line with the positive development in recent years. This is the result of improvements made by Member States in their management and control systems, the strict interruptions and suspensions policy applied by DG EMPL since 2008 and the positive impact of the simplification measures provided in the regulations for the current programming period.*

<sup>(1)</sup> The Court calculates its estimate of error from a representative statistical sample. The figure quoted is the best estimate (known as the MLE). The Court has 95 % confidence that the rate of error in the population lies between LEL 0,9 % and UEL 3,4 % (the lower and upper error limits respectively).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

6.14. Management and control systems established in the Member States should provide procedures for ensuring the correctness and regularity of declared expenditure<sup>(2)</sup>. The results of the Court's audit indicate weaknesses in particular in the 'first level checks' of the expenditure, which are the responsibility of the managing authorities and intermediate bodies in the Member States.

6.15. For ESF, the Court considers, on the basis of its review of each transaction affected by error, that sufficient information was available for the Member State authorities to have detected and corrected at least some of the errors before certifying the expenditure to the Commission for 76 % of the transactions affected by error.

#### Ineligible and incorrectly calculated costs

6.16. The Court detected the reimbursement of ineligible costs (eligibility errors) in 13 % of the 180 transactions audited. All of these eligibility errors related to ESF projects. Such errors account for 77 % of all quantifiable errors and make up approximately 73 % of the estimated error rate for this policy group (see example 6.1).

#### Example 6.1 — Ineligible costs

- (a) *Ineligible training participants*: ESF funding was provided for training courses to increase the qualifications and knowledge of employees working in the electronics sector. The Court found that many of the participants were employed outside of the electronics sector and were therefore not eligible for such training. The cost declared for the ineligible participants was 29 % of the audited amount.
- (b) *Overcharging of staff costs*: ESF funding was provided to a commercial association, as support for its activities, which included the provision of advice to small and medium-sized enterprises (SMEs). The costs of several staff members of the association were charged to the ESF project, although evidence supporting the charging of their time to the project could not be provided. The Court considers that the project staff costs have been overcharged by 60 %.

As shown in Table 1.3 of Chapter 1, the combined most likely error for Regional Policy, Transport, Energy and Employment and Social Affairs decreased considerably compared to 2010, from 7,7 % to 5,1 %.

**6.14.** Managing authorities are required to perform documentary checks on all claims submitted by beneficiaries, before certification of expenditure. However, on-the-spot verifications on operations may also intervene at a later stage of project implementation, after certification and up to closure, which explains why part of the errors in the Court's sample could not be detected. The impact of the control system in reducing error rates is usually only seen in subsequent years, after all layers of controls have been implemented.

**6.15.** The Commission is strictly following up these cases to ensure that appropriate action plans are implemented in the concerned systems in order to prevent errors prior to certification of expenditure in the future.

See also reply to paragraph 6.14.

**6.16 and 6.17.** The Commission will follow up all errors reported by the Court and will ensure that corrective measures are adopted by the Member States and, where necessary, financial corrections made.

<sup>(2)</sup> Article 58(c) of Council Regulation (EC) No 1083/2006 (OJ L 210, 31.7.2006, p. 25).

## THE COURT'S OBSERVATIONS

- (c) *Ineligible staff costs*: for a professional training course, the expenditure declared by the beneficiary included payments received by staff working on the project as termination of employment benefits. However, the national eligibility rules specify that such payments are considered ineligible. Therefore, 2,5 % of the declared costs for the audited project is considered as being ineligible.

6.17. A further 3 % of the 180 transactions audited concerned projects where the costs claimed for reimbursement had been incorrectly calculated (*accuracy errors*). These errors represent 20 % of all transactions affected by quantifiable error and make up approximately 9 % of the total estimated error rate (see example 6.2).

**Example 6.2 — Incorrectly calculated costs**

- (a) *Incorrect calculation of overhead costs*: for a project consisting of training courses for unemployed persons, the overhead costs for the project were allocated using a ratio based on the proportion of the area of the building used by the project. The Court found that the ratio had been incorrectly calculated, leading to an overstatement of 2,4 % of the audited amount.
- (b) *Incorrectly calculated cost declaration*: the project concerned measures for upgrading the quality of education and modernising the educational system, managed by local authorities. The Court identified a difference in the amount declared by the audited local authority to the managing authority, compared to the amount for the project declared by the managing authority to the Commission. The managing authority had made calculation errors when compiling the reporting from the local authority, resulting in an overstatement of eligible costs of 6,7 % of the audited amount.

**Numerous failures to observe procedural requirements**

6.18. Almost all of the transactions affected by non-quantifiable error found by the Court (40 out of 42) concerned various failures by managing authorities and beneficiaries to observe procedural requirements in the management and implementation of ESF projects. In 23 cases, the failures are considered by the Court as serious issues of non-compliance. Example 6.3 shows the main categories of such error.

## THE COMMISSION'S REPLIES

**6.18.** *The Commission will follow up all errors reported by the Court and ensure that corrective measures take place.*

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Example 6.3 — Failures to observe procedural requirements**

- (a) *Absence of separate accounting*: for a set of vocational training actions targeting young unemployed persons, the project accounting did not separately identify all expenditure related to the project, such as the staff salary costs. In the absence of adequate separate accounting, there is no assurance that the costs have not also been declared for other projects.
- (b) *Non-compliance with accreditation rules for training companies*: the beneficiary was a training company which, in order to maintain its accredited status, should have put procedures in place to measure the degree of satisfaction of trainees and to follow up whether or not they had gained employment as a result of the training. The Court found that the beneficiary had not complied with these requirements.
- (c) *Contract award notice sent late*: according to public procurement rules contracting authorities must send a notice of the results of the award procedure no later than 48 days after the award of the contract. The Court found three cases where this rule has not been followed.

**EFFECTIVENESS OF SYSTEMS****In-depth examination of two audit authorities (AAs)**

6.19. The Court assessed the work of two audit authorities (AAs) in two Member States in 2011, as part of its examination of a total of seven AAs covering the ERDF, CF and ESF. The scope of the Court's audit is described in paragraph 5.40. For the two ESF AAs audited in Italy (Sicily) and Latvia the review of their work and re-performance of their audits of operations focused on ESF expenditure. The results of the Court's audit of the AAs for all Structural Funds are reported in Chapter 5 (paragraphs 5.41 to 5.43 and **Annex 5.2**).

**6.19.** *The audit authorities indeed play a central role in the assurance building process, as from the beginning of the programming period and set-up of systems. Thereafter, they report each year an audit opinion on the functioning of management and control systems to the Commission, based on audits on management and control systems and on statistical samples of operations carried out in accordance with an audit strategy. For this reason the Commission is closely cooperating and coordinating with them, and has started reviewing their methodologies and audit results as early as 2009. This contributed to capacity building by providing advice, guidance and recommendations to audit authorities through the Commission's reperformance work. The regulation provides the Commission the possibility to rely on the work of an audit authority for its assurance under certain conditions (Article 73).*

## THE COURT'S OBSERVATIONS

6.20. The AA of Latvia is rated as effective in complying with key regulatory requirements and in ensuring the regularity of transactions. The AA of Italy (Sicily) is rated as partially effective. The Court noted particular problems in the AA's sampling of operations for audit and in its extrapolation of errors, which led to the disclosure of an understated error rate in the AA's Annual Control Report (ACR). The Commission, based on its own work, also considered the error rate as unreliable (see paragraphs 5.42 to 5.43).

**Assessment of the Commission's supervision of AAs**

6.21. The results of the Court's review of the Commission's supervision of AAs are shown in paragraphs 5.44 to 5.51.

6.22. The Court found that in all cases where the Commission identified specific weaknesses as a result of its enquiries in Member States, the national authorities were notified about the corrective action to be taken (paragraph 5.47).

6.23. The Court is of the opinion that the Commission drew appropriate conclusions from its reviews of ACRs and that the Commission, based on its assessment, had adjusted the reported error rates where necessary (paragraph 5.51).

**Reliability of Commission management representations**

6.24. The Court assessed the 2011 Annual Activity Report (AAR) and accompanying declaration of the Director-General for DG Employment, Social Affairs and Inclusion. In particular, with regard to the regularity of payments authorised during 2011, the Court:

- (a) assessed the reservations made in the AAR;
- (b) checked the consistency and accuracy of the Commission's calculation of the residual error rate and the amounts of 'payments at risk'.

6.25. DG EMPL estimates that the overall error rate for the 2011 interim payments in the 2007-2013 programming period is in the range of 2 % to 2,5 %. The Annual Activity Report of DG EMPL contains a reservation relating to the payments made for the 2007-2013 programming period for an amount of 58,7 million euro covering 24 of 117 OPs and a reservation, without financial impact, for the 2000-2006 programming period.

## THE COMMISSION'S REPLIES

**6.20.** *In 2011, DG EMPL carried out audits to review the work of 42 ESF audit authorities, including the AA of Sicily and Latvia. In this sample, 12 AAs were selected following a risk analysis, updated on an annual basis, and the other 30 were chosen at random. Based on its own audit work, DG EMPL concurs with the assessment of the two AAs sampled by the Court.*

**6.25.** *Further to the Court's positive assessment of DG Employment's Annual Activity Report 2010, the Court made a recommendation with regard to risks related to Operational Programmes with an estimated error rate below 5 %. In order to address these risks, DG EMPL has enhanced its methodology which now includes this category in the assessment of the potential reservations to be made. Therefore, the methodology applied in the 2011 AAR is stricter, in line with the Court's recommendation.*

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

6.26. DG EMPL has issued its reservations for those OPs of the 2000-2006 programming period for which the Member State had not yet adequately corrected weaknesses identified during the closure process. The Commission did not quantify these reservations (which are referred to by the Commission as the follow-up of last year's reservation). As shown by the Court's work there remains a risk that the closure might be based on unreliable closure documents leading to insufficient financial corrections (see paragraphs 5.63 to 5.64 and Special Report No 3/2012<sup>(3)</sup>, paragraphs 65 to 67).

**6.26.** *The Commission considers that the remaining risks referred to by the Court for the 2000-2006 programming period are being adequately covered during the ongoing closure process. The Commission services have made a thorough assessment of the closure documents submitted by the Winding Up Bodies and have taken the necessary measures to address the issues identified, including the interruption of the closure process, the request of additional information, the performance of closure audits based on its risk assessment and eventually for some programmes the application of financial corrections.*

*Based on the above closure procedures, only once the residual error for each operational programme is considered to be below the 2 % materiality threshold, the Commission proceeds with the final payment. Therefore, no quantification of the follow up reservations for the 2000-2006 programming period was made in DG EMPL's AAR since these had no impact on the final payments made in 2011.*

**CONCLUSIONS AND RECOMMENDATIONS****Conclusions**

6.27. Based on its audit work, the Court concludes that the payments for the year ended 31 December 2011 for employment and social affairs were affected by material error.

**6.27.** *The Commission notes the low error rate in 2011 which confirms the positive development in recent years. This improvement has been achieved thanks to appropriate action taken by Member States, and an effective interruptions and suspensions policy applied by DG EMPL since 2008 coupled with a successful implementation of simplification measures.*

*The Commission intends to continue, in partnership with Member States, with its efforts to further improve on its performance as recommended by the Court.*

6.28. Based on its audit work on the examined supervisory and control systems, the Court found that:

- (a) audit authorities were partially effective in ensuring the regularity of operations for the 2007-2013 programming period;
- (b) the procedures of the Commission and Member States have been partially effective in carrying out the initial phase of the closure process for the 2000-2006 programming period.

**6.28.** *The Commission underlines that the effectiveness and quality of the work of audit authorities differs by programme and Member State, as shown by the Court's assessment in paragraph 5.41 and by the results of the Commission's audit work. In accordance with Article 73 of Council Regulation (EC) No 1083/2006, the Commission is as from June 2012 formally relying on the work of nine audit authorities for ESF. The Commission will continue to review the work of the remaining audit authorities and to monitor the situation for programmes for which an Article 73 letter was granted.*

<sup>(3)</sup> <http://eca.europa.eu>

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*The Commission considers to have established robust procedures and guidance for the closure process, and considers that most Member States have carried out important and professional work to enable the closure of programmes and to increase assurance at closure. The Commission also considers to have made a comprehensive work at closure, analysing thoroughly all closure documents, carrying out additional audits and enquiries where necessary, which has led in many cases to additional financial corrections being applied at closure to address remaining risks.*

**Recommendations**

6.29. **Annex 6.2** shows the results of the Court's review of progress in addressing recommendations made in previous annual reports (2008 and 2009) for the cohesion area. The following points should be noted:

- (a) the Commission has published a working document in May 2011 on the main audit findings regarding the application of public procurement rules, in view of launching a discussion with Member States on reducing non-compliance with public procurement rules;
- (b) the Commission has continued its programme of audits in the Member States during the current programming period, but, as demonstrated by the results of the Court's audit, the national management and control systems are only partially effective;
- (c) the Commission has continued to interrupt or suspend payments, and to impose financial corrections, but the expenditure certified to the Commission by the Member States remains affected by material error.

**6.29.**

- (a) *The Commission has made considerable efforts to ensure strict compliance with eligibility requirements and the correct application of public procurement rules. Training and guidance have been provided on eligibility and public procurement rules. Moreover, when it identifies complex rules at programme level, the Commission makes recommendations to simplify the rules. It has also shared with Member States an analysis of the types of procurement errors detected by EU audits in cohesion policy during previous years and has launched an exercise to collect best practices and possible answers by Member States to remedy such errors and reduce their occurrence.*

*The application of public procurement rules is mostly relevant to ERDF and CF funding and has a limited impact on ESF funded projects.*

- (b) and (c) *In the course of its extensive audit work, the Commission notified targeted recommendations to management and control authorities to remedy the identified weaknesses.*

*The Commission will continue to pursue a strict approach to interruptions and suspensions. As a result of this policy and efforts made by Member States a positive impact on the error rate in the Cohesion area can be observed (see Table 1.3 of Chapter 1).*



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

6.30. Following this review and the findings and conclusions for 2011, the Court recommends that the Commission:

- **Recommendation 1:** strictly requires compliance with the eligibility requirements for ESF funding and, on the basis of its experience gained during the 2007-2013 programming period, carries out an assessment of the use of national eligibility rules in view of identifying possible areas for further simplification and to eliminate potential sources of errors for the period after 2013;
  
- **Recommendation 2:** reminds Member States of their responsibility to provide for procedures which ensure the correctness and regularity of expenditure declared and addresses the weaknesses in 'first level checks' by managing authorities and intermediate bodies through further guidance and training measures;
  
- **Recommendation 3:** encourages national authorities to rigorously apply the corrective mechanisms prior to certification of the expenditure to the Commission (2008). Whenever significant deficiencies in the functioning of the management and control systems are identified, the Commission should interrupt or suspend payments until remedial corrective action has been taken by the Member State and make financial corrections if necessary;
  
- **Recommendation 4:** provides further guidance to AAs for the current programming period, in particular on sampling and the scope of verifications to be undertaken for audits of projects and quality control;
  
- **Recommendation 5:** rigorously verifies the accuracy and completeness of information disclosed by AAs in their ACRs and audit opinions. The Commission's verification should take full account of the information available on system audits and audits of operations undertaken by the AAs;

**6.30.** See joint reply to paragraphs 1.12 and 1.13.

*The Commission has committed in 2010 to continue to monitor compliance with eligibility rules through its regular audit activity and the follow-up of all EU and national audits. Information on this is reported in the annual activity report of the Director-General of DG EMPL. When necessary the Commission will continue to take corrective measures.*

*In terms of assessing national eligibility rules and seeking further ways of simplification, the Commission refers to the significant efforts already made in this regard as part of its targeted action plan on specific Member States where recurring issues have been identified. The Commission will continue to pursue these efforts with a special focus on tackling ineligible costs, overcharged staff costs and streamlining national rules.*

*The Commission will continue to draw Member States' attention to the critical importance of the recurring issues identified by the Court concerning management verifications.*

*The Commission took the commitment in 2010, to continue to timely interrupt or suspend payments, when necessary. This strict policy is again reflected in the 2011 Annual Activity Report of the Director-General of DG EMPL (see Commission reply to paragraph 6.29(c)).*

*The Commission will continue to provide guidance and advice to audit authorities on a wide range of technical and regulatory issues. In this respect, DG REGIO and DG EMPL organised a seminar in June 2012, during which guidance on sampling was provided.*

*The ACRs are one of the main elements on which the Commission builds its assurance. As such, full account is taken of the information provided therein. Further guidance has been provided on the treatment of error rates for the ACR 2011.*

## THE COURT'S OBSERVATIONS

- **Recommendation 6:** encourages the use by Member States of the simplified cost options permitted in the regulations in order to reduce the scope for error.

## THE COMMISSION'S REPLIES

*As explained in DG EMPL's 2011 AAR, a thorough review of all ACRs is conducted every year; it constitutes the basis for the formulation of reservations in view of ensuring their reliability and consistency with the abovementioned guidance.*

*The Commission continues its efforts to provide advice, training and guidance to Member States so that this possibility offered by the regulations leads to real simplification for all stakeholders.*

*Some 70 % of the OPs use at least one of the simplified cost options. Among the different options, flat rate for indirect costs and standard scale of unit costs are the most used.*

## ANNEX 6.1

## RESULTS OF TRANSACTION TESTING FOR EMPLOYMENT AND SOCIAL AFFAIRS

	2011				2010	2009	2008
	ESF	IPA	Other social matters	Total			
<b>SIZE AND STRUCTURE OF THE SAMPLE</b>							
Total transactions (of which):	160	6	14	<b>180</b>	66	44	49
Advances	0	0	0	<b>0</b>	0	0	0
Interim/Final payments	160	6	14	<b>180</b>	66	44	49
<b>RESULTS OF TESTING <sup>(1)</sup> <sup>(2)</sup></b>							
<b>Proportion (number) of transactions tested found to be:</b>							
Free of error	56 % (90)	100 % (6)	86 % (12)	<b>60 % (108)</b>	73 %	75 %	82 %
Affected by one or more errors	44 % (70)	0 % (0)	14 % (2)	<b>40 % (72)</b>	27 %	25 %	18 %
<b>Analysis of transactions affected by error</b>							
<b>Analysis by type of error</b>							
Non-Quantifiable errors:	59 % (41)	0 % (0)	50 % (1)	<b>58 % (42)</b>	39 %	0 %	56 %
Quantifiable errors:	41 % (29)	0 % (0)	50 % (1)	<b>42 % (30)</b>	61 %	100 %	44 %
Eligibility	79 % (23)	0 % (0)	0 % (0)	<b>77 % (23)</b>	91 %	64 %	50 %
Occurrence	4 % (1)	0 % (0)	0 % (0)	<b>3 % (1)</b>	9 %	0 %	0 %
Accuracy	17 % (5)	0 % (0)	100 % (1)	<b>20 % (6)</b>	0 %	36 %	50 %
<b>ESTIMATED IMPACT OF QUANTIFIABLE ERRORS</b>							
Most likely error rate				<b>2,2 %</b>			
Upper error limit (UEL)				3,4 %			
Lower error limit (LEL)				0,9 %			

<sup>(1)</sup> To improve insight into areas with different risk profiles within the policy group, the sample was split up into segments.

<sup>(2)</sup> Numbers quoted in brackets represent the actual number of transactions.

## FOLLOW-UP OF PREVIOUS RECOMMENDATIONS FOR COHESION

Year	Court recommendation	Court's analysis of the progress made	Commission reply
2009	<p><b>Cohesion:</b></p> <p>The Commission should monitor compliance with the eligibility requirements for EU funding, including the correct application of the EU and national public procurement rules</p> <p>(see the 2009 Annual Report, paragraph 4.38)</p>	<p>The Commission issues guidance to Member States' managing and audit authorities. In May 2011, the Commission published a working document on the main audit findings regarding the application of public procurement rules, in view of launching a discussion with Member States on reducing the number of public procurement errors in Structural Funds projects. The Commission's overall evaluation of the impact and effectiveness of EU public procurement legislation was published in June 2011.</p>	<p><i>The Commission has explained in the Staff Working Document (SEC(2011) 1179 dated 5.10.2011) the specific actions undertaken in order to mitigate the risks identified, which include in particular preventive and corrective measures, such as guidance, training, and interruptions of payments.</i></p>
	<p><b>Cohesion:</b></p> <p>The Commission should ensure that the substitution of ineligible with new expenditure (withdrawal) does not result in new irregular expenditure being declared by Member States.</p> <p>(see the 2009 Annual Report, paragraph 4.37(b)).</p>	<p>The Commission is following up this risk during the closure of the 2000-2006 programmes. The Commission's proposal for the 2014-2020 regulatory framework provides that, where irregularities affecting annual accounts are detected by EU audits, the resulting correction reduces funding to the OP, which would limit withdrawal and replacement of expenditure to the ongoing financial year.</p>	<p><i>The Commission proposal for the 2014-2020 regulatory framework provides, within a logic of annual closure, that 'where irregularities affecting annual accounts sent to the Commission are detected by the Commission or the Court, the resulting financial correction shall reduce support from funds to the operational programme'. The proposal thereby limits the possibilities of withdrawal/replacement.</i></p>
2009 and 2008	<p><b>Cohesion:</b></p> <p>The Commission should ensure, through its supervision, an effective functioning of the national management and control systems</p> <p>(see the 2009 Annual Report, paragraph 4.37(c); the 2008 Annual Report, paragraphs 6.37(a) and (c))</p>	<p>The Commission performs compliance assessments of the national management and control systems at the beginning of the programming period and carries out audits throughout the programming period. In addition, for the 2007-2013 programming period, the Commission increasingly relies on national audit authorities (AAs) to seek to obtain assurance on the effective functioning of the systems. In 2011, the Commission has continued its examination of the work of the AAs for 2007-2013 OPs, including in-depth enquiries of AAs (see paragraphs 5.35 to 5.37 and 5.44 to 5.51). As a whole, the management and control systems are partially effective in ensuring the regularity of transactions: payments for ERDF, CF and ESF remain subject to material error.</p>	<p><i>The Commission has strengthened its supervisory role since the adoption of the 2008 Action Plan and continues to implement a strict policy of suspensions and interruptions of payments as soon as deficiencies are identified. Those persistent actions have improved the effective functioning of the management and control systems in Member States and the lower error rates reported by the Court for the DAS 2011 confirm this positive development.</i></p> <p><i>As explained in the reply to paragraph 5.44, the Commission reliance on audit authorities is based on extensive audit work. The Commission welcomes the Court's assessment that it notified the Member States about the corrective action to be taken in all cases where specific weaknesses were identified (see paragraph 5.47). On the basis of this audit work, the Commission is as from July 2012 formally relying on the work of 13 audit authorities for ERDF/CF and 9 audit authorities for ESF.</i></p>

Year	Court recommendation	Court's analysis of the progress made	Commission reply
2009 and 2008	<p><b>Cohesion:</b></p> <p>The Commission should encourage national authorities to rigorously apply the corrective mechanisms prior to certification of the expenditure to the Commission</p> <p>(see the 2009 Annual Report, paragraph 4.37(a); the 2008 Annual Report, paragraphs 6.37(b) and (d))</p>	<p>The Commission has continued its policy of interruption or suspension of payments in case of serious irregularities or systems deficiencies. Member States are requested to send information on financial corrections to the Commission by 31 March each year. The Commission may impose financial corrections where the Member State fails to take appropriate corrective measures. In 2011, for 2007-2013 programmes, the Commission has decided financial corrections of 217,6 million euro for ESF and 2,7 million euro for ERDF. However, the certified statements of expenditure submitted by Member States to the Commission continue to be affected by material error.</p>	<p><i>An audit of the Member States' systems has been launched beginning 2011 with the objective to improve the reporting of national financial corrections to the Commission, and ensure completeness, accuracy and timeliness of reporting. The results showed improvements in MSs systems to apply financial corrections and report on them. Moreover, the multiannual nature of the expenditure and control cycle allows financial corrections at various stages of implementation, including at closure where final checks are performed on the legality and regularity of expenditure and final corrections are made where necessary.</i></p>



## CHAPTER 7

**External relations, aid and enlargement**

## TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	7.1-7.14
Specific characteristics of the policy group	7.2-7.6
Risks characteristics	7.7-7.11
Budget support	7.9-7.10
Eligibility for co-financed actions	7.11
Audit scope and approach	7.12-7.14
Regularity of transactions	7.15-7.20
Effectiveness of systems	7.21-7.25
DG ECHO	7.22
FPI	7.23-7.24
Commission's management representations	7.25
Conclusions and recommendations	7.26-7.28
Conclusions	7.26-7.27
Recommendations	7.28

## THE COURT'S OBSERVATIONS

## INTRODUCTION

7.1. This Chapter presents the Court's specific assessment of external relations, aid and enlargement, which comprises policy areas: 19 — External relations, 21 — Development and relations with African, Caribbean and Pacific (ACP) States <sup>(1)</sup>, 22 — Enlargement, and 23 — Humanitarian aid. Key information on the activities covered and the spending in 2011 is provided in **Table 7.1**.

**Table 7.1 — External relations, aid and enlargement — Key information 2011**

(million euro)

Budget Title	Policy area	Description	Payments	Management mode
19	External relations	Administrative expenditure	157	Centralised direct
		Cooperation with third countries in the area of migration and asylum	39	Centralised direct
		Common foreign and security policy (CFSP)	308	Centralised indirect/joint
		European instrument for democracy and human rights (EIDHR)	123	Centralised direct
		Relation and cooperation with industrialised non-member countries	20	Centralised direct
		Crisis response and global threats to security	238	Centralised direct/joint
		European neighbourhood policy and relations with Russia	1 448	Centralised direct/decentralised
		Relations with Latin America	282	Centralised direct/decentralised
		Relations with Asia, Central Asia and Middle Eastern countries	670	Centralised direct/decentralised/joint
		Policy strategy and coordination	28	Centralised direct
		<b>3 313</b>		
21	Development and relations with ACP States	Administrative expenditure	338	Centralised direct
		Food security	320	Centralised direct
		Non-State actors in development	202	Centralised direct
		Environment and sustainable management of natural resources, including energy	136	Centralised direct
		Human and social development	172	Centralised direct/joint
		Geographical cooperation with African, Caribbean and Pacific (ACP) States	300	Centralised direct/decentralised/joint
		Development cooperation actions and ad hoc programmes	30	Centralised direct
		Policy strategy and coordination	15	Centralised direct
		<b>1 513</b>		

<sup>(1)</sup> Aid provided through the European Development Funds is reported separately as it is not financed from the general budget.



(million euro)

Budget Title	Policy area	Description	Payments	Management mode
22	Enlargement	Administrative expenditure	93	Centralised direct
		Enlargement process and strategy	835	Centralised direct/indirect/decentralised
			<b>928</b>	
23	Humanitarian aid	Administrative expenditure	33	Centralised direct
		Humanitarian aid	1 008	Centralised direct/joint
		Civil Protection Financial Instrument	27	Centralised direct
			<b>1 068</b>	
Total administrative expenditure <sup>(1)</sup>			<b>621</b>	
Total operational expenditure			<b>6 201</b>	
Of which: — advances			4 080	
— interim/final payments			2 121	
<b>Total payments for the year</b>			<b>6 822</b>	
<b>Total commitments for the year</b>			<b>8 285</b>	

(<sup>1</sup>) The audit of administrative expenditure is reported in Chapter 9.

Source: 2011 annual accounts of the European Union.

#### THE COURT'S OBSERVATIONS

### Specific characteristics of the policy group

7.2. The external relations and development budget was implemented in 2011 by the DG for Development and Cooperation — EuropeAid and also by the Service for Foreign Policy Instruments (FPI).

7.3. The budget (around 3 840 million euro <sup>(2)</sup>) implemented by EuropeAid covers:

- (a) development assistance to, and economic cooperation with, countries in Asia, Latin America and ACP States;
- (b) the 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.

7.4. Development projects are dispersed through more than 150 countries, and the implementing organisations vary greatly both in size and experience. To be eligible for EU support, projects are required to comply with complex rules including tendering and contract award procedures.

(<sup>2</sup>) Under budget Titles 19 and 21, as set out in **Table 7.1**.

## THE COURT'S OBSERVATIONS

7.5. The Service for Foreign Policy Instruments is a Commission department established on 1 January 2011, reporting directly to the High Representative of the Union for Foreign Affairs and Security Policy. Expenditure managed by FPI (around 490 million euro <sup>(3)</sup>) mainly relates to actions implemented under:

- (a) the common foreign and security policy (CFSP) (indirect centralised management), supporting the preservation of stability in sensitive countries and the non-proliferation of weapons of mass destruction;
- (b) the Instrument for Stability (IfS) (direct centralised/joint management), supporting the prevention, management and resolution of conflicts and the peace-building activities;
- (c) the Election Observation Missions (EOMs) (direct centralised management) aiming at strengthening democratisation, good governance and conflict prevention; and
- (d) the Industrialised Countries Instrument (ICI) (direct centralised management) which is the main vehicle for improving cooperation with industrialised countries.

7.6. The enlargement budget <sup>(4)</sup> (835 million euro <sup>(5)</sup>) was implemented by the Directorate-General for Enlargement (DG ELARG) and the humanitarian aid budget <sup>(6)</sup> by the Directorate-General for Humanitarian Aid and Civil Protection — ECHO (1 008 million euro <sup>(7)</sup>). DG ECHO is also in charge of the European Civil Protection Mechanism <sup>(8)</sup> (27 million euro <sup>(9)</sup>).

<sup>(3)</sup> Under budget Title 19.

<sup>(4)</sup> Mainly under the Instrument for Pre-Accession Assistance, the Phare programme including post-accession aid, CARDS, and pre-accession financial assistance for Turkey.

<sup>(5)</sup> Under budget Title 22.

<sup>(6)</sup> Approximately half of the budget is provided to non-governmental organisations (NGOs) and the other half to UN or other international organisations. Funding agreements are only concluded with NGOs that have signed the Framework Partnership Agreement or UN organisations that have signed the Financial Administrative Framework Agreement.

<sup>(7)</sup> Under budget Title 23.

<sup>(8)</sup> Is aimed at supporting the efforts of the Member States, EFTA, candidate countries and third countries concerning response, preparedness and prevention actions with regard to natural and man-made disasters, acts of terrorism and technological, radiological or environmental accidents.

<sup>(9)</sup> Under budget Title 23.

## Risks characteristics

7.7. Most of the budget managed by the DGs/Service is implemented on the basis of advances, which only require compliance with a limited number of conditions. Interim and final payments on the other hand are conditional upon the submission and validation of expenditure actually incurred for the project and is therefore in general subject to greater risk of errors in legality and regularity than advances.

7.8. The inherent nature of some instruments and payment modalities of the policy area allow the Commission a considerable degree of flexibility in determining the eligibility of expenditure. Therefore these operations are less prone to legality and regularity errors.

## Budget support

7.9. The EU regulations governing cooperation with partner countries<sup>(10)</sup> stipulate that direct budgetary assistance<sup>(11)</sup> in support of macroeconomic or sectoral reforms is conditional upon public financial management (PFM) in the recipient countries being sufficiently transparent, accountable and effective.

7.10. These legal provisions offer broad scope for interpretation<sup>(12)</sup> and what is considered as 'sufficient' in terms of transparency, accountability and effectiveness of PFM can vary greatly, depending on the specific situation of the country but also on the direction taken by its government. Under such circumstances, it should be recalled that:

**7.8.** *The Commission operates in the framework of the legislation in force approved by the European Parliament and the Council.*

**7.9-7.10.** *The Commission does not fully share the Court's analysis of the operation of budget support.*

*Budget support operates in a development context where core government systems such as public financial management can have major weaknesses. Nevertheless eligibility conditions are rigorous. A partner country is eligible for budget support only when the government has a relevant and credible strategy in place to address these weaknesses. The Commission can also require specific short term measures to mitigate risks. New budget support guidelines<sup>(1)</sup> (which were revised in 2012 following the Commission proposals<sup>(2)</sup> and Council Conclusions of 14 May 2012 for a new approach to budget support) now include a number of new provisions to further clarify the rules. This includes new eligibility rules on transparency and oversight, a formal risk assessment process and a senior management governance framework.*

<sup>(10)</sup> Article 25(b) of 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 15(1) of Council Regulation (EC) No 1085/2006 of 17 July 2006 establishing an Instrument for Pre-Accession Assistance (IPA) (OJ L 210, 31.7.2006, p. 82), Article 15(2)(e) of 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) and Article 11(1)(b) of Regulation (EC) No 1717/2006 of the European Parliament and of the Council of 15 November 2006 establishing an Instrument for Stability (OJ L 327, 24.11.2006, p. 1).

<sup>(11)</sup> The budget support payments made in 2011 from the general budget are 1 billion euro.

<sup>(12)</sup> See paragraph 46 the Court's Annual Report on the activities of the sixth, seventh, eighth and ninth European Development Funds (EDFs) for the financial year 2003 (OJ C 293, 30.11.2004, p. 315).

<sup>(1)</sup> See [http://ec.europa.eu/europeaid/what/economic-support/documents/guidelines\\_budget\\_support\\_en.pdf](http://ec.europa.eu/europeaid/what/economic-support/documents/guidelines_budget_support_en.pdf)

<sup>(2)</sup> See the Commission's Communication on The Future Approach to EU Budget Support to Third Countries (COM(2011) 638 final).

## THE COURT'S OBSERVATIONS

- (a) budget support is often provided to countries with weak PFM systems. One important risk is that the budget of the recipient country may be affected by fraud and corruption. Given that the funds transferred under budget support operations are merged with other budget resources within the country's budget (known as 'fungibility'), they are also exposed to the same PFM weaknesses;
- (b) as budget support operations are implemented through the partner countries' PFM systems, processes and institutions, the Court's audit of legality and regularity cannot go beyond the stage where the aid is paid into the partner countries' budgets;
- (c) the Commission has wide flexibility in deciding whether a partner country is eligible for budget support. Due to this broad scope for interpretation, budget support operations carried out by the Commission are less prone to legality and regularity errors.

*Eligibility for co-financed actions*

7.11. The Commission channels part of its aid through multi-donor actions implemented by international and UN organisations<sup>(13)</sup>. These contributions are fungible by nature. However, in some cases the Commission does not act as a provider of general support but seeks to restrict its contributions by reference to specific spending criteria. Should another donor follow the same approach and apply the same eligibility criteria for its contribution, there is a risk that overall spending does not meet the combined conditionality requirements of the Commission and the second donor(s).

## THE COMMISSION'S REPLIES

*Untargeted budget support is designed to reward results rather than finance activities. Therefore it is clear that audit cannot go beyond the stage where funds are transferred following the achievement of agreed conditions. However, the audit of activities which budget support payments may finance is the remit of national audit authorities to which accompanying programmes offer concrete support.*

*This aid delivery mechanism represents one of the ways in which the Commission has responded to calls by the international development community and EU stakeholders for more effective interventions which focus on results and ownership and are less administratively complex, thereby reducing transaction costs for partner countries.*

7.11. *The Commission is not aware of any specific problems with the 'notional approach' (which has been developed in recent years to allow the Commission to participate in multi-donor actions including trust funds). This approach guarantees that the legal requirements applicable to EU funding in external actions are met (by ensuring that the amount contributed by other donors is sufficient to pay for any activities which are ineligible under EU rules) while spending EU funds in the most efficient way (through donor coordination), in accordance with the principle of sound financial management.*

*The Commission limits this risk by assessing the accounting, audit, internal control and procurement procedures of the partner international organisations in advance of any joint working, the presence of its staff in the field (and participation in steering groups) and the rigorous overall financial reporting required of the international organisation. In addition, during the implementation of external actions, systems are regularly reviewed through the performance of verification missions undertaken by external auditors.*

*EuropeAid and ECHO auditors have not to date reported any findings or 'specific risks' of this nature, nor is the Commission aware of any other donor with 'the same eligibility criteria'.*

<sup>(13)</sup> The value of the contracts is estimated at 1,5 billion euro.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*The Commission believes that these internal control measures which it has put in place together with those of the international organisation concerned limits this theoretical risk to a level where it is indeed negligible.*

### Audit scope and approach

7.12. **Annex 1.1, Part 2**, of Chapter 1 describes the Court's overall audit approach and methodology. For the audit of external relations, aid and enlargement, the following specific issues should be noted:

- (a) the audit involved examination of a sample of 150 payments, comprising 30 advances and 120 interim and final payments. The advances audited covered 18 countries. The tested interim/final payments approved by Commission headquarters or EU delegations covered 11 countries<sup>(14)</sup>. In the case of DG ECHO, the audited interim/final payments were made under projects implemented by four DG ECHO partners<sup>(15)</sup>;
- (b) the assessment of systems covered the supervisory and control systems of EuropeAid, DG ECHO and FPI at headquarters as well as at EU delegations, where relevant, including:
  - (i) *ex-ante* controls;
  - (ii) monitoring and supervision;
  - (iii) *ex-post* controls/external audits;
  - (iv) internal audit.

7.13. These four layers of internal control have been identified by the Court to assess the range of controls that the external actions DGs can use to prevent, detect and correct errors affecting the legality and regularity of the expenditure.

7.14. The Court applies a rotation policy in the assessment of the supervisory and control systems. DG ELARG was not assessed for the year 2011; however a follow-up of previous years' recommendations was carried out (see **Annex 7.3**).

<sup>(14)</sup> Cameroon, Georgia, Malawi, Palestine, Philippines, Russia, Tunisia and Vietnam (EuropeAid) and Albania, Montenegro and Serbia (DG ELARG).

<sup>(15)</sup> Two based in Switzerland, one in France and another one in Ireland (payments made under 16 humanitarian aid projects implemented in 11 countries were audited).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**REGULARITY OF TRANSACTIONS**

7.15. **Annex 7.1** contains a summary of the results of transaction testing. The Court's testing of its sample of transactions found 33 % to be affected by error. The most likely error rate estimated by the Court is 1,1 % <sup>(16)</sup>. All the errors have been found in interim or final payments. Furthermore, the Court found a high frequency of non-quantifiable errors.

7.16. 22 out of 150 payments were affected by quantifiable errors. Most of these errors (16) were found in final payments. These errors had not been detected by Commission controls. The errors involve ineligible expenditure incurred at final beneficiary level such as: expenditure incurred outside the eligibility period, inclusion of ineligible expenditure (e.g. VAT, staff costs and unjustified overheads) charged in the project cost claims and expenditure without adequate supporting documents. Examples of errors are provided below (see example 7.1).

7.17. The fact that ineligible expenditure declared by final beneficiaries of grants or service providers has been paid by the Commission, shows that the preventive and detective controls applied by the Commission are not fully effective (e.g. insufficient number and limited scope of on-the-spot visits and direct testing of expenditure declared; insufficient quality of the expenditure verifications subcontracted by the beneficiaries).

**7.16.** *The Commission's checks are designed in such a way that the detection and correction of errors, through ex-post audits — after final payments — is still possible. An extensive programme of ex-post audits is managed by the external aid DGs on an annual basis, based on a formal risk assessment process.*

*The Commission considers that it operates in countries where it is often difficult if not impossible to prevent or correct a number of errors observed by the Court. For example, this is the case for contractors (often NGOs) who have difficulties getting mandatory VAT payments reimbursed by the State.*

**7.17.** *The Commission believes that detective and corrective measures prior to final payments (e.g. accreditation of beneficiaries, submission of reports, external audits, expenditure verifications and transactional checks by Commission staff) are effective <sup>(3)</sup>. In addition, potential irregularities can still be corrected ex-post through the launching of ex-post audits and appropriate recoveries. Nevertheless, the risk of financial error cannot be realistically reduced to zero.*

<sup>(16)</sup> The Court calculates its estimate of error from a representative statistical sample. The figure quoted is the best estimate (known as MLE). The Court has 95 % confidence that the rate of error in the population lies between LEL 0 % and UEL 2,4 % (the lower and upper error limits respectively).

<sup>(3)</sup> On the basis of the conclusions of the annual activity reports.

## THE COURT'S OBSERVATIONS

**Example 7.1 — Ineligible expenditure in a final payment**

EuropeAid — Cameroon

A final payment for a project providing assistance for banana suppliers in Cameroon was affected by serious eligibility errors<sup>(17)</sup>. There were irregularities in the tendering procedures carried out by the beneficiary. In addition, the beneficiary did not respect the Rule of Origin<sup>(18)</sup> when purchasing equipment.

An ECHO partner

A final payment under a grant agreement for promoting and supporting the welfare of displaced populations in Darfur was affected by several irregularities (e.g. costs incurred outside the eligibility period, incorrect allocation of shared costs and expenditure without adequate supporting documents)<sup>(19)</sup>.

## THE COMMISSION'S REPLIES

**Example 7.1 — Ineligible expenditure in a final payment**

EuropeAid — Cameroon

*The legislation in force does specifically allow for formal derogations to the restricted origin of goods rules, where duly justified. It is currently almost impossible to avoid sourcing goods from 'non-eligible' countries when implementing these kinds of projects in Africa. The beneficiary should have requested derogation to the Commission which would have been given if duly justified, as it was in this case as (due to the specialised nature of the tender) the (Columbian) bid was the only one received.*

An ECHO partner

*In the example given, ECHO insists on the fact that this humanitarian action was delivered in Darfur, which is one of the most difficult environments in the world characterised by unpredictability, volatility, insecurity and problematic access to affected people, which represents a major management challenge. Although some contractual requirements were not fully respected in this case, the Partner ensured that results were achieved. It is also worth noting that the two other transactions audited by the Court on the same partner, and implemented in different countries, were not affected by any errors. Nevertheless, ECHO reminded the Partner of its contractual duties and of the need to further improve its internal control systems.*

7.18. 27 transactions out of 150 were affected by 51 non-quantifiable errors, including 31 errors in contracting procedures carried out or endorsed by the Commission, 8 linked to budget support payments, and 11 relating to non-compliance with legal or contractual obligations.

7.19. The 31 errors in contracting procedures were detected in 22 of the 85 payments subject to a competitive awarding procedure. These procurement errors include:

- (a) unclear selection criteria or the use of a wrong type of procurement procedure (16);

7.19.

<sup>(17)</sup> The audited amount of the project is 1,6 million euro with an error rate of 81,7 %.

<sup>(18)</sup> The supplier and the goods have to originate from an ACP country or a Member State.

<sup>(19)</sup> The audited amount of the grant agreement is 0,42 million euro with an error rate of 13,2 %.

## THE COURT'S OBSERVATIONS

(b) insufficient documentation of the evaluation procedures and unequal treatment of candidates (9);

(c) contracts amended after the implementation period (3).

An example is provided hereafter (see example 7.2).

**Example 7.2 — Irregularity in a tendering procedure**

DG ELARG HQ

A tendering procedure for TAIEX<sup>(20)</sup> concerning three interim payments was found to be irregular. The Commission awarded the contract to a company that did not comply with the clause on expert availability, where others did. Indeed, according to the Terms of Reference provided to the tenderers, the starting date on which the experts had to be available was 1 April 2008. The experts proposed by the successful tenderer were only available as of 21 May 2008. The contract was nevertheless awarded to that company. This has been treated as non-quantifiable error.

## THE COMMISSION'S REPLIES

**Example 7.2 — Irregularity in a tendering procedure**

DG ELARG HQ

*The Commission's interpretation of the clause on expert availability did not confer any competitive advantages to the successful tenderer. It was obvious that the experts proposed by the tenderer would not be called to work in parallel under two different contracts with the Commission.*

7.20. In the case of 4 budget support transactions out of 8 audited, the Court found 8 non-quantifiable errors. This result from the fact that the Commission did not compare the PFM achievements of the recipient countries with the objectives set for the period under review and did not ensure that the recipient country applied the correct exchange rate.

**EFFECTIVENESS OF SYSTEMS**

7.21. **Annex 7.2** contains a summary of the results of the Court's examination of supervisory and control systems. The Court found that the systems of EuropeAid, DG ECHO and FPI were partially effective. The detailed results of the assessment of EuropeAid systems are presented in the Court's Annual Report on the eighth, ninth and 10th European Development Funds.

7.21. For EuropeAid please see reply to the 2011 Annual Report on the EDFs, paragraph 56.

<sup>(20)</sup> TAIEX — Technical Assistance and Information Exchange Instrument.



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**DG ECHO**

7.22. In recent years, DG ECHO has continued to improve all the components of its supervisory and control systems. However, due to the frequency of quantifiable errors found in the final payments (10 out of 16) the *ex-ante* control procedures are considered partially effective (see paragraphs 7.16 and 7.17).

**FPI**

7.23. The main instruments managed by FPI are IfS and CFSP, which represent 87 % of the operational budget of FPI. The Court assessed these two instruments' supervisory and control systems separately given their widely differing characteristics and found that overall they were partially effective.

7.24. The main weaknesses identified relate to:

- (a) the absence of an effective Internal Audit Capability;

**7.22.** DG ECHO considers that indeed it has improved its control systems which reached a satisfactory level of effectiveness. The final residual risk is limited and evidenced, and any further development would not be cost-efficient.

DG ECHO considers that certain errors observed by the Court are of very low value both in relative or absolute terms. DG ECHO estimates its residual error rate to be below 1 % in 2011.

In addition, ECHO underlines the fact that *ex-ante* controls have to be considered within the context of the overall control system. The supervisory and control systems in place could have still detected the errors through the implementation of *ex-post* controls, as the actions audited by the Court were not audited after the final steps of the ECHO control chain.

**7.24.**

- (a) This was due to factors outside the influence of FPI. For the same reasons, the IAC of EuropeAid was not in a position to carry out any audits on FPI activities in 2011.

In the absence of an Internal Audit Capability the Commission considers that a service can rely on the other building blocks for its assurance, as identified in its AAR including the work of the Internal Audit Service. FPI's internal audit needs are included in the 2012 work plan of the EuropeAid IAC, (one new audit and one follow up audit agreed on FPI activities).

## THE COURT'S OBSERVATIONS

- (b) insufficient risk assessment for selecting the contracts to submit to *ex-post* control procedures (CFSP) and insufficiently developed contract selection criteria used for risk assessment (IfS);
- (c) the *ex-ante* control procedures which did not prevent some of the errors to occur (IfS);
- (d) the prior fulfilment of conditions for the CFSP missions <sup>(21)</sup>;
- (e) the backlog of CFSP contracts to be closed.

## THE COMMISSION'S REPLIES

- (b) *The selection of CFSP and IfS projects for ex-post controls (EPC) and the EPC plans of the two operational units concerned were based on objective criteria (such as value of contracts managed, date of the last ex-post control, and incidence of potential fraud or suspicions of fraud). The Commission acknowledges that the risk assessment made by FPI can be improved. Efforts are being made in 2012 to improve the risk assessment methodology for all instruments managed by FPI, including CFSP.*
- (c) *Where the Commission accepts that errors occurred, it notes at the same time that its ex-ante control procedures detected them in nearly all of the cases identified by the Court and also that management took appropriate follow-up action.*
- (d) *The Commission recalls that in accordance with the principle of sound financial management, CFSP operations have to prove that they are effective in the use of the EU budget. Since the CSDP missions are established from scratch, and need to be operational from scratch, they cannot immediately comply with the requirements of Article 56 of the Financial Regulation. However, the Commission is still obliged to ensure that the operations it finances are effective in accordance with the aforementioned principle. The mitigating controls reported in the AAR provide an adequate basis for an assurance to be given even if formally the conditions for Article 56 compliance are not met.*
- FPI will continue carrying out 6-pillar assessments at the rate of two per year which means that the most significant missions in financial terms should be assessed by the end of 2013.*
- (e) *FPI will continue its efforts in closing old CFSP contracts and has set up an action plan for this purpose. It is also reviewing procedures for closing CFSP operations in future in a more streamlined way.*

<sup>(21)</sup> Article 56 of the Financial Regulation provides the conditions required before entrusting an entity with the implementation of EU budget. This provision is not suitable for CFSP missions, as it is not possible for the Commission to obtain evidence of the fulfilment of these conditions before their setting up. Therefore, the objective of FPI is to accredit the missions as soon as possible after their start. Mitigating controls have been introduced to limit the risks during this intermediary period. However, by the end of 2011 only one (EULEX Kosovo) out of nine on-going CFSP missions had received its accreditation.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Commission's management representations**

7.25. The Directors-General of EuropeAid and DG ECHO and the Director of FPI declare that they have obtained reasonable assurance that the control procedures put in place give the necessary guarantees concerning the regularity of underlying transactions <sup>(22)</sup>. However:

- (a) FPI does not present a residual error rate <sup>(23)</sup> in its Annual Activity Report on which to base its conclusion;
- (b) DG ECHO uses a specific method to calculate the residual error rate, which is not sufficiently explained in its Annual Activity Report.

7.25.

- (a) As indicated in its 2011 Annual Activity Report, FPI will aim to have a residual error rate in place, based on a similar methodology to that of EuropeAid but adapted for the control environment of FPI, for the 2012 Annual Activity Report.
- (b) The residual error rate calculated by DG ECHO is built up on the implementation of the DG ECHO's audit strategy.

DG ECHO considers that this methodology adequately reflects the risk exposure of its operational budget since:

- audited population is highly representative,
- systemic errors are identified and the related impact fully scrutinised,
- audited budget is 'cleaned' thanks to the recovery of ineligible items.

**CONCLUSIONS AND RECOMMENDATIONS****Conclusions**

7.26. Based on its audit work, the Court concludes that the payments for external relations, aid and enlargement for the year ended on 31 December 2011 were free from material error. However, interim and final payments (about one third of the amount paid in 2011) were affected by material error.

7.27. Based on its audit work, the Court found that the examined supervisory and control systems for external relations, aid and enlargement were partially effective.

7.26. The Commission welcomes the Court's conclusion that transactions in the policy group External Aid Development and Enlargement were free from material error in 2011.

7.27. The Commission has designed its controls to cover the full lifecycle of its multi-annual projects. It believes that these supervisory and control systems are effective and have significantly improved year on year, covering both the operation of the EDFs and activities financed by the EU Budget. Despite the challenges of a high risk external aid environment, the Court's most likely estimated annual error rate for external aid under the EU Budget has been below materiality for 2010 and 2011, and was below materiality for the EDFs in 2009.

<sup>(22)</sup> The detailed results on EuropeAid AAR are presented in the Court's Annual Report of the eighth, ninth and 10th European Development Funds. As noted in paragraph 7.14, the supervisory and control systems of DG ELARG were not assessed for the year 2011.

<sup>(23)</sup> See paragraphs 1.21 to 1.23.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Recommendations**

7.28. **Annex 7.3** shows the result of the Court's review of the Commission's progress in addressing recommendations made in the previous annual reports. All recommendations were addressed by the Commission and four of them have now been implemented. The recommendations regarding EuropeAid supervisory and control systems are included in the Court's Annual Report on the eighth, ninth and 10th EDFs. Following this review and the findings and conclusions for 2011, the Court recommends that:

— **Recommendation 1:** EuropeAid, DG ECHO and FPI improve the supervision of grant contracts, making better use of on-the-spot visits to prevent and detect ineligible expenditure declared and/or increase the coverage of the audits contracted by the Commission.

— **Recommendation 2:** FPI should:

- ensure that the Internal Audit Capability becomes operational,
- make explicit the criteria used for the risk assessments when selecting contracts to be audited under IfS and CFSP,
- ensure that all CFSP missions are accredited in accordance with the 'six-pillar assessments',
- accelerate the closure of old CFSP contracts.

7.28. See joint reply to paragraphs 1.12 and 1.13.

*Different Commission services have different practices as regards the nature and purpose of 'on-the-spot controls' in the framework of their overall control systems, as well as the use they do or do not make of them for the purposes of assurance. Therefore — taking into account cost-effectiveness aspects — the Commission cannot accept a general recommendation that improving on-the-spot controls would significantly improve the financial management of grant agreements regarding the eligibility of expenditure.*

*As regards the coverage of contracted audits the Commission considers that the audit coverage in relation to grants is substantial and sufficient. Taking into account the Court's own error rate established for this chapter, the Commission can only partially accept this recommendation in terms of continuing its constant efforts to improve existing arrangements.*

- *FPI will fully cooperate with the Internal Audit Capability of EuropeAid, in its role as auditee,*
- *FPI is already undertaking efforts to improve its risk assessments linked to the ex-post controls it performs including a better identification of the criteria for selecting the contracts / projects for audit,*
- *FPI has developed a schedule for the accreditation of its CFSP missions and will continue its efforts in this area. According to this schedule, all significant missions in financial terms should be accredited by the end of 2013,*
- *FPI will increase its efforts in closing old CFSP contracts and has set up an action plan for this purpose.*

## ANNEX 7.1

## RESULTS OF TRANSACTION TESTING FOR EXTERNAL RELATIONS, AID AND ENLARGEMENT

	2011					2010	2009	2008
	EuropeAid <sup>(3)</sup>	FPI	ELARG	ECHO	Total			
<b>SIZE AND STRUCTURE OF THE SAMPLE</b>								
Total transactions (of which):	81	8	38	23	<b>150</b>	165	180	180
Advances	17	2	4	7	<b>30</b>	75	83	71
Interim/Final payments	64	6	34	16	<b>120</b>	90	97	109
<b>RESULTS OF TESTING <sup>(1)</sup> <sup>(2)</sup></b>								
<b>Proportion (number) of transactions tested found to be:</b>								
Free of error	73 % (59)	50 % (4)	68 % (26)	52 % (12)	<b>67 % (101)</b>	77 %	87 %	73 %
Affected by one or more errors	27 % (22)	50 % (4)	32 % (12)	48 % (11)	<b>33 % (49)</b>	23 %	13 %	27 %
<b>Analysis of transactions affected by error</b>								
<b>Analysis by type of expenditure</b>								
Advances	0 % —	0 % —	0 % —	0 % —	<b>0 % —</b>	11 %	17 %	19 %
Interim/Final payments	100 % (22)	100 % (4)	100 % (12)	100 % (11)	<b>100 % (49)</b>	89 %	83 %	81 %
<b>Analysis by type of error</b>								
Non-Quantifiable errors:	59 % (13)	50 % (2)	92 % (11)	9 % (1)	<b>55 % (27)</b>	53 %	74 %	60 %
Quantifiable errors:	41 % (9)	50 % (2)	8 % (1)	91 % (10)	<b>45 % (22)</b>	47 %	26 %	40 %
Eligibility	67 % (6)	100 % (2)	100 % (1)	100 % (10)	<b>86 % (19)</b>	72 %	100 %	79 %
Occurrence	0 % —	0 % —	0 % —	0 % —	<b>0 % —</b>	17 %	0 %	21 %
Accuracy	33 % (3)	0 % —	0 % —	0 % —	<b>14 % (3)</b>	11 %	0 %	0 %
<b>ESTIMATED IMPACT OF QUANTIFIABLE ERRORS</b>								
Most likely error rate						<b>1,1 %</b>		
Upper Error Limit (UEL)						2,4 %		
Lower Error Limit (LEL)						0,0 %		

<sup>(1)</sup> To improve insight into areas with different risk profiles within the policy group, the sample was split up into segments.

<sup>(2)</sup> Numbers quoted in brackets represent the actual number of transactions.

<sup>(3)</sup> Includes two transactions of EACEA.

## RESULTS OF EXAMINATION OF SYSTEMS FOR EXTERNAL RELATIONS, AID AND ENLARGEMENT

## Assessment of the selected supervisory and control systems of EuropeAid

	<i>Ex-ante</i> controls	Monitoring and supervision	External audits	Internal audit	Overall assessment
Central Systems	Partially effective	Effective	Effective	Partially effective	Partially effective
Delegations	Partially effective	Partially effective	Partially effective	N/A	Partially effective

## Assessment of the selected supervisory and control systems of DG ECHO

	<i>Ex-ante</i> controls	Monitoring and supervision	<i>Ex-post</i> controls	Internal audit	Overall assessment
Central Systems	Partially effective	Effective	Effective	Effective	Partially effective

## Assessment of the selected supervisory and control systems of FPI

	<i>Ex-ante</i> controls	Monitoring and supervision	<i>Ex-post</i> controls	Internal audit	Overall assessment
IFS	Partially effective	Effective	Effective	Not effective	Partially effective
CFSP	Partially effective	Partially effective	Partially effective		Partially effective

## ANNEX 7.3

## FOLLOW-UP OF PREVIOUS RECOMMENDATIONS FOR EXTERNAL RELATIONS, AID AND ENLARGEMENT

Year	Court recommendation	Court's analysis of the progress made	Commission reply
2009	DG ECHO should improve the documentation of assessments of proposals for humanitarian aid actions (e.g. the introduction of standardised evaluation reports).	DG ECHO has improved the documentation of proposals for humanitarian aid actions.	<i>DG ECHO agrees with the Court's analysis.</i>
	DG ECHO should define and put in place a mechanism for collecting and analysing the data concerning the use of 'Humanitarian Procurement Centres' (HPCs) by its partners.	DG ECHO implemented in 2011 an interim solution to collect as much information possible directly from the HPCs pending the introduction of an automated mechanism for the collection of this information from the partners themselves.	<i>DG ECHO agrees with the Court's analysis.</i>
	DG RELEX should devote sufficient resources to the analysis and closure of the old RRM and the CFSP contracts for which the implementation deadlines have already expired.	FPI has taken appropriate actions for the closure of RRM and IfS contracts. However for CFSP still more efforts are needed to fulfil the Court's recommendation.	<i>The Commission acknowledges that more efforts are necessary regarding the closure of old CFSP contracts, therefore an action plan has been prepared with the aim of improving the situation by the end of 2012.</i>
	DG ELARG should review its internal control checklists in order to document all the checks carried out.	New checklists have been developed, circulated to the relevant staff and uploaded on the ELARG Intranet.  The DAS 2010 and 2011 audit work confirms that up-to-date checklists are currently used by the EU delegations.	
	DG ELARG should continue to devote sufficient resources to the analysis of the outstanding final declarations submitted under Phare and the Transition Facility in the new Member States.	The backlog of final declarations has been further reduced during the exercise. However, out of 401 programmes, 88 final declarations remain pending at the end of 2011 and further effort is still needed to implement this recommendation.	<i>DG ELARG is committed to make the necessary efforts to further reduce the left backlog. DG ELARG will continue to make all the necessary efforts to clear the accounts for Phare/Transition Facility EU-12.</i>

Year	Court recommendation	Court's analysis of the progress made	Commission reply
2009	<p>DG ELARG defines in more detail the criteria for lifting <i>ex-ante</i> control and suspending the 'conferral of management' to decentralised countries and tests the performance of the systems used by national authorities</p> <p><i>(This is the 2010 follow up/update of a 2009 recommendation)</i></p>	<p>In 2011 DG ELARG started the analysis of the possible options to define in more detail criteria and benchmarks for the conferral of management powers and for the waiver of <i>ex-ante</i> controls. Four subsystems audits were carried out in 2011. These cover the actual functioning of some key aspects of the national systems in Croatia and Turkey.</p> <p>The relevant EU delegations implemented their audit and on-the-spot mission plans, gaining in this way additional assurance on the performance of the national systems.</p>	<p><i>This analysis will be deepened in the framework of the renewed Instrument for Pre-Accession. The regular monitoring of the national systems by HQ and delegations continues, whereby the subsystem audits are one of the tools used.</i></p>
	<p>DG ELARG continues to improve the quality of the data entered in its management information system.</p> <p><i>(This is the 2010 follow up/update of a 2009 recommendation)</i></p>	<p>DG ELARG approved a new guideline document to ensure the quality of CRIS data. The new Decentralised implementing System payment checklists provide for checks on iPerseus contract data. The effectiveness of the new procedures still needs to be assessed in future.</p>	
	<p>DG ELARG should develop a tool to facilitate the consolidation of the visit outcomes related to legality and regularity issues</p> <p><i>(This is the 2010 follow up/update of a 2009 recommendation)</i></p>	<p>Some EU delegations started to develop their own consolidation tools but further efforts are necessary in order to establish a common baseline, harmonise the different approaches, and verify their effective implementation.</p>	<p><i>In the execution of its supervision activities, ELARG HQ will encourage and monitor the implementation of the measures.</i></p>
	<p>DG ELARG increases <i>ex-post</i> reviews of transactions for centralised management.</p> <p><i>(This is the 2010 follow up/update of a 2009 recommendation)</i></p>	<p>The <i>ex-post</i> controls were substantially increased in 2011. Four out of six 'centralised' delegations were visited by the <i>ex-post</i> controllers.</p>	<p><i>The efforts are being pursued in 2012, one more country has been visited and the initial work programme will be completed by the end of the year.</i></p>
2008	<p>DG RELEX should consolidate its <i>ex-post</i> control methodology and promptly address the recommendations made by the internal auditor in that respect. (Included also in the 2008 Annual Report)</p>	<p>FPI consolidated its <i>ex-post</i> control methodology for CFSP and IfS. However these guidelines are still incomplete and the criteria for the risk assessments should be better defined.</p>	<p><i>FPI has already completed its methodological guidance and will continue to improve it throughout the year, based on feedback from controls carried out. The criteria for the risk assessments are being refined in 2012 in order to ensure enhanced clarity regarding the selection of projects to be controlled in 2013. All recommendations made by the internal auditor to DG RELEX in relation to <i>ex-post</i> controls have been implemented.</i></p>



## CHAPTER 8

**Research and other internal policies**

## TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	8.1-8.11
Specific characteristics of the policy group	8.2-8.10
Research Framework Programmes	8.3-8.8
Competitiveness and Innovation Framework Programme (CIP)	8.9-8.10
Audit scope and approach	8.11
Regularity of transactions	8.12-8.18
Effectiveness of systems	8.19-8.36
Research Framework Programmes	8.20-8.30
<i>Ex-ante</i> desk checks	8.20-8.21
Audit certification of cost claims	8.22-8.24
The Commission's <i>ex-post</i> financial audits	8.25-8.30
Competitiveness and Innovation Framework Programme (CIP) — ICT Policy Support Programme (ICT-PSP)	8.31-8.36
<i>Ex-ante</i> desk checks	8.31
Audit certification of cost claims	8.32
The Commission's <i>ex-post</i> financial audits	8.33-8.34
Reliability of Commission management representations	8.35-8.36
Conclusions and recommendations	8.37-8.40
Conclusions	8.37-8.38
Recommendations	8.39-8.40
Results of the audit of the Guarantee Fund for external actions	8.41-8.43

## THE COURT'S OBSERVATIONS

## INTRODUCTION

8.1. This Chapter presents the Court's specific assessment of research and other internal policies, which comprises policy areas 01 — Economic and financial affairs, 02 — Enterprise, 03 — Competition, 08 — Research, 09 — Information society and media, 10 — Direct research, 12 — Internal market, 15 — Education and culture, 16 — Communication, 18 — Area of freedom, security and justice and 20 — Trade as well as the Court's recurrent audit of the Guarantee Fund for External Actions <sup>(1)</sup>. Key information on the activities covered and spending in 2011 is provided in **Table 8.1**.

**Table 8.1 — Research and other internal policies — Key information 2011**

(million euro)

Budget Title	Policy area	Description	Payments	Management mode
08	Research	Administrative expenditure	321	Centralised direct
		FP7	3 494	Centralised direct
		FP7 Euratom	271	Centralised indirect
		Completion of previous framework programmes (FPs)	518	Centralised direct
			<b>4 604</b>	
15	Education and culture	Administrative expenditure	131	Centralised direct
		Lifelong learning, including multilingualism	1 376	Centralised indirect
		Developing cultural cooperation in Europe	167	Centralised indirect
		Encouraging and promoting cooperation in the field of youth and sports	156	Centralised indirect
		People — Programme for the mobility of researchers	584	Centralised indirect
			<b>2 414</b>	
09	Information society and media	Administrative expenditure	132	Centralised direct
		FP7	1 218	Centralised direct
		Other	139	Centralised direct
			<b>1 489</b>	

<sup>(1)</sup> Council Regulation (EC, Euratom) No 480/2009 of 25 May 2009 establishing a Guarantee Fund for external actions (OJ L 145, 10.6.2009, p. 10) stipulates in its recitals that the financial management of the Guarantee Fund should be subject to audit by the Court of Auditors in accordance with the procedures agreed upon by the Court of Auditors, the Commission and the European Investment Bank.

(million euro)

Budget Title	Policy area	Description	Payments	Management mode
02	Enterprise	Administrative expenditure	123	Centralised direct
		Competitiveness, industrial policy, innovation and entrepreneurship	187	Centralised direct/centralised indirect via EACI
		Internal market for goods and sectoral policies	33	Centralised direct
		FP7 — Cooperation — Space and security	423	Centralised direct
		EU satellite navigation programmes (EGNOS and Galileo)	570	Centralised direct
		<b>1 336</b>		
18	Freedom, security and justice	Administrative expenditure	76	Centralised direct
		Solidarity — External borders, visa policy and free movement of people	445	Shared/Centralised direct
		Migration flows — Common immigration and asylum policies	159	Shared/Centralised direct
		Fundamental rights and citizenship	48	Centralised direct
		Security and safeguarding liberties	133	Centralised direct
		Justice in criminal and civil matters	62	Centralised direct
		Drugs prevention and information	18	Centralised direct
		Policy strategy and coordination	3	Centralised direct
		<b>944</b>		
10	Direct research	Staff, running costs and investments	352	Centralised direct
		FP7	41	Centralised direct
		Historical liabilities resulting from nuclear activities	24	Centralised direct
		Completion of previous framework programmes (FPs)	24	Centralised direct
		<b>441</b>		
01	Economic and financial affairs	Administrative expenditure	70	Centralised direct
		Economic and monetary union	12	Centralised direct
		International economic and financial affairs	55	Centralised direct
		Financial operations and instruments	252	Centralised direct/Joint management with EIF/centralised indirect via EIF
		<b>389</b>		
16	Communication	Administrative expenditure	125	Centralised direct
		Communication and the media	35	Centralised direct
		Going Local communication	37	Centralised direct
		Analysis and communication tools	26	Centralised direct
		Fostering European citizenship	36	Centralised direct
		<b>259</b>		
20	Trade	Administrative expenditure	93	Centralised direct
		Trade policy	11	Centralised direct/Joint management with IO
		<b>104</b>		

(million euro)

Budget Title	Policy area	Description	Payments	Management mode
12	Internal Market	Administrative expenditure	61	Centralised direct
		Policy strategy and coordination for the Directorate-General for the Internal Market	34	Centralised direct
			<b>95</b>	
03	Competition	Administrative expenditure	94	Centralised direct
		Cartels, anti-trust and liberalisation	0	Centralised direct
			<b>94</b>	
Total administrative expenditure <sup>(1)</sup>			1 578	
Framework programmes (FPs)			5 965	
Lifelong learning, including multilingualism (LLP)			1 376	
Other operational expenditure			3 250	
Total operational expenditure			10 591	
Of which: — advances <sup>(2)</sup>			6 911	
— interim/final payments <sup>(3)</sup>			3 680	
<b>Total payments for the year</b>			<b>12 169</b>	
<b>Total commitments for the year</b>			<b>13 968</b>	

<sup>(1)</sup> The audit of administrative expenditure is reported in Chapter 9.

<sup>(2)</sup> Advances under the Seventh Framework Programme (2007-2013) and under the Lifelong Learning Programme amounted to 3 837 million euro and 1 208 million euro respectively.

<sup>(3)</sup> Interim/Final payments under the Seventh Framework Programme (2007-2013) and the Lifelong Learning Programme amounted to 2 128 million euro and 168 million euro respectively.

Source: 2011 annual accounts of the European Union.

#### THE COURT'S OBSERVATIONS

### Specific characteristics of the policy group

8.2. The main components of this policy group are the framework programmes for research and technological development (FPs), accounting for 56 % of total operational expenditure (or 5 965 million euro). Other internal policies include the Lifelong Learning Programme, accounting for 11 % of total operational expenditure (or 1 376 million euro), the 'Solidarity and management of migration flows' (SOLID) general programme for 4 % (or 445 million euro) and the Competitiveness and Innovation Framework Programme (CIP) for 2 % (or 258 million euro).

## THE COURT'S OBSERVATIONS

*Research Framework Programmes*

8.3. The Sixth and Seventh Framework Programmes for Research and Technological Development (FP6 and FP7) are the European Union's main instruments for supporting research and innovation. Both FPs are designed with the aim to support the Lisbon and Europe 2020 strategies and the European Research Area <sup>(2)</sup>.

8.4. The FPs are implemented under centralised direct and centralised indirect management involving six Directorates-General and two executive agencies <sup>(3)</sup>. Part of the budget is also implemented under indirect centralised management by different bodies such as the Joint Undertakings <sup>(4)</sup> and the European Investment Bank.

8.5. Both FPs are primarily project-based competitive funding programmes in which potential beneficiaries must compete for the funding by presenting their project. Grant agreements are signed between the successful applicants and the Commission. Once the grant agreement has been signed, a first advance payment is disbursed followed by interim and final payments which are triggered by the cost claims submitted by the beneficiaries.

8.6. The principal risk of irregularity is that beneficiaries may overstate eligible costs in their cost claims, and that this may not be detected and subsequently corrected by the Commission's supervisory and control systems. This risk is exacerbated by the complexity of the rules for calculating eligible costs and in certain areas the implementing bodies (see paragraph 8.4) apply the rules differently.

<sup>(2)</sup> The European Research Area is composed of all research and development activities, programmes and policies in Europe which involve a transnational dimension. Together, they provide greatly enhanced opportunities for researchers, research institutions and businesses to circulate, compete and cooperate across borders.

<sup>(3)</sup> The six Directorates-General are: DG Research and Innovation (RTD), DG Information Society and Media (INFOS), DG Education and Culture (EAC), DG Enterprise and Industry (ENTR), DG Mobility and Transport (MOVE) and DG Energy (ENER). The two executive agencies are: (i) the Research Executive Agency (REA) and (ii) the European Research Council Executive Agency (ERCEA).

<sup>(4)</sup> The European Union Research Joint Undertakings (JUs) are: the European JU for ITER and the Development of Fusion Energy; the Clean Sky JU; the ARTEMIS JU; the Innovative Medicines Initiative JU; the ENIAC JU; and the Fuel Cells and Hydrogen JU.

## THE COURT'S OBSERVATIONS

8.7. On 24 January 2011 the Commission took the three following measures with the aim of simplifying the rules applicable to FP7:

- (a) a widening of acceptance of beneficiaries' methodologies for calculating average personnel costs;
- (b) the introduction of flat-rate financing for SME owners;
- (c) the creation of a Research Clearing Committee in order to achieve a uniform interpretation and application of the rules.

It is too early to assess the impact of these measures on the level of ineligible costs.

8.8. In this policy area, the European Commission is also responsible for the implementation of two major space programmes: the Galileo programme and the global monitoring for environment and security programme (GMES). These tasks are either delegated to or carried out in cooperation with the European Space Agency (ESA). Total payments made by the Commission to ESA in 2011 amounted to 660 million euro (133,6 million euro for GMES and 526,4 million euro for Galileo).

*Competitiveness and Innovation Framework Programme (CIP)*

8.9. The CIP programme (the area of other internal policies, which the Court selected for systems audit following a rotational approach) covers three sub-programmes managed by three DGs (in 2011, DG ECFIN <sup>(5)</sup>: 29 million euro, DG ENTR <sup>(6)</sup>: 114 million euro and DG INFSO: 115 million euro). DG INFSO manages the information and communications technology (ICT) policy support programme (ICT-PSP) which aims to stimulate innovation and competitiveness through the wider uptake and best use of ICT by citizens, governments and businesses, particularly SMEs.

## THE COMMISSION'S REPLIES

**8.8.** *The payments made to ESA in 2011 as annual contribution from the EU budget to the jointly managed GMES programme and the amounts determined for the implementation of the Galileo programme are pre-financing payments. The final amount of funds used by ESA is determined by the Commission only at the end of the two programmes.*

<sup>(5)</sup> DG ECFIN supports small and medium-sized enterprises (SMEs) with access to equity, venture capital and loan finance, through Union financial instruments operated on behalf of the Commission by the European Investment Fund (EIF).

<sup>(6)</sup> DG ENTR manages the sub-programme related to entrepreneurship and innovation through CIP-grants managed via the Executive Agency for Competitiveness and Innovation (EACI).

## THE COURT'S OBSERVATIONS

8.10. The programme is implemented through direct centralised management of grants, with direct financial contributions through co-financed grant agreements which the Commission signs with beneficiaries forming a consortium. The main risk of irregularity in the case of PSP research projects, is that beneficiaries may include ineligible costs in their claims, which may not be detected and corrected by the Commission's supervisory and control systems before reimbursement.

### Audit scope and approach

8.11. **Annex 1.1, Part 2**, of Chapter 1 describes the Court's overall audit approach and methodology. For the audit of research and other internal policies, the following specific issues should be noted:

- (a) the audit involved an examination of a sample of 150 payments, comprising 25 advances for research FPs, 39 advances covering other measures in this policy group, 60 interim or final payments for research FPs and 26 interim or final payments covering other measures in this policy group;
- (b) the assessment of systems covered:
  - *ex-ante* desk checks at the Commission <sup>(7)</sup>;
  - audit certificates of project cost claims provided by independent auditors <sup>(8)</sup>;
  - *ex-post* financial audits of projects <sup>(9)</sup>;
  - Commission management representations <sup>(10)</sup>;
- (c) the audit of the Guarantee Fund focused on compliance with the agreement between the Commission and the EIB for the management of the Fund's assets as well as the Commission's monitoring procedures. The work performed by a private firm of auditors was also reviewed.

<sup>(7)</sup> For research, this assessment was based on the sample of the 85 payments relating to the FPs. For other internal policies, this assessment, and the assessment of *ex-post* financial audits of projects, was based on an additional sample of 30 payments relating to the CIP programme managed by DG INFSO, i.e. the ICT-PSP.

<sup>(8)</sup> This was based on a sample of 31 beneficiary cost claims for which a certificate had been provided.

<sup>(9)</sup> This was primarily based on the review of 30 *ex-post* audit files.

<sup>(10)</sup> The annual activity reports of the Directors-General of DG RTD, DG INFSO, DG ENTR and DG EAC and two executive agencies: ERCEA and REA were reviewed.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**REGULARITY OF TRANSACTIONS**

8.12. **Annex 8.1** contains a summary of the results of transaction testing. The Court's testing of its sample of transactions found 49 % to be affected by error. The most likely error estimated by the Court is 3,0 % <sup>(11)</sup>.

8.13. In total, the Court found that 74 of the sample of 150 transactions were affected by error. The main source of error is the over-declaration of costs by beneficiaries for projects funded by the research FPs. This is consistent with the errors detected by the Commission's *ex-post* financial audits <sup>(12)</sup> (see paragraphs 8.25 to 8.30). As noted by the Court in previous years <sup>(13)</sup>, errors are found in all cost categories: personnel costs and other direct costs and indirect costs.

8.14. Personnel costs: the calculation of actual personnel costs should be based on a reliable time recording system. The Court's audits revealed: discrepancies between the time-sheets and other personnel records (e.g. absence and holiday records), cases of staff fully declared on a project while the time-sheets showed that they were working on several projects and cases of unpaid overtime charged to the Commission (see example 8.1).

**8.14.** *Errors identified in a cost claim may have no financial impact on the EU funds.*

<sup>(11)</sup> The Court calculates its estimate of error on the basis of a representative statistical sample. The figure quoted is the best estimate (known as the MLE). The Court has 95 % confidence that the rate of error in the population lies between LEL 1,1 % and UEL 4,9 % (the lower and upper error limits respectively).

<sup>(12)</sup> This was also confirmed by the Commission in the note for beneficiaries dated 19 March 2012 'How to avoid common errors identified in costs claims' which states that most errors arise from misinterpreting the rules or from the beneficiaries not giving due consideration to the provisions of the grant agreement and the financial guidelines.

<sup>(13)</sup> See paragraph 6.13 of the 2010 Annual Report, paragraphs 5.19 to 5.20 and 8.11 to 8.12 of the 2009 Annual Report, paragraphs 7.12 to 7.15 and 10.12 to 10.13 of the 2008 Annual Report.



## THE COURT'S OBSERVATIONS

**Example 8.1 — Error identified in a cost claim relating to personnel costs**

A beneficiary involved in a FP7 project declared 308 000 euro of personnel costs. The Court's audit revealed that the beneficiary:

- underestimated the productive hours worked by its employees;
- over-charged hours for several employees involved in the audited project.

In total these findings resulted in the over-declaration of 45 000 euro of personnel costs.

## THE COMMISSION'S REPLIES

**Example 8.1 — Error identified in a cost claim relating to personnel costs**

*In the case quoted by the Court the amount unduly claimed has already been offset against the following payment.*

8.15. Other direct costs: in order for other direct costs to be eligible, they must be actual, supported by adequate evidence (such as invoices and proof of payment) and a clear link with the project and the reporting period should exist. During its audits, the Court often found that beneficiaries included invoices for consumables either ordered or delivered after the end of the project as well as invoices for external services which should have been classified as subcontracting. Beneficiaries also failed to provide invoices in support of the costs or the proof of payment. As regards equipment, cases were found where the purchase cost was fully charged to the research project instead of being depreciated according to the beneficiary's usual accounting practices.

8.16. Indirect costs: for beneficiaries using actual indirect costs, these must be related to the project. Beneficiaries often failed to exclude ineligible costs linked to commercial activities, provisions or costs directly charged to the project (see example 8.2).

**8.16.****Example 8.2 — Error identified in a cost claim relating to other indirect costs**

A beneficiary declared overheads amounting to 366 891 euro and included the indirect costs of all its departments while only considering the research personnel as an allocation key when charging these costs to research projects. This resulted in non-related related costs being charged, leading to an over-claim of 180 670 euro.

**Example 8.2 — Error identified in a cost claim relating to other indirect costs**

*The Commission has carried out the contradictory procedure with the beneficiary. Following complementary information and explanations supplied by the beneficiary, the Commission has concluded that the over-claim for indirect costs for this project amounts to 39 735 euro which has been fully recovered in 2012. In addition, the Commission has informed the beneficiary that this systemic error should be corrected also in the other projects in which he participates, what he has accepted to do.*

*The problem of the calculation of indirect costs is well known to the Commission. The proposal for Horizon 2020, if adopted, would avoid the problem by paying indirect costs as a flat rate percentage of direct costs.*

## THE COURT'S OBSERVATIONS

8.17. 19 out of 65 transactions (29 %) relating to other internal policies were affected by errors. These included errors related to reimbursement of non-eligible costs similar to the errors found in FP6 and FP7.

8.18. The Court's audit found errors such as advances which should have been claimed in the following reporting period and ineligible provisions in the financial report provided by ESA (see also paragraph 8.36) as well as weaknesses in the procurement procedures carried out when implementing the two space programmes (see paragraph 8.8).

## EFFECTIVENESS OF SYSTEMS

8.19. **Annex 8.2** contains a summary of the results of the Court's examination of supervisory and control systems. The Court found that the systems were partially effective in ensuring the regularity of transactions for both research and ICT-PSP.

## Research Framework Programmes

## Ex-ante desk checks

8.20. Before a payment is made all relevant operational and financial aspects are subject to desk checks to verify the regularity of the payments and to ensure compliance with contracts. As a result of the Commission's efforts to simplify as far as possible its *ex-ante* control procedures, these controls are often limited to a desk review of the cost claims and related deliverables provided by the beneficiaries.

8.21. The audit of 108 payments <sup>(14)</sup> out of the sample of 150 (see paragraph 8.11) revealed 51 cases affected by weaknesses in the *ex-ante* desk checks which the Court, however, does not consider as substantial such as the retroactivity of the project start-date (without a prior written request from the beneficiary), payment delays and inconsistencies in the authorisation procedure. As a result, this control procedure is considered to be partially effective.

## THE COMMISSION'S REPLIES

**8.18.** *The Commission performs on-the-spot audits for each financial report submitted by ESA. Any identified errors are corrected. The inclusion in the 2010 reporting of advances, which should have been claimed in the following reporting period, does not have a financial impact on the programme. The provision identified by the Court was already corrected by ESA in the next reporting period. In the Commission's view the procurement issues identified by the Court do not lead to waste of EU funds. The Commission considers that the procurement procedures as amended following the Court's audits are adequate and aligned with the particular nature of the Space procurement activities.*

**8.20.** *The Commission is of the view that the control system has to be considered in its entirety including ex-ante and ex-post checks.*

<sup>(14)</sup> This consists of: 60 FPs interim or final payments, 25 FPs advances, 21 payments linked with the contributions to the Research Joint Undertakings, the Risk Sharing Finance Facility, the EGNOS and Galileo programmes and 2 advances for the Research Fund for Coal and Steel.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Audit certification of cost claims*

8.22. Grant agreements set out the conditions under which the beneficiaries' cost claims should be accompanied by an audit certificate (FP6) or a certificate on the financial statements (FP7) <sup>(15)</sup> issued by an independent auditor. The purpose of these certificates is to provide the Commission with relevant information so that it can assess whether the costs claimed by beneficiaries are eligible and all receipts and interest generated by pre-financing have been declared.

8.23. For the beneficiary cost claims for which a certificate had been provided (31 out of the 60 interim and final payments), the Court compared the results of its own audit with the conclusion of the certificate. In 25 cases where the independent auditor had issued an unqualified opinion the Court detected errors. In 14 of the cases the errors had a financial impact above 2 %.

8.24. In line with the findings for previous years and despite the Commission's efforts to raise awareness among beneficiaries and auditors (see **Annex 8.3**), this control procedure is still only partially effective as there are still ineligible items not being identified by the independent auditors.

*The Commission's ex-post financial audits*

8.25. For both FPs the research family DGs have common *ex-post* audit strategies. The main objectives are:

- (a) to assess the legality and regularity of cost claims and thus provide input to the Annual Declaration of Assurance of the Authorising Officers (AO) by delegation; and
- (b) to provide the basis for the recovery of unduly paid EU funds.

8.26. Overall, the system of *ex-post* audits put in place by the Commission was assessed as effective.

**Reliance on the work of external auditors**

8.27. The majority of the representative audits <sup>(16)</sup> of the Commission are performed by external audit firms under its responsibility and control.

**8.24.** *The Commission is aware that the CFS does not entirely avoid errors, but nevertheless they reduce error levels substantially. They are therefore an important contributor to the overall level of assurance of the Commission.*

<sup>(15)</sup> FP7 beneficiaries are required to provide a certificate if the EU contribution exceeds 375 000 euro. It is estimated by the Commission that 80 % of them will remain under this threshold.

<sup>(16)</sup> Audits selected on a random basis and designed to establish an error rate representative of the whole population.

## THE COURT'S OBSERVATIONS

8.28. The Court performed a detailed review of 30 *ex-post* audit files, focusing on the quality of audit documentation, consistency of the methodology applied and reporting to the Commission. While the Court identified weaknesses in the area of audit documentation and the audit methodology<sup>(17)</sup> applied by external auditors, it assessed reporting as satisfactory overall.

**Systems related to the recovery of unduly paid EU funds**

8.29. As a result of errors identified during the Commission's *ex-post* financial audits, unduly paid EU funds need to be recovered (either through a recovery order or a set-off against a future payment). Consolidated data for DG RTD and DG INFSO show that the recovery is a lengthy process. As at year-end 2011, 81 % and 33 % of the audits<sup>(18)</sup> closed in 2010 and in 2011 respectively were considered as implemented.

8.30. In addition, extrapolation of identified systematic errors to non-audited projects of audited beneficiaries is an even longer process. The implementation rate of systematic errors<sup>(19)</sup> for DG RTD for both FP6 and FP7 programmes was 44,8 % at the end of 2011.

### **Competitiveness and Innovation Framework Programme (CIP) — ICT Policy Support Programme (ICT-PSP)**

*Ex-ante desk checks*

8.31. The Court's audit compared the evidence of *ex-ante* checks in the ABAC Accounting system with that of DG INFSO's local system. In 23 out of 30 cases the persons authorising the transaction in ABAC were not the same as those authorising them in the local system. For the ICT-PSP programme the ABAC system does not reliably identify the persons performing the actual checks. As a consequence, this control procedure is considered to be only partially effective.

## THE COMMISSION'S REPLIES

**8.28.** The Commission considers that the weaknesses identified by the Court had a low financial impact. Nevertheless, it will intensify its efforts to ensure that the external audit firms meet the specific requirements set out in the framework contract for every audit assignment.

**8.29-8.30.** For the correction of errors in multiannual FP projects, offsetting against the next payment is the usual practice. In many cases the next payments are requested 1 or 1½ years later, which influences significantly the level of implementation of audits closed in 2010 and 2011. As the extrapolation process requires the recalculation and resubmission of cost claims by the beneficiaries, corrections via extrapolation of audit results indeed take even more time than the implementation of audit results referred to in paragraph 8.29.

**8.31.** The local system in place in DG INFSO records the visa of all the actors involved in the validation of the transactions. This system is automatic and secure and offers therefore a 100 % certainty as to who has done what, based on the electronic visas recorded in this system.

The names of the persons indicated in ABAC may be different as they correspond to people who have been actually involved in the transactions, but with a different role in the case of interim and final payments. This results from a deliberate decision taken by DG INFSO to limit the access in ABAC to experienced people in order to limit the risk of errors. This principle is properly documented in the description of DG INFSO financial circuits.

<sup>(17)</sup> The weaknesses detected mainly concerned the wrong acceptance of ineligible costs, sampling not representative of the population and the validation of incorrect indirect costs.

<sup>(18)</sup> Audits covering both FP6 and FP7.

<sup>(19)</sup> An error is considered as being 'implemented' when the beneficiary accepts the flat rate correction proposed by the Commission or submits revised cost claims for the projects affected by the extrapolation.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Audit certification of cost claims*

8.32. For the 30 transactions audited for *ex-ante* checks, three required audit certificates. These were provided and their conclusions taken into account when establishing the amount due.

*The Commission's ex-post financial audits*

8.33. In 2011 no formal *ex-post* audit strategy for the non-research programmes managed by DG INFSO had been approved. As a result no specific audit procedures were in place during 2011 for *ex-post* audits of the ICT-PSP projects and no specific risk assessment was carried out for the ICT-PSP programme.

8.34. At the time of the Court's audit only two audits had been carried out by the Commission for ICT-PSP projects (one in 2011 and one in 2010). In both cases the error rates were very high: 96 % and 100 % respectively. Additionally, the Court audited two ICT-PSP projects as part of its substantive testing. The error rates were 99,82 % and 2,86 %. The lack of an *ex-post* audit strategy for the ICT-PSP programme represents a significant weakness in the supervisory and control systems, particularly considering the high error rates found. This control is considered to be not effective.

In order to resolve the issue identified by the Court, DG INFSO intends to develop during 2013 a technical solution to address the issue of visas in ABAC in the framework of the next generation of programmes (Horizon 2020).

**8.33.** The non-research programmes of DG INFSO are subject to regular audits. In 2011 12 *ex-post* audits, out of which two relate to ICT-PSP, were closed concerning this funding area. The audits performed are selected on the basis of risk considerations and typically are requested by the services in charge of the operational project management.

In view of the increasing financial importance of this funding area DG INFSO services have designed an audit strategy which is being implemented in 2012. Further, in 2011 DG INFSO services concluded a framework contract for *ex-post* audit services in the field of this funding area. A first batch of 22 audits, concerning non-research funds, has been launched in the first semester of 2012 on the basis of this framework contract.

The interim and final payments for non-research programmes represented less than 4 % of the total INFSO payments made in 2011. DG INFSO considers that the measures initiated in 2011 being implemented in 2012 are adequate given the financial importance of the funding activity in question.

**8.34.** The two audits carried out by the Commission in 2010 and 2011 for ICT-PSP, which is one of the non-research programme managed by DG INFSO, were selected on the basis of risk considerations; for these audits, the error rate found is often very high and is not representative of the population as a whole.

One of the purposes of the audit strategy being implemented in 2012 for non-research programmes is to define sampling approaches which allows determining a meaningful error rate whilst maximising the audit economy by concentrating on large and risk prone beneficiaries.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Reliability of Commission management representations**

8.35. The AARs that were audited provide a fair assessment of financial management as regards the legality and regularity of underlying transactions. The information that was provided corroborates the Court's observations and conclusions.

8.36. Three DGs <sup>(20)</sup> issued a reservation concerning the residual errors affecting the accuracy of cost claims in FP7 and two DGs <sup>(21)</sup> maintained the reservation relating to the cost claims in FP6. DG ENTR also expressed a reservation concerning the reliability of ESA's financial reporting (see paragraph 8.18).

**CONCLUSIONS AND RECOMMENDATIONS****Conclusions**

8.37. Based on its audit work, the Court concludes that the payments for the year ended 31 December 2011 for research and other internal policies were affected by material error <sup>(22)</sup>.

8.38. Based on its audit work, the Court found that the examined supervisory and control systems for research and other internal policies were partially effective.

**Recommendations**

8.39. **Annex 8.3** shows the result of the Court's review of progress in addressing recommendations made in previous annual reports (2008 to 2009). The following points should be noted:

- (a) Where *ex-post* audits detect large discrepancies between certified and audited amounts, as at the end of 2011, there was no direct feedback process in place to make certifying auditors aware of the Commission's audit findings.

**8.36.** *The Commission will continue auditing the financial reports provided by ESA and will encourage and support ESA in implementing its actions towards further improving the quality of financial reporting to the Commission. Given the actions currently under way, the Commission expects the issues to be corrected soon which will enable reducing and finally lifting this reservation.*

**8.38.** *The Commission considers that seen from a management perspective — i.e. when balancing the objectives in terms of legality and regularity with considerations on risk-proportionality and cost-effectiveness of controls — its management and control systems provide reasonable assurance, subject to the reservations issued by the AODs as mentioned in paragraph 8.36.*

**8.39.**

- (a) *The Commission services have in place a process to provide feedback to the certifying auditors where the Commission's ex-post audits identified material differences between the certified cost statements and its own findings. This is achieved either by writing to the beneficiaries inviting them to communicate the feedback to the certifying auditor or by directly addressing the certifying auditors.*

<sup>(20)</sup> DG ENTR, DG INFSO and DG RTD.

<sup>(21)</sup> DG ENTR and DG RTD.

<sup>(22)</sup> See paragraphs 8.12 and 8.13.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

(b) The Commission continued with its efforts to implement audit results (by adjusting the costs claims or by issuing recovery orders) when participants had been found to have overstated expenditure in their cost claims. It was however noted that in practice, especially for extrapolation, the recovery is a lengthy process (see paragraphs 8.29 and 8.30).

8.40. Following this review and the findings and conclusions for 2011, the Court recommends that the Commission should:

— in the area of the research FPs:

— **Recommendation 1:** intensify its efforts to address the errors found in interim and final payments,

— **Recommendation 2:** enhance its initiatives to make beneficiaries and independent auditors aware of the errors detected during the Court's and the Commission's *ex-post* audits,

— **Recommendation 3:** ensure that the external audit firms conducting audits on its behalf align their procedures with the Commission's guidelines and standard practice and in particular enhance the quality of their audit documentation,

(b) *The Commission has already addressed the Court's finding. For the correction of errors in multiannual FP projects, offsetting against the next payment is the usual practice. In many cases the next payments are requested 1 or 1½ years later, which influences significantly the level of implementation of audits closed in 2010 and 2011.*

**8.40.** See joint reply to paragraphs 1.12 and 1.13.

— *The possibilities to simplify the FP7 rules have been exhausted. The Commission will however continue to address errors through the following actions:*

— *reinforced on-going efforts to provide guidance and feedback to participants and certifying auditors,*

— *reviewing ex-ante control procedures without however unduly increasing time to payment,*

— *continuing its audit work and recovery actions,*

— *monitoring the financial impact of the errors identified, which may well be lower than the error, over the multiannual period.*

*Further simplification has been proposed in Horizon 2020 which, if adopted, will lead to a reduced error rate.*

— *The Commission services have in place a process to provide feedback to the certifying auditors where the Commission's ex-post audits identified material differences between the certified cost statements and its own findings. This is achieved either by writing to the beneficiaries inviting them to communicate the feedback to the certifying auditor or by directly addressing the certifying auditors.*

— *The Commission will intensify its efforts to ensure that the external audit firms meet all the specific requirements set out in the framework contract for every audit assignment. In this context, reviews of the working papers retained by the external audit firms will be performed to ensure these are in line with requirements of the framework contract. The first such reviews will take place before the end of 2012.*

## THE COURT'S OBSERVATIONS

— in the area of the other internal policies:

- **Recommendation 4:** introduce as soon as possible an *ex-post* audit strategy for the ICT-PSP programme, drawing on the lessons learnt by DG INFSO's risk-based *ex-post* audit strategy for framework programmes projects.

## THE COMMISSION'S REPLIES

- *DG INFSO has designed an audit strategy for non-research programmes, covering among others the ICT-PSP programme which is being implemented in 2012.*

## RESULTS OF THE AUDIT OF THE GUARANTEE FUND FOR EXTERNAL ACTIONS

8.41. The purpose of the Guarantee Fund for External Actions <sup>(23)</sup> (the Fund), which guarantees loans to third countries, is to reimburse the EU's creditors <sup>(24)</sup> in the event of a beneficiary's defaulting on a loan and to avoid direct calls on the EU budget. The administrative management of the fund is carried out by the Directorate-General for Economic and Financial Affairs (DG ECFIN) while the European Investment Bank (EIB) is responsible for its treasury management.

8.42. At 31 December 2011, as shown in the 2011 consolidated accounts of EU, the Fund's net assets were 1 475 million euro, compared with 1 346 million euro at 31 December 2010 <sup>(25)</sup>. No guarantee calls were made on the Fund in the year under review.

8.43. The EIB and the Commission use a benchmark index to review the Fund's annual performance. The return on the Fund's portfolio in 2011 amounted to 0,72 %, representing an underperformance of 139 basis points in comparison to its benchmark.

<sup>(23)</sup> 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).

<sup>(24)</sup> Principally the EIB, but also Euratom external lending and EC macro financial assistance (MFA) loans to third countries.

<sup>(25)</sup> The stand alone net assets of the fund before consolidation amounted to 1 495 million euro.



## ANNEX 8.1

## RESULTS OF TRANSACTION TESTING FOR RESEARCH AND OTHER INTERNAL POLICIES

	2011					2010	2009	2008
	FP6	FP7	LLP	Other	Total			
<b>SIZE AND STRUCTURE OF THE SAMPLE</b>								
Total transactions (of which):	17	68	10	55	<b>150</b>	150	351	361
Advances	2	23	9	30	<b>64</b>	77	125	237
Interim/Final payments	15	45	1	25	<b>86</b>	73	226	124
<b>RESULTS OF TESTING <sup>(1)</sup> <sup>(2)</sup></b>								
<b>Proportion of transactions tested found to be:</b>								
Free of error	47 % (8)	32 % (22)	100 % (10)	65 % (36)	<b>51 % (76)</b>	61 %	72 %	86 %
Affected by one or more errors	53 % (9)	68 % (46)	0 % (0)	35 % (19)	<b>49 % (74)</b>	39 %	28 %	14 %
<b>Analysis of transactions affected by error</b>								
<b>Analysis by type of expenditure</b>								
Advances	0 % (0)	11 % (5)	0 % (0)	63 % (12)	<b>23 % (17)</b>	12 %	9 %	19 %
Interim/Final payments	100 % (9)	89 % (41)	0 % (0)	37 % (7)	<b>77 % (57)</b>	88 %	91 %	81 %
<b>Analysis by type of error</b>								
Non-quantifiable errors:	0 % (0)	39 % (18)	0 % (0)	53 % (10)	<b>38 % (28)</b>	33 %	35 %	34 %
Quantifiable errors:	100 % (9)	61 % (28)	0 % (0)	47 % (9)	<b>62 % (46)</b>	67 %	65 %	66 %
Eligibility	100 % (9)	96 % (27)	0 % (0)	100 % (9)	<b>98 % (45)</b>	97 %	55 %	65 %
Occurrence	0 % (0)	0 % (0)	0 % (0)	0 % (0)	<b>0 % (0)</b>	0 %	6 %	3 %
Accuracy	0 % (0)	4 % (1)	0 % (0)	0 % (0)	<b>2 % (1)</b>	3 %	39 %	32 %
<b>ESTIMATED IMPACT OF QUANTIFIABLE ERRORS</b>								
Most likely error rate						<b>3,0 %</b>		
Upper error limit						4,9 %		
Lower error limit						1,1 %		

<sup>(1)</sup> To improve insight into areas with different risk profiles within the policy group, the sample was split up into segments.

<sup>(2)</sup> Numbers quoted in brackets represent the actual number of transactions.

## ANNEX 8.2

## RESULTS OF EXAMINATION OF SYSTEMS FOR RESEARCH AND OTHER INTERNAL POLICIES

## Assessment of the systems examined

System concerned	Ex-ante desk checks	Audit certification	Ex-post financial audits	Overall assessment
Research framework programmes	Partially effective	Partially effective	Effective	Partially effective
Competitiveness and Innovation Framework programme — ICT Policy Support Programme	Partially effective	N/A	Not effective	Partially effective

## FOLLOW-UP OF PREVIOUS RECOMMENDATIONS FOR RESEARCH AND OTHER INTERNAL POLICIES

Year	Court recommendation	Court's analysis of the progress made	Commission reply
2009	<p>The Commission should raise the certifying auditors' awareness of the eligibility of expenditure with the aim of improving the reliability of the audit certificates they issue.</p> <p>(paragraph 8.32)</p>	<p>Where <i>ex-post</i> audits detect large discrepancies between certified and audited amounts, there is no feedback process in place to make certifying auditors aware of the Commission's audit findings. The Commission intends to put such a practice in place in 2012. In addition, in 2012 the Commission has embarked on a communication campaign targeting beneficiaries and their certifying auditors with the objective of improving the reliability of submitted cost claims and (where relevant) the respective audit certificates.</p>	<p><i>The Commission services already have in place a process to provide feedback to the certifying auditors where the Commission's ex-post audits identified material differences between the certified cost statements and its own findings. This is achieved either by writing to the beneficiaries inviting them to communicate the feedback to the certifying auditor or by directly addressing the certifying auditors.</i></p>
2008	<p>The Commission should ensure rigorous application of the controls, in particular by imposing penalties where appropriate and making recoveries or adjustments in cases of undue reimbursement of claimed costs.</p> <p>(paragraph 7.42)</p>	<p>In 2011, the Commission continued with its efforts to implement audit results by adjusting the cost claims or by issuing recovery orders. Moreover, since 2009 the Commission has imposed systematically liquidated damages on participants that have been found to have overstated expenditure and that have therefore received an unjustified financial contribution from the Commission.</p> <p>However, it was noted that in practice, especially for extrapolation, more cases are launched than closed.</p>	<p><i>As the Commission services have to take into account the rights of beneficiaries at all stages, the implementation of audit results, especially relating to extrapolation, is a difficult and lengthy process. Furthermore, some cases can only be implemented when the project is closed. High priority has been given recently to the management of extrapolation cases. As an example, in DG RTD the team in charge of this process has been reinforced and, as result, in 2012 17 extrapolation cases have been closed and 13 opened up to 8 May.</i></p>



## CHAPTER 9

**Administrative and other expenditure**

## TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	9.1-9.8
Specific characteristics of the policy group	9.4-9.5
Audit scope and approach	9.6-9.8
Regularity of transactions	9.9
Effectiveness of systems	9.10
Observations on specific institutions and bodies	9.11-9.29
European Parliament	9.12-9.17
European Council and Council	9.18
Commission	9.19-9.21
Court of Auditors	9.22
European Economic and Social Committee	9.23-9.24
European External Action Service	9.25-9.28
Other institutions and bodies	9.29
Conclusions and recommendations	9.30-9.34
Conclusions	9.30-9.32
Recommendations	9.33-9.34

## THE COURT'S OBSERVATIONS

## INTRODUCTION

9.1. This Chapter presents the Court's specific assessment of the administrative and other expenditure of the institutions and bodies of the European Union. Key information on the institutions and bodies covered, and on the spending in 2011 is provided in **Table 9.1**.

**Table 9.1 — Administrative and other expenditure — Key information 2011**

(million euro)

Budget Title	Policy group	Description	Payments	Management mode
14, 24-31	Administrative and other expenditure	European Parliament	1 580	Centralised direct
		Council	547	Centralised direct
		Commission	6 264	Centralised direct
		Court of Justice	334	Centralised direct
		Court of Auditors	137	Centralised direct
		European Economic and Social Committee	126	Centralised direct
		Committee of the Regions	91	Centralised direct
		European Ombudsman	9	Centralised direct
		European Data Protection Supervisor	7	Centralised direct
		European External Action Service	682	Centralised direct
		Total administrative expenditure	9 777	
		Total operational expenditure	—	
		<b>Total payments for the year</b>	<b>9 777</b>	
		<b>Total commitments for the year</b>	<b>11 721</b>	

Source: 2011 annual accounts of the European Union.

9.2. This Chapter also covers expenditure considered in the general budget as operational although its purpose is in most cases the functioning of the Commission's administration rather than policy delivery. This expenditure includes the following titles of the general budget: Title 14 — Taxation and customs union, Title 24 — Fight against fraud, Title 25 — Commission's policy coordination and legal advice, Title 26 — Commission's administration, Title 27 — Budget and Title 29 — Statistics.

9.3. The Court reports separately on the EU agencies and executive agencies and on the European Schools <sup>(1)</sup>. The Court's mandate does not cover the financial audit of the European Central Bank.

<sup>(1)</sup> The Court's Specific Annual Report on the European Schools is submitted to the Board of Governors of the European Schools, and is copied to the European Parliament, the Council and the Commission.

## THE COURT'S OBSERVATIONS

**Specific characteristics of the policy group**

9.4. Administrative and other expenditure comprises expenditure on human resources (salaries, allowances and pensions), which accounts for 60 % of total administrative and other expenditure, and expenditure on buildings, equipment, energy, communications, and information technology.

9.5. The main risks regarding administrative and other expenditure are non-compliance with the procedures for procurement, for the implementation of contracts, for recruitment and for the calculation of salaries and allowances.

**Audit scope and approach**

9.6. **Annex 1.1, Part 2**, of Chapter 1 describes the Court's overall approach and methodology. For the audit of administrative and other expenditure, the following specific issues should be noted:

- the audit involved the examination of a sample of 56 transactions, comprising three advances and 53 final payments,
- the assessment of systems covered the compliance of the supervisory and control systems <sup>(2)</sup> applied by each institution and body with the requirements of the Financial Regulation,
- the review of Commission management representations covered the annual activity reports of four of the Commission's directorates-general and offices primarily responsible for administrative expenditure <sup>(3)</sup>.

9.7. The Court also audited the following selected topics in all institutions and bodies <sup>(4)</sup>:

- (a) eligibility criteria, calculation and payment of social allowances to staff (household allowance, allowance for a dependent child or person treated as such and education allowances, including the deduction of allowances of like nature paid from other sources);

<sup>(2)</sup> *Ex-ante* and *ex-post* controls, internal audit function, exception reporting and internal control standards.

<sup>(3)</sup> The review covered the following Commission directorates-general and offices: the Office for Administration and Payment of Individual Entitlements (PMO), the Office for Infrastructure and Logistics in Brussels (OIB), the Office for Infrastructure and Logistics in Luxembourg (OIL) and the Directorate-General for Informatics (DIGIT).

<sup>(4)</sup> Except for the Court of Auditors (see paragraph 9.8).

---

THE COURT'S OBSERVATIONS

---

(b) procedures for extending and modifying the contracts of temporary and contract staff;

(c) open, restricted and negotiated procurement procedures.

9.8. The Court of Auditors is audited by an external audit firm<sup>(5)</sup> which issued an audit report on the financial statements for the financial year from 1 January 2011 to 31 December 2011 and an assurance report concerning the regularity of the use of the Court's resources, and the control procedures in place from 1 January 2011 to 31 December 2011 (see paragraph 9.22).

### REGULARITY OF TRANSACTIONS

9.9. *Annex 9.1* contains a summary of the results of the transaction testing. The Court's testing of its sample of transactions found 7 % to be affected by error. The most likely error (MLE) estimated by the Court is 0,1 %<sup>(6)</sup>.

### EFFECTIVENESS OF SYSTEMS

9.10. *Annex 9.2* contains a summary of the results of the Court's examination of supervisory and control systems.

### OBSERVATIONS ON SPECIFIC INSTITUTIONS AND BODIES

9.11. The specific observations that follow are presented by institution or body of the European Union and do not affect the assessments referred to in paragraphs 9.9 and 9.10. Whilst they are not material to administrative expenditure as a whole, they are significant in the context of the individual institution or body concerned.

---

<sup>(5)</sup> PricewaterhouseCoopers, Société à responsabilité limitée, Réviseur d'Entreprises.

<sup>(6)</sup> The Court calculates its estimate of error from a representative statistical sample. The figure quoted is the best estimate (known as the Most Likely Error — MLE). The Court has 95 % confidence that the rate of error in the population lies between LEL 0,0 % and UEL 0,3 % (the lower and upper error limits respectively).



## THE COURT'S OBSERVATIONS

**European Parliament****Payment of social allowances and benefits to staff members**

9.12. In two cases out of five audited, information available to the European Parliament's services on the personal and family situation of staff members was either not up-to-date or not properly processed. In one of these cases, it led to overpayments.

**Employment of accredited parliamentary assistants (APAs)**

9.13. Under the Internal Rules <sup>(7)</sup> for the employment of accredited parliamentary assistants (APAs), the latter are allowed to submit the medical certificate and other documents required for the conclusion of contracts within three months after the date on which the contract for their initial recruitment takes effect. This derogation conflicts with the provision laid down in Articles 128 and 129 of the Conditions of Employment of Other Servants of the European Communities (CEOS) <sup>(8)</sup>, by which all requirements for recruitment must be satisfied before the contract is concluded. This is illustrated by the fact that, in five out of the 10 cases audited, the APAs submitted the required medical certificates between three and seven months after the conclusion of the contract. As regards compliance with the requirement concerning the knowledge of languages <sup>(9)</sup>, in none of the 10 cases audited were there documents on file evidencing that checks had been performed.

## REPLY OF THE EUROPEAN PARLIAMENT

**9.12.** *Recovery of overpayments began in November 2011, and deductions were made from the pay of the staff member concerned. Measures have also been taken to ensure that information on staff members' personal and family situation is up-to-date and properly processed, involving ongoing efforts to enhance the control environment and personalised reminders, via management channels, about the annual process of confirming or updating personal data in order to ensure that all staff members reply. These personalised reminders are a preliminary to any more coercive action which may be taken where staff fail to reply.*

## REPLY OF THE EUROPEAN PARLIAMENT

**9.13.** *Parliament notes the Court's position that the provisions of Articles 15(2) and 16(3) of the Implementing Measures are not entirely in line with the requirements of Article 128 of Regulation (EC) No 160/2009. Parliament notes that, as regards checks on physical fitness, the legislative authority had decided not to adopt arrangements identical to those applicable to officials and temporary staff and, accordingly, had not expressly stated that the medical examination had to be carried out before recruitment took place, as stipulated, for example, in Article 33 of the Staff Regulations of Officials.*

*Since February 2012 the recruitment form contains a field in which a Member declares on his or her honour that the APA whom he or she wishes to recruit possesses the requisite language knowledge.*

<sup>(7)</sup> Implementing measures for Title VII of the conditions of employment of other servants of the European Communities (Bureau Decision of 9 March 2009).

<sup>(8)</sup> Council Regulation (EC) No 160/2009 of 23 February 2009 amending the Conditions of Employment of Other Servants of the European Communities (OJ L 55, 27.2.2009, p. 1).

<sup>(9)</sup> Article 128(2)(e) of the Conditions of Employment of Other Servants of the European Communities requires that the assistant has a thorough knowledge of one of the languages of the Community and a satisfactory knowledge of another Community language to the extent necessary for the performance of his duties.

## THE COURT'S OBSERVATIONS

**Performance of the ex-ante verification of recruitment procedures**

9.14. Articles 47 and 48 of the implementing rules of the Financial Regulation provide that every act implementing the budget must be subject to an *ex-ante* verification. In 9 out of the 10 procedures for recruiting APAs audited, there were no documents on file evidencing the *ex-ante* checks of recruitment documents performed. Best practice is to ensure that all formal documentation is duly filled in and archived for internal control purposes.

**Procurement**

9.15. The audit examined 10 procurement procedures. In two cases, relating to the maintenance of buildings and to printing services, there were weaknesses in the application of selection and award criteria.

9.16. In the procedure regarding the maintenance of buildings, tenderers did not receive detailed information on the method applied for the evaluation of their bids. For one lot valued at 750 000 euro over four years (out of a total contract value of 23 141 740 euro), the estimated value of materials to use, which amounted to 40 % of the value of the lot, was not disclosed in the tender documentation. Tenderers were only asked to submit a gross profit margin rate on materials and were thus prevented from making a more competitive bid by combining optimally the components of their financial offer.

9.17. In the case of one negotiated procedure relating to printing services, the specification for the location of the services to be provided was not drafted in a clear and transparent manner. In addition, the potential tenderers consulted were all based in Luxembourg, thereby restricting cross border competition. Out of the 11 potential tenderers consulted, only the previous contractor submitted a bid and was awarded the contract for 60 000 euro over four years. Furthermore, compliance with selection criteria was not checked before entering into the negotiation, in contradiction with the provisions of Article 122(3) of the implementing rules of the Financial Regulation.

## REPLY OF THE EUROPEAN PARLIAMENT

**9.14.** *Substantial improvements are currently being made to the ex-ante verifications carried out by the unit with responsibility for recruitment (thorough revision of checklists and introduction of cross-checking). The underlying documentation for those verifications is now being kept.*

## REPLY OF THE EUROPEAN PARLIAMENT

**9.16.** *In this particular lot Parliament has included the materials as an invariable sum in order to individualise and weigh in a transparent way the real cost of the works.*

## REPLY OF THE EUROPEAN PARLIAMENT

**9.17.** *Parliament agrees with the Court's observations and will take them into account when preparing the next procedure. However, Parliament underlines that for this particular small value contract the services to be provided were essentially local.*

## THE COURT'S OBSERVATIONS

**European Council and Council****Procurement**

9.18. The audit examined five procurement procedures. In two cases relating to cleaning services (contract value of 16 214 000 euro over four years) and to the purchase of service clothing and shoes (contract value of 344 000 euro over four years) if tenderers did not propose a price for certain items of the tender, tender specifications enabled the Council to estimate a price based on the average price submitted for this item by the other tenderers. The Council thus modifies the value of the tender in a way which is not laid down in the Financial Regulation.

**Commission****Calculation and payment of social allowances to staff members**

9.19. In 15 cases out of 28 audited, the information available in the Office for Administration and Payment of Individual Entitlements (PMO) on the personal and family situation of the staff members, was not up-to-date. In six of these cases, it led to incorrect payments because the amounts deducted did not reflect the latest applicable value of benefits paid by national authorities<sup>(10)</sup>.

## REPLY OF THE COUNCIL

**9.18.** *The Council observes first, that there has been no violation of the Financial Regulation, as Article 148(3) of the Regulation laying down the implementation rules targets contacts that lead to modification of the value of the tender. No such contacts have taken place in the procedures examined by the Court. The Council fully acknowledges that this provision does not allow an institution to ask for prices which have been overlooked by a tenderer.*

*In order not to exclude the candidate and to preserve the competition for complex tenders which cover an array of products or services, the tender documents explicitly mention that in the event of a price omission the evaluation committee may apply itself (barring any contact with the tenderers) a theoretical average price. In order to not distort the intention of the tenderer this method is only used to correct a limited number of omissions. It was only used in one of the cases identified by the Court for a minor item which was lacking in a list of 81 prices (corresponding with a financial impact of 0,67 % of the bid).*

*The General Secretariat of the Council considers that this approach respects fully the spirit and the principles of the Financial Regulation: transparency, proportionality and non-discrimination. Coupled with a measured and cautious implementation, it represents a safeguard for adequate competition and sound financial management.*

## REPLY OF THE COMMISSION

**9.19.** *An automatic update of the amounts of the allowances of like nature from the Belgian State is being implemented by the Commission in SYSPER2/Rights (the information system for the management of individual entitlements) since April 2012. This automatism will significantly decrease the risk of errors as the update will not be done manually any more. The other Member States will follow.*

*Additionally, a new module will be put in place in the front office of SYSPER2/Rights. Staff will be asked to declare the professional activity of their spouse. The other modules of SYSPER2/Rights being implemented also include sections of allowances of like nature.*

<sup>(10)</sup> Article 67(2) of the Staff Regulations requires allowances of like nature received from other sources to be deducted from those paid by the institutions.

## THE COURT'S OBSERVATIONS

**Procurement**

9.20. The audit examined four procurement procedures performed by the Office for Infrastructure and Logistics in Luxembourg (OIL). In three of them for the provision of security services (contract value of 46 000 000 euro over four years), training services (contract value of 860 000 euro over four years) and maintenance services (contract value of 11 000 000 euro over four years), which were concluded under the automatic award procedure, weaknesses were noted: the application of award criteria at the selection stage, the use of similar criteria several times during the evaluation process and inconsistencies in the definition and evaluation of the selection criteria.

9.21. OIL also organised an open procurement procedure to provide assistance and consultancy in technical, architectural and financial fields. The total value of the market amounts to 3 124 000 euro over four years. The type of contract chosen is a multiple framework contract in cascade signed with three companies. This means that, if the company ranked first in the cascade cannot provide the requested service, the company ranked second in the cascade is invited to submit a bid, and so on. The company ranked second in the cascade should have been eliminated at the stage of examination of selection criteria as it did not fulfil the requirement relating to previous experience in the field of the contract.

**Court of Auditors**

9.22. The external auditor's report <sup>(1)</sup> states that, in the auditors' opinion, 'the financial statements give a true and fair view of the financial position of the European Court of Auditors as of 31 December 2011, and of its financial performance and its cash flows for the year then ended in accordance with Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002, Commission Regulation (EC, Euratom) No 2342/2002 of 23 December 2002 laying down detailed rules for the implementation of the said Council Regulation and the Accounting Rules of the European Union'. The report will be published in the Official Journal.

## REPLY OF THE COMMISSION

**9.20.** All procurement procedures analysed by the Court were launched at the end of 2010 or the beginning of 2011. In mid-2011, OIL revised its approach with regards to calls for tender procedures with a view to streamlining all aspects of the tender specifications, such as reducing the number of selection and award criteria and defining them more precisely. For all new procurement procedures launched since then, most of the formal weaknesses highlighted by the Court have been resolved (for the ones still existing at the time of the audit of the Court, action has now been taken to eliminate them).

## REPLY OF THE COMMISSION

**9.21.** In the course of the tender procedure, OIL should have requested from the concerned bidder a more recent justification of experience in the field of the contract. If this information could not be provided, and only then, the bidder should have been eliminated.

However, it should be noted that since the signature of the contract on the 4 March 2011 and until end of May 2012, OIL signed only one purchase order of a value of 1 116 euro with the concerned company.

<sup>(1)</sup> See the external auditor's report on the financial statements referred to in paragraph 9.8.

## THE COURT'S OBSERVATIONS

**European Economic and Social Committee****Conclusion of contracts with temporary and contract staff**

9.23. An examination of the procedures for the extension and modification of contracts of temporary and contract staff found that the provisions included in the internal rules and in the guidelines applicable to the selection and grading of these staff did not consistently take into account professional experience acquired by these staff. In addition, one of the guidelines applied had no date of entry into force. These inconsistencies increase the risk of error in the grading of temporary staff employed under the provisions of Article 2(b) of the CEOS.

9.24. One staff member recruited as a temporary agent under the above mentioned provisions, out of four cases examined, was graded one grade above the basic grade of his career. This staff member was re-graded to the basic grade six months later when it was found that there was a lack of posts for the promotion of permanent staff. This situation shows a weakness in the planning of the allocation of available posts among the various categories of staff.

## REPLY OF THE EESC

**9.23.** *The current guidelines for the grading of temporary agents (DRHF 001/08) were adopted 14 January 2008. However, since July 2010, grading for all temporary 2b agents has remained at AD5 level, initially due to a lack of available grades at a higher level, but later applied as a matter of policy. The guidelines have indeed not been updated to reflect this change in policy and the EESC will adjust the provisions of its current regulation/guidelines concerning the grading of temporary staff employed under the provisions of Article 2(b) of the CEOS, in order to ensure a consistent and transparent application. The Court will be informed of the date of implementation of the future decision, which is expected by the end of autumn 2012.*

*The undated document referred to was an internal working document intended solely to provide practical guidance for engagement procedures related to both contractual and temporary agents, which will be integrated in the updated guidelines as mentioned above.*

## REPLY OF THE EESC

**9.24.** *In the case referred to by the Court, the staff member was indeed re-graded to the basic grade of his career at the occasion of his contract extension, six months after the initial contract entered into force, due to the unavailability of a post with the initial grade at that moment.*

*The Committee makes constant effort to improve the forecast of the utilisation of posts. However, the margins are limited for smaller institutions, as the effect of only a few unforeseen movements in staff can have significant repercussions and therefore be difficult to counterbalance.*

## THE COURT'S OBSERVATIONS

**European External Action Service****Payment of social allowances and benefits to staff members**

9.25. In six cases out of 17 audited, information available to the services of the European External Action Service (EEAS) on the personal and family situation of the staff members, was not up-to-date. In three of these cases, it led to incorrect payments because the amounts deducted did not reflect the latest applicable value of benefits paid by national authorities.

**Conclusion of contracts with temporary staff**

9.26. The analysis of the salary paid to three temporary staff, out of a sample of eight audited, showed that contracts of employment were signed by both parties between three and seven months after the staff members had taken up their duties. This practice creates a situation of legal uncertainty for both parties.

**Management of a contract for the provision of security services**

9.27. The invoice related to the monthly payment of 5 340 euro for the provision of security services to the Delegation to Venezuela was wrongly endorsed as 'certified correct' whereas these services had not yet been provided. This practice is contrary to Article 79 of the Financial Regulation. In addition, the related security contract has been in force for 24 years without modification. The audit also noted that the delegation had only obtained informal exemption from paying VAT, although the VAT recovery legislation has been in force in Venezuela since the year 2000. It has not calculated the amount of VAT unrecovered over this period.

## REPLY OF THE EEAS

**9.25.** *The EEAS will address its staff regularly, once a year, to request the update of their personal file and remind them of their duty to declare such allowances. This message will be issued in September.*

*The IT systems must allow a regular update of the amounts perceived in accordance with national or regional legislation/rules on increases of such allowances. The EEAS understands that PMO has developed an IT tool and recently tested it for allowances perceived from Belgium authorities and will successively extend this IT application for other populations including EEAS staff. The EEAS will ask PMO to be able to benefit from this IT application as soon as possible.*

## REPLY OF THE EEAS

**9.26.** *During the transitional period when a large number of diplomats from Member States were recruited as temporary agents, some contracts may have been signed only some time after the staff members had taken up their duties. Such cases remained exceptional. All persons were recruited according to standard and regular procedures. The EEAS will take the necessary steps so that such cases are not happening in the future.*

## REPLY OF THE EEAS

**9.27.** *The delegation has been instructed to tender a new security contract and to recover the VAT unduly paid since 2000.*

*More generally, the delegations have been repeatedly and all levels reminded about the importance of regular new tendering of their services contracts.*

## THE COURT'S OBSERVATIONS

**Procurement**

9.28. In three restricted procurement procedures relating to the provision of security services out of five audited, weaknesses were found in the definition and application of award criteria and in the evaluation of tenders, in the drafting of tendering documents, in the definition and application of selection criteria and in the opening and evaluation committees' performance of their respective roles. In one of these cases, the evaluation committee chose to reject without further analysis an offer which included an abnormally low bid although the tenderer confirmed that this resulted from a clerical error. In two other procedures related to the provision of facility management services (contract value of 285 000 euro over four years) and the rental of offices (contract value of 9 000 000 euro over 10 years), key documentation related to the performance of some steps of the procedures could not be provided to the Court.

**Other institutions and bodies**

9.29. The audit did not identify any significant weakness in respect of the topics audited for the Court of Justice, the Committee of the Regions, the European Ombudsman and the European Data Protection Supervisor.

**CONCLUSIONS AND RECOMMENDATIONS****Conclusions**

9.30. Based on its audit work, the Court concludes that the payments as a whole for the year ended on 31 December 2011 for administrative and other expenditure of the institutions and bodies were free from material error (see paragraph 9.9).

9.31. Based on its audit work, the Court found that the examined supervisory and control systems for administrative and other expenditure were effective.

9.32. The Court draws attention to the errors and weaknesses which did not affect the Court's conclusion. The Court examined a sample of procurement procedures (see paragraphs 9.15, 9.16, 9.17, 9.18, 9.20, 9.21 and 9.28) and noted several weaknesses in the application of selection and award criteria, some of which had an impact on the results of the procedure. Other weaknesses related to the organisation of cross border competition, to the management of automatic award procedures and to the respect of provisions as regards the drafting and filing of tendering documents. The Court also detected weaknesses in the examination of a sample of calculations and payments of social allowances (see paragraphs 9.12, 9.19 and 9.25) and of a sample of employment contracts for non-permanent staff (see paragraphs 9.13, 9.23, 9.24 and 9.26).

## REPLY OF THE EEAS

**9.28.** *The preparation of tender documents before April 2011 was done by the former RELEX K8 unit (now MDR-B1). With the creation of the EEAS and the setting up of the contract division (MDR-A2) the quality of the tender documents has improved.*

*The facility management services mentioned here relates to a tender done without the input from division MDR-A2 at that time. Regarding the remark on the 9 million euro contract for the rental of offices, the main documents (building report of the delegation and positive opinion of HQ) have been sent in the meantime (June 2012) to the Court.*

## REPLY OF THE COMMISSION

**9.30-9.31.** *The Commission notes that for many years in a row now transactions related to administrative expenditure as a whole are free from material errors and the related supervisory and control systems are effective.*

## THE COURT'S OBSERVATIONS

**Recommendations**

9.33. **Annex 9.3** shows the result of the Court's review of progress in addressing recommendations made in the 2009 Annual Report. The following points should be noted:

- (a) Social allowances: the Court recommended to the European Parliament, the European Commission and the European Data Protection Supervisor (see paragraphs 9.14, 9.19 and 9.26 of the 2009 Annual Report) that they request their staff to deliver at appropriate intervals documents confirming their personal situation and that they implement a system for the timely monitoring of these documents.
- (b) The audit found that the problems identified in the Court's 2009 Annual Report persisted, albeit to a lesser extent, in 2011 at the European Parliament and at the EEAS (formerly the Directorate-General for External Relations of the European Commission). The risk of making incorrect or undue payments if the circumstances of the staff member have changed thus remains. As regards the European Data Protection Supervisor, measures implemented as a result of the Court's audit were effective.

## REPLY OF THE COMMISSION

**9.33.**

- (a) *The Commission will put in place a new module in the front office of SYSPER2/Rights. Staff will be asked to declare the professional activity of their spouse. The other modules of SYSPER2/Rights being implemented also include sections of allowances of like nature.*

## REPLY OF THE EEAS

**9.33.** *The EEAS will address its staff regularly, once a year, to request the update of their personal file and remind them of their duty to declare such allowances. This message will be issued in September.*

*The IT systems must allow a regular update of the amounts perceived in accordance with national or regional legislation/rules on increases of such allowances. The EEAS understands that PMO has developed an IT tool and recently tested it for allowances perceived from Belgium authorities and will successively extend this IT application for other populations including EEAS staff. The EEAS will ask PMO to be able to benefit from this IT application as soon as possible.*



## THE COURT'S OBSERVATIONS

## REPLY OF THE COMMISSION

9.34. Following this review and the findings and conclusions for 2011, the Court recommends that:

— **Recommendation 1:** The institutions and bodies concerned (see paragraphs 9.12, 9.19 and 9.25) take steps to ensure that staff deliver at appropriate intervals documents confirming their personal situation and implement a system for the timely monitoring of these documents. The IT systems used to manage these payments should be enhanced to ensure that the allowances paid by national authorities are updated automatically;

— **Recommendation 2:** The institutions and bodies concerned (see paragraphs 9.13, 9.23, 9.24 and 9.26) take steps to ensure that the provisions of the relevant regulations are applied when concluding, extending or modifying employment contracts with non-permanent staff;

**9.34.**

*An automatic update of the amounts of the allowances of like nature from the Belgian State is being implemented by the Commission in SYSPER2/Rights (the information system for the management of individual entitlements) since April 2012. This automatism will significantly decrease the risk of errors as the update will not be done manually any more. The other Member States will follow.*

*Additionally, a new module will be put in place in the front office of SYSPER2/Rights. Staff will be asked to declare the professional activity of their spouse. The other modules of SYSPER2/Rights being implemented also include sections of allowances of like nature.*

## REPLY OF THE EEAS

*The EEAS will address its staff regularly, once a year, to request the update of their personal file and remind them of their duty to declare such allowances. This message will be issued in September. The IT systems must allow a regular update of the amounts perceived in accordance with national or regional legislation/rules on increases of such allowances. The EEAS understands that PMO has developed an IT tool and recently tested it for allowances perceived from Belgium authorities and will successively extend this IT application for other populations including EEAS staff. The EEAS will ask PMO to be able to benefit from this IT application as soon as possible.*

## REPLY OF THE EEAS

*During the transitional period when a large number of diplomats from Member States were recruited as temporary agents, some contracts may have been signed only some time after the staff members had taken up their duties. Such cases remained exceptional.*

*All persons were recruited according to standard and regular procedures. The EEAS will take the necessary steps so that such cases are not happening in the future.*

---

THE COURT'S OBSERVATIONS

---

- **Recommendation 3:** The institutions and bodies concerned (see paragraphs 9.15, 9.16, 9.17, 9.18, 9.20, 9.21 and 9.28) should ensure that authorising officers improve the design, coordination and performance of procurement procedures through appropriate checks and better guidance.

---

REPLY OF THE COMMISSION

---

*OIL has already revised its approach with regards to calls for tender procedures with a view to streamlining all aspects of the tender specifications.*

---

REPLY OF THE EEAS

---

*is being implemented with the creation of the MDR-A2 division and the important work provided in order to improve the quality of procurement procedures. MDR-A2 division has also produced a procurement guide and a template for security contracts in delegation. Other templates are under preparation.*

## ANNEX 9.1

## RESULTS OF TRANSACTION TESTING FOR ADMINISTRATIVE AND OTHER EXPENDITURE

	2011				2010	2009	2008
	Expenses related to staff	Expenses related to buildings	Other expenses	Total			
<b>SIZE AND STRUCTURE OF THE SAMPLE</b>							
Total transactions (of which):	43	4	9	56	58	57	57
advances	0	0	3	3	4	2	0
Final payments	43	4	6	53	54	55	57
<b>RESULTS OF TESTING <sup>(1)</sup> <sup>(2)</sup></b>							
<b>Proportion of transactions tested found to be:</b>							
Free of error	91 % (39)	100 % (4)	100 % (9)	93 % (52)	93 %	93 %	91 %
Affected by one or more errors	9 % (4)	0 % (0)	0 % (0)	7 % (4)	7 %	7 %	9 %
<b>ESTIMATED IMPACT OF QUANTIFIABLE ERRORS</b>							
Most likely error rate				0,1 %			
Upper error limit				0,3 %			
Lower error limit				0,0 %			

<sup>(1)</sup> To improve insight into areas with different risk profiles within the policy group, the sample was split up into segments.

<sup>(2)</sup> Numbers quoted in brackets represent the actual number of transactions.

## ANNEX 9.2

## RESULTS OF EXAMINATION OF SYSTEMS FOR ADMINISTRATIVE AND OTHER EXPENDITURE

## Assessment of the systems examined

System concerned	Overall assessment
All systems	Effective

## FOLLOW-UP OF PREVIOUS RECOMMENDATIONS FOR ADMINISTRATIVE AND OTHER EXPENDITURE

Year	Court recommendation	Court's analysis of the progress made	Institution reply
	<p><b>Parliament</b></p> <p><i>Payment of social allowances to staff members</i></p> <p>Staff should be requested to deliver at appropriate intervals documents confirming their personal situation. In addition, the Parliament should implement a system for the timely monitoring and control of these documents.</p>	<p>As mentioned in Annex 7.4 of the 2010 Annual Report the Parliament implemented measures to mitigate the risk: campaign to check eligibility for some allowances; implementation of an automated control tool ('electronic fiche') allowing an annual verification of the staff's personal and administrative data; and performance of checks on the establishment of individual entitlements during recruitment procedures or when staff change category. The Court's audit showed, however, that the risk of making incorrect or undue payments remains.</p>	<p><i>As part of the process of continually enhancing the relevant control environment, and with a view to a marked increase in the staff response rate in connection with the annual exercise to confirm or update personal data, personalised reminders — via management channels — have been introduced. Accordingly, resource directorates have received a list of staff members in their directorates-general who have not replied during the 2012 exercise. This measure is a preliminary to more coercive action where staff fail to reply.</i></p>
2009	<p><b>Commission — DG RELEX</b></p> <p><i>Payment of social allowances and benefits to staff members</i></p> <p>Staff should be requested to deliver at appropriate intervals to the Commission's services documents proving their personal situation. In addition, DG RELEX should implement a system for the timely monitoring and control of these documents.</p>	<p>As mentioned in Annex 7.4 of the 2010 Annual Report the creation of the European External Action Service (EEAS) would be an opportunity to remind staff of the obligations to update files when rights are concerned and to set up adequate controls. The Court's audit showed, however, that the risk of making incorrect or undue payments remains.</p>	<p><b>Commission</b></p> <p><i>An automatic update of the amounts of the allowances of like nature from the Belgian State is being implemented by the Commission in SYSPER2/Rights (the Information System for the management of Individual Entitlements) since April 2012. This automatism will significantly decrease the risk of errors as the update will not be done manually any more. The other Member States will follow.</i></p> <p><i>Additionally, a new module will be put in place in the front office of SYSPER2/Rights. Staff will be asked to declare the professional activity of their spouse. The other modules of SYSPER2/Rights being implemented also include sections of allowances of like nature.</i></p> <p><b>EEAS</b></p> <p><i>The Paymaster Office (PMO), which is responsible for the administration of entitlements of EEAS staff in headquarters, will adopt an automatic updating of benefits received from other sources. The automatic updating will be introduced for EEAS staff in Headquarters during the last quarter of 2012. In conformity to Article 67 of the Staff Regulations, also EEAS officials in Delegations will be requested to declare in Sysper 2 their benefits received from other sources.</i></p>

Year	Court recommendation	Court's analysis of the progress made	Institution reply
2009	<p><b>European Data Protection Supervisor</b></p> <p><i>Payment of social allowances to staff members</i></p> <p>Staff should be requested to deliver at appropriate intervals documents proving their personal situation. In this respect, the European Data Protection Supervisor should improve its system for the timely monitoring and control of these documents.</p>	<p>As mentioned in Annex 7.4 of the 2010 Annual Report the EDPS has implemented tools for better management of the allowances (formal contacts within the EDPS' Office and with the Office for Administration and Payment of Individual Entitlements and yearly information fiche). The Court's audit showed that these measures were effective.</p>	<p><i>The EDPS takes good note of the result of the Court's analysis and intends to continue to improve its system for timely monitoring and control.</i></p>

## CHAPTER 10

**Getting results from the EU budget**

## TABLE OF CONTENTS

	<i>Paragraph</i>
Introduction	10.1-10.2
Evaluation report on the Union's finances based on results achieved	10.3-10.4
The Commission's management reporting on the achievements of the year	10.5-10.18
Introduction	10.5-10.6
Some welcome changes since last year	10.7
Relevance remains an issue in some cases	10.8-10.12
Comparability suffers from lack of explanations	10.13-10.16
Consistency of objectives, indicators and targets	10.14-10.15
Providing explanations for performance achieved	10.16
Reliability of data a challenge when received from external sources	10.17-10.18
Results of the Court's audits on performance	10.19-10.33
Introduction	10.19-10.21
Needs analysis: no robust evidence	10.22-10.24
Design: insufficiently clear what is to be achieved	10.25-10.30
EU added value: justification for the EU intervention	10.31-10.33
Conclusions and recommendations	10.34-10.39
Conclusions	10.34-10.38
Recommendations	10.39

## THE COURT'S OBSERVATIONS

**INTRODUCTION**

10.1. This Chapter focuses on performance. An initial, short section covers the Commission's first evaluation report <sup>(1)</sup>. The remainder of the Chapter presents the Court's observations on the Commission's self-assessments on performance as stated in part 1 of the annual activity reports of the Commission's directors-general <sup>(2)</sup>, and highlights some of the main themes arising from the Court's 2011 special reports on performance <sup>(3)</sup>.

10.2. Performance is assessed on the basis of the sound financial management principles (economy, efficiency and effectiveness) <sup>(4)</sup>. Its measurement is key throughout the public intervention process, covering inputs (financial, human, material, organisational or regulatory means needed for the implementation of the programme), outputs (the deliverables of the programme), results (the immediate effects of the programme on direct addressees or recipients) and impacts (long-term changes in society that are, at least partly, attributable to the EU's action).

**EVALUATION REPORT ON THE UNION'S FINANCES BASED ON RESULTS ACHIEVED**

10.3. In February 2012, the Commission published a report to the European Parliament and the Council on the evaluation of the Union's finances based on the results achieved (the evaluation report) <sup>(5)</sup>. The Treaty requires that the Commission produce such a report, and that the report is part of the evidence on which the Parliament gives a discharge each year to the Commission in respect of the budget <sup>(6)</sup>.

<sup>(1)</sup> Article 318 of the Treaty on the Functioning of the European Union (TFEU) (OJ C 83, 30.3.2010) provides for a report from the Commission to the European Parliament and the Council on the evaluation of the Union's finances based on the results achieved.

<sup>(2)</sup> Article 60(7) of the 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) provides that the annual activity reports 'shall indicate the results of the operations by reference to the objectives set, the risks associated with these operations, the use made of resources provided and the efficiency and effectiveness of the internal control system'.

<sup>(3)</sup> The Court's special reports cover the EU budget, as well as the European Development Funds.

<sup>(4)</sup> Article 27 of the Financial Regulation.

<sup>(5)</sup> Report from the Commission to the European Parliament and the Council on the evaluation of the Union's finances based on the results achieved (COM(2012) 40 final).

<sup>(6)</sup> Articles 318 and 319 TFEU.



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

10.4. In response to an invitation from the Parliament, the Court issued Opinion No 4/2012 on the evaluation report <sup>(7)</sup> in June 2012. In this Opinion the Court states that the evaluation report is vague, short on substance and consequently adds little value, and that the Parliament, Council and Commission should use the opportunity afforded by the report to discuss and agree on how it might be made useful to the discharge authority.

**10.4.** *The 2010 Evaluation Report was subject to discussions with the discharge authority in early 2012. Based on these discussions, the Commission has reconsidered the approach used for the first Evaluation Report towards more comprehensive reporting on results of activities financed by the budget, relying on existing reporting material. However, the Commission continues further developing the Evaluation Report as a key contribution to the discharge process in the light of the reactions from the discharge authority.*

## THE COMMISSION'S MANAGEMENT REPORTING ON THE ACHIEVEMENTS OF THE YEAR

### Introduction

10.5. The directors-general of the Commission set performance objectives for their directorate-general (DG) in annual management plans, and then report on achievements in annual activity reports. The Court assessed the reporting of three DGs: those for Agriculture and Rural Development (DG AGRI), for Regional Policy (DG REGIO) and for Development and Co-operation — EuropeAid (EuropeAid) <sup>(8)</sup>. Together these three DGs are responsible for around three-quarters of the payments made from the EU budget in 2011 <sup>(9)</sup>.

10.6. The Court considered the changes made to the Commission's internal reporting arrangements since the previous year and, for the three DGs referred to above, analysed whether the objectives and performance indicators presented were:

- (a) relevant — whether they were coherent with the policy objectives and management mode, and linked to quantified targets;

<sup>(7)</sup> Opinion No 4/2012 on the Commission's evaluation report on the Union's finances based on results achieved established under Article 318 of the Treaty of the Functioning of the European Union (OJ C 179, 20.6.2012).

<sup>(8)</sup> The annual activity reports of DG AGRI and DG REGIO were also examined in the Court's 2010 Annual Report. EuropeAid was created in January 2011 by the merger of the DGs for Development and Relations with African, Caribbean and Pacific States (DG DEV), and the EuropeAid Co-operation Office (DG AIDCO).

<sup>(9)</sup> DG AGRI: 56,2 billion euro, DG REGIO: 32,9 billion euro, EuropeAid: 4,1 billion euro.

---

THE COURT'S OBSERVATIONS

---

- (b) *comparable* — whether indicators selected at the planning stage were later used for reporting, with any changes explained; and
- (c) *reliable* — whether the reader can have reasonable assurance that the reported information is accurate <sup>(10)</sup>.

### **Some welcome changes since last year**

10.7. In November 2011, the Commission issued revised guidelines to its directors-general for the preparation of the 2011 annual activity reports. The revision addressed, among other things, observations made by the Court in its 2010 Annual Report <sup>(11)</sup>. For example, instructions for reporting on policy achievements in the first part of the annual activity report were clarified, with directors-general required to focus more on the progress towards the achievement of the objectives in terms of the results and impact, as well as to provide a description of the outputs secured.

### **Relevance remains an issue in some cases**

10.8. At the strategic level, DGs are required to define a limited number of 'general objectives', together with a set of 'impact indicators' allowing progress against the general objectives to be tracked. The general objectives and impact indicators, taken together, are tools for Commission management — and therefore also for readers of the annual activity report, such as the discharge authority — to assess the extent to which the DG is meeting its high level goals. The Court found a number of problems with the objectives and indicators, limiting their usefulness, as set out in the following paragraphs.

---

<sup>(10)</sup> For this aspect, the Court carried out only a limited review — see paragraph 10.17.

<sup>(11)</sup> The timing of the Court's annual report is such that there is limited time available for the Commission's annual activity reports to take account of its messages.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

10.9. In some cases there were weaknesses in the internal coherence of the objectives and indicators (see example 10.1).

**Example 10.1****DG AGRI: impact indicator does not cover entirety of objective**

One general objective in the annual activity report has three aims:

- to promote a viable and competitive agricultural sector,
- which respects high environmental and production standards,
- ensuring at the same time a fair standard of living for the agricultural community.

The only impact indicator for this objective is 'farmers' income developments'. This relates only to the third aim above, meaning that there are no indicators for the first two aims.

**EuropeAid: impact indicator formulated as an objective**

The impact indicator 'EU coordinated approach' corresponding to general objective 4: 'Promote an international development framework based on enhanced multilateral cooperation and global governance' and having the target 'New EU budget support contracts are concluded in coherence with the principles of COM 638' is formulated as an objective rather than an indicator.

10.10. Many of the high level objectives and indicators set within the three DGs audited are not well suited to the annual measurement that the annual activity report process involves. This is because some policies are designed to have an impact over a longer term, with a significant delay between investment and benefit. Most indicators and targets related to the entire 2007-2013 period, with no use made of interim indicators or milestones.

10.9.

**Example 10.1**

*The basic requirements of the internal control standard 5 establish that Management Plans should provide for at least one indicator per objective, both at policy area and at activity level, to monitor and report on achievements. This requirement is reproduced in SG standing instructions and DG AGRI is in compliance with it.*

*The Commission has made significant efforts to define the objectives and indicators in a coherent and comprehensive way. In certain policy areas it is very difficult and it should be taken into consideration that indicators in the AAR should not be read in isolation.*

*The Commission considers that the indicator 'farmer's income developments' does cover the entirety of the general objective 1 as it responds not only to the aim of ensuring a fair standard of living for the agricultural community but also to the viability of farms and rural areas. Additionally, as for the receipts of single payments farmers need to maintain the land in good agricultural and environmental conditions, the general objective 1 aim of respecting 'high environmental and production standards' is also met.*

*The Commission will explore alternative ways of defining indicators based on 'SMART' objectives.*

**10.10.** *The Commission confirms that it is the very nature of multiannual programmes to invest in the longer term with a possibility to evaluate impact only over a significant period of time. For the 2014-2020 period, the Commission has proposed milestones for output indicators which are more directly related to the policy.*

## THE COURT'S OBSERVATIONS

10.11. Impact indicators should have quantified targets associated with them. However:

- (a) of the 29 impact indicators in the three annual activity reports examined, 11 did not have quantified targets — and no deadlines — associated with them <sup>(12)</sup>;
- (b) for DG REGIO, while all but one of its targets have deadlines, these deadlines are frequently at some point in the medium term future. As a consequence, its Annual Activity Report for 2011 often reports against results achieved in relation to the previous programming period, 2000-2006.

10.12. The Court noted in its 2010 Annual Report that DGs did not set or report on objectives for operational activities relating to economy (the cost of inputs) or efficiency (the relation between inputs, outputs and results). As a separate observation, the Court also reported last year that the description of the policy achievements in part 1 of the annual activity reports provide limited information on results and impacts; they tend to focus more on inputs and outputs, rather than the outcomes of actions. The Court's examination of management plans and annual activity reports this year did not reveal any significant progress in this area.

### Comparability suffers from lack of explanations

10.13. As a principle, as well as reporting on the objectives/targets that have been set, good practice requires that performance information should be consistent from one period to the next, or explain changes made so that users of the information can make comparisons and assess trends.

## THE COMMISSION'S REPLIES

**10.11.** *Quantified targets are not always feasible, adequate or even appropriate notably because for the impact indicators a number of external factors come into play. In such cases, a trend is sufficient as a benchmark to measure the achievement.*

- (a) *The Commission strives to establish quantified targets wherever possible. However, in some cases, for instance in relation to human rights in third countries, quantified targets may not always be meaningful and appropriate.*
- (b) *Section 1.2 of the AAR uses impact indicators based on macro-economic models and statistical information to relate to the global objectives of the policy, with a baseline set in most cases in 2006. Evolution of the impact indicators reflects the contribution of many factors of which cohesion policy is only one.*

**10.12.** *The Commission services complied with the obligations set up in the Financial Regulations and in the instructions for the drafting of the Annual Activity Reports (AARs).*

*The Commission strengthened the standing instructions for the 2011 AARs, in terms of economy, efficiency and effectiveness, and requested the directorates-general to add indicators on voluntary basis on sound financial management in Part 3.*

*The Commission is confident that AARs as a whole provide sufficient information on results/outcomes.*

**10.13.** *The Commission is of the view that performance information should be based on a process of continuous improvement where necessary rather than on consistency. It agrees that changes in this regards should be explained. It is however of the view that sufficient information has been provided in this respect.*

<sup>(12)</sup> DG AGRI: five indicators; EuropeAid: five indicators; DG REGIO: one indicator.

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

*Consistency of objectives, indicators and targets*

10.14. The annual activity reports should report against the objectives, indicators and targets set in the management plan. This was generally the case for DG AGRI, which reclassified some impact indicators as the Court had suggested in its work on the 2010 annual activity reports. However, DG AGRI did not explain the substance of two other changes in either the Management Plan or the Annual Activity Report. And since Member States were able to modify quantified targets at their own discretion, three of the four quantified targets changed between the 2011 Management Plan and the 2011 Annual Activity Report as a result of Member States updating their Rural Development Plans (see example 10.2).

Example 10.2		
Target	2011 Management Plan	2011 Annual Activity Report
Increase in production of renewable energy	20 500 ktoe <sup>(13)</sup>	12 300 ktoe
Job creation	346 000	344 000
Utilised agricultural area of High Nature Value	3 400 000 ha	3 620 000 ha

10.15. In addition to general objectives, DG REGIO also sets 'multiannual priorities'. Compared to the 2011 Management Plan, the 2012 Plan increases the number of multiannual priorities from four to five, and changes the wording of some of the other priorities. Furthermore, the 2012 Management Plan increases the number of lower level 'specific operational priorities' from 28 to 39. The plan provides no explanations for any of these changes.

**10.14.** *The Commission considers that there is stability over the years as regards indicators and targets. As indicated in this finding, the change in indicators and targets is an exception and it followed the Court's recommendations to re-assess two impact indicators as result indicators. This is very clearly signalled in the Management Plan 2011 update.*

*Indeed, Member States have the possibility to adapt their targets to improve the Rural Development Plan (see reply to Example 10.2).*

Example 10.2
<i>Member States have the possibility to adapt their targets and the mid-term evaluations were a relevant opportunity to refine data and method and where found necessary — adapt the targets.</i>
<i>As for the significant reduction of the target 'increase in production of renewable energy', this is due to a mistake in one Rural Development Plan which has been corrected. In the light of the mid-term evaluations, it has been possible to carry on further quality checks and therefore identify and remedy this mistake.</i>

**10.15.** *The title and number of multiannual priorities are defined by DG REGIO on the basis of an analysis on how ensuring its mission in the best legal and most efficient manner, as well as the number of specific operational annual priorities.*

*The changes noted by the Court reflect the present challenges the European Union is facing with the financial and economic crisis and corresponding adjustments in the definition of the priorities for regional policy and DG REGIO.*

<sup>(13)</sup> A kilotonne of oil equivalent (ktoe) is the amount of energy released by burning one kilotonne of crude oil.

## THE COURT'S OBSERVATIONS

*Providing explanations for performance achieved*

10.16. The purpose of reporting on performance is to inform stakeholders. However, even where it would have been possible to provide an adequate explanation for why performance achieved did not meet the relevant objective or target, the annual activity reports did not do so. This was the case for DG AGRI even when performance fell well short of target: for four indicators, performance was less than half the target. In the case of DG REGIO, the Annual Activity Report provides a detailed, point by point, analysis of performance in relation to the multiannual priorities (paragraph 10.15), but there is no equivalent for the general objectives and impact indicators.

**Reliability of data a challenge when received from external sources**

10.17. Examining the reliability of all the data in the three annual activity reports was outside the scope of the Court's audit. On the basis of the limited assessment that it carried out, the Court found that the data relating to EuropeAid was generally reliable, as in most cases the indicators are internationally recognised and independently verifiable. However, it noted a number of problems in the annual activity reports of DG AGRI and DG REGIO — both of which are largely reliant on data from the Member States — set out in example 10.3.

**Example 10.3****DG AGRI: reporting of performance achieved based on incomplete data**

There are 88 rural development plans in place across the European Union. But the performance reported at EU level for three indicators was based on data from six, nine and 32 respectively of these 88. And one other indicator reported EU performance on the basis of data from only eight of the 27 Member States.

## THE COMMISSION'S REPLIES

**10.16.** *The Commission is of the view that it has sufficiently provided explanations. Indicators presented in the AAR should not be read in isolation. It is the indicator system in the Management Plan as a whole that allows drawing conclusions on the impact and result of the policy as they are based on macro-economic modelling and statistics relating to the global objectives of the policy evolution.*

**10.17.**

**Example 10.3****DG AGRI: reporting of performance achieved based on incomplete data**

*The EU aggregation of the net effect of the Rural Development Plan policy on the impact indicators has been made with the available quantified data submitted by the Member States. Most of the mid-term evaluations did not provide quantified impact stating that the mid-term evaluations were carried out too early in the programming period in order to be able to capture measurable effect and impact. Impacts are dealing with long-term processes.*

## THE COURT'S OBSERVATIONS

**DG REGIO: internal inconsistencies within Annual Activity Report**

The number of jobs created is recorded variously as 200 000 in 25 Member States (page 34) and 165 000 in 21 Member States (Annex 6, page 169) — the footnote to which lists 19 Member States (footnote 126).

The additional population with broadband access is given variously as 900 000 (page 34) and 806 826 (Annex 6, page 172).

New roads built is given variously as 920 km in 12 Member States (page 34), and 805 km in 10 Member States (Annex 6, page 171).

## THE COMMISSION'S REPLIES

**DG REGIO: internal inconsistencies within Annual Activity Report**

The Commission points out that there are two approaches to the presentation of information with regard to targets and latest known results. All internal inconsistencies are adequately explained in the text.

— In the main part of the AAR, information is on the overall level of achievement of cohesion policy and figures from all Member States reporting are included, whether they have targets or not (having targets is not a requirement).

— In Annex 6, direct comparison is made between targets and achievements. Figures are included only for those Member States that report on both (i.e. Member States who report on achievements without reporting on targets are excluded). This approach is consistent over years and is designed to allow an assessment of relevant progress against target.

10.18. The ability of DGs AGRI and REGIO to ensure the quality of data supplied by the Member States is limited. DG REGIO has recommended that Member States should focus on core indicators and has issued guidelines on data input. It has also started an annual verification procedure, which led to it detecting some mistakes in data submitted. The introduction for the next programming period of a 'performance reserve' for the Common Strategic Framework (CSF) funds<sup>(14)</sup> may prove to be one way of providing Member States with an incentive to supply relevant, comparable and reliable performance data. However, the timeliness of this data will remain a challenge. For example, the present deadline for Member States to provide data to DG REGIO is June of the subsequent year, so that the data reported in the 2011 Annual Activity Report, published in 2012, relates to 2010.

**10.18.** The Commission's quality checking of the data supplied by the Member States for the current programming period will be continued and intensified.

According to the Commission's legal proposal for the new period as an incentive for the Member States, 5 % of the funds should remain unallocated at the beginning of the new programming period to provide additional funds for those Member States that had attained their milestones (see COM(2011) 615 final).

The Commission does not consider the timeliness of the data as challenging. DG REGIO always uses latest available data, but recognises — under the reporting arrangements in the current and proposed future regulations — that data for the previous year will not be available by April of the following year.

<sup>(14)</sup> These funds comprise the European Regional Development Fund (ERDF), the European Social Fund (ESF), the Cohesion Fund (CF), the European Agricultural Fund for Rural Development (EAFRD) and the European Maritime and Fisheries Fund (EMFF).

## THE COURT'S OBSERVATIONS

**RESULTS OF THE COURT'S AUDITS ON PERFORMANCE****Introduction**

10.19. The Court's special reports examine whether the principles of sound financial management (paragraph 10.2) are applied to the European Union budget. The Court chooses its topics for special reports — specific budgetary areas or management themes — to have maximum impact, based on a range of criteria, such as the level of income or spending involved (materiality), the risks to sound financial management and the degree of stakeholder interest.

10.20. In 2011, the Court adopted <sup>(15)</sup> 16 special reports, as listed in box 10.1:

**Box 10.1****Special Reports adopted by the Court of Auditors in 2011 <sup>(16)</sup>**

- No 1/2011 'Has the devolution of the Commission's management of external assistance from its headquarters to its delegations led to improved aid delivery?'
- No 2/2011 'Follow-up of Special Report No 1/2005 concerning the management of the European Anti-Fraud Office?'
- No 3/2011 'The efficiency and effectiveness of EU contributions channelled through United Nations organisations in conflict-affected countries'.
- No 4/2011 'The audit of the SME Guarantee facility'.
- No 5/2011 'Single Payment Scheme (SPS): issues to be addressed to improve its sound financial management'.
- No 6/2011 'Were ERDF co-financed tourism projects effective?'
- No 7/2011 'Is agri-environment support well designed and managed?'
- No 8/2011 'Recovery of undue payments made under the Common Agricultural Policy'.
- No 9/2011 'Have the e-Government projects supported by ERDF been effective?'

<sup>(15)</sup> Adopted means approved for publication. Publication itself, which requires layout and translation etc., is generally around two months later.

<sup>(16)</sup> The ECA's special reports are available on the Court's website at: <http://eca.europa.eu/portal/page/portal/publications/auditreportsandopinions/specialreports>.



## THE COURT'S OBSERVATIONS

- No 10/2011 'Are the School Milk and School Fruit Schemes effective?'
- No 11/2011 'Do the design and management of the geographical indications scheme allow it to be effective?'
- No 12/2011 'Have EU measures contributed to adapting the capacity of the fishing fleets to available fishing opportunities?'
- No 13/2011 'Does the control of customs procedure 42 prevent and detect VAT evasion?'
- No 14/2011 'Has EU assistance improved Croatia's capacity to manage post-accession funding?'
- No 15/2011 'Do the Commission's procedures ensure effective management of State aid control?'
- No 16/2011 'EU financial assistance for the decommissioning of nuclear plants in Bulgaria, Lithuania and Slovakia: achievements and future challenges'.

10.21. In last year's Annual Report, the Court illustrated how the findings of its 2010 special reports covered the entirety of the typical management lifecycle; from strategic planning and the identification of needs, through to reporting on the performance achieved. The scope of the Court's special reports in 2011 was similarly wide-ranging. However, as the Union prepares to enter into the new 2014-2020 programming period, the Court examines here the lessons that can be learned from its 2011 special reports for the preparation of new programmes and projects, focusing on three themes: needs analysis, design, and the concept of EU added value. These three themes are also reflected, to varying degrees, in the Court's recent opinions on the proposed regulations for the Common Strategic Framework and the common agricultural policy <sup>(17)</sup>.

<sup>(17)</sup> Opinions No 7/2011 on the proposal for a Regulation of the European Parliament and of the Council laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund covered by the Common Strategic Framework and laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1083/2006 (OJ C 47, 17.2.2012) and No 1/2012 on certain proposals for regulations relating to the common agricultural policy for the period 2014-2020 (<http://eca.europa.eu>).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Needs analysis: no robust evidence**

10.22. In its 2010 Annual Report, the Court stated that, if good results are to be produced, it is important clearly to identify the needs which the programmes are intended to fulfil<sup>(18)</sup>. The assistance provided to Croatia so that it will be able to manage EU funding after it joins the Union is an example where the Commission generally ensured that key needs were identified<sup>(19)</sup>.

10.23. In 2011, the Court continued to find and report on cases where sound needs analyses had not been carried out. For example, early strategies for e-Government — where projects may be supported by the European Regional Development Fund (ERDF) — were prepared mainly in response to political declarations rather than rigorous needs assessments, with the result that projects did not address the most important issues<sup>(20)</sup>. And for two out of the three nuclear decommissioning programmes audited by the Court, no needs assessment was carried out in relation to the programmes' objective to reduce the impact of closing the nuclear plants earlier than originally planned<sup>(21)</sup>.

10.24. One consequence of inadequate needs analysis is that it makes it harder to determine which of competing projects are likely to offer the best value for money. This was the case in the audit of e-Government projects referred to above<sup>(22)</sup>, and also in the audit of the EU support for agri-environment. In the latter case, the Court reported that targeting funds at those areas most in need was key to enhancing the environmental effects of agri-environment support; however, Member States had not considered targeting on the basis of an analysis of the costs and benefits involved<sup>(23)</sup>.

**10.22.** *The Commission agrees that a sound needs analysis forms an important part of the programme cycle and is analysing carefully the cases in which the Court found that a needs analysis had not been carried out sufficiently.*

**10.23.** *The cost of migrating to e-Government is very high. Priorities are needed and it is reasonable that they are provided by political statements and declarations, which served to raise awareness and as early strategies. However, priority setting has improved significantly in the interim period, and today all Member States have developed more sophisticated e-Government strategies.*

*The Accession Treaties or subsequent regulations identified the need for mitigating measures. The EU support scheme is designed to ensure that the measures proposed by the Member States are in accordance with and based on their national energy strategies, which inevitably consider the impact of the nuclear plants' closure.*

**10.24.** *The Commission agrees that needs analysis can help identify the priority projects. However, as regards agri-environment support, some Member States have considered the desirable degree of targeting on the basis of an analysis of the costs and benefits involved. Romania, for example, targets High Nature Value agri-environment payments on a geographical basis, and the eligible areas are established using macro-level data. In view of e-Government projects, following EU policy initiatives, today, all Member States have developed more sophisticated e-Government strategies based on the e-Government Action Plan 2011-2015.*

<sup>(18)</sup> Annual Report concerning the financial year 2010, paragraph 8.36.

<sup>(19)</sup> Special Report No 14/2011 'Has EU assistance improved Croatia's capacity to manage post-accession funding?', paragraph 17 (<http://eca.europa.eu>).

<sup>(20)</sup> Special Report No 9/2011 'Have the e-Government projects supported by ERDF been effective?', paragraph 56(a) (<http://eca.europa.eu>).

<sup>(21)</sup> Special Report No 16/2011 'EU financial assistance for the decommissioning of nuclear plants in Bulgaria, Lithuania and Slovakia: achievements and future challenges', paragraph 26 and Figure 7 (<http://eca.europa.eu>).

<sup>(22)</sup> Special Report No 9/2011, paragraph 56(b).

<sup>(23)</sup> Special Report No 7/2011 'Is agri-environment support well designed and managed?', paragraphs 72 and 78 (<http://eca.europa.eu>).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Design: insufficiently clear what is to be achieved**

10.25. Identifying needs is only the start of the process. Good design both of the programmes and of the individual projects within those programmes is essential for sound financial management, so that funds achieve the maximum impact at the minimum cost. The design of programmes and of individual projects within them should establish a link between the activities funded by the budget and the intended outputs, results and impacts of that spending.

10.26. In one case, the Commission took into consideration the design problems of one scheme to improve, at least in part, the design of a similar scheme. As a result, measures to encourage the consumption of fruit in schools do not suffer from problems of unattractiveness to beneficiaries and the deadweight effect<sup>(24)</sup> that the similar school milk scheme does<sup>(25)</sup>. However, the Court continued to find a number of weaknesses in the design of the funding streams that it audited in 2011, as set out in the following paragraphs.

10.27. The Commission channels some support for conflict-affected countries through United Nations organisations. However, almost all (18 out of 19) contribution agreements audited by the Court had one or more of a number of design weaknesses, such as the absence of baseline criteria, unspecific objectives or missing indicators. As a result, there was a lack of clarity about what was to be achieved, and how success could be assessed<sup>(26)</sup>.

**10.26.** *The Commission is of the view that the latest revision of the School Milk Scheme (SMS) has addressed to a large extent the observations of the Court with a view to improving the overall efficiency of the system.*

**10.27.** *The Commission acknowledges the importance of project design but considers that only two of the 18 cases cited had weaknesses that could directly influence the project results.*

*The Commission has introduced new training and guidance in 2011 to improve project design, which it considers largely meet the concerns of the Court.*

*Furthermore, the Court's special report recognised that, even in extremely difficult circumstances, projects implemented with the UN in conflict-affected countries achieve good results and are reasonably sustainable.*

<sup>(24)</sup> Deadweight occurs where a measure is used to support beneficiaries who would have made the same choice in the absence of the aid.

<sup>(25)</sup> Special Report No 10/2011 'Are the School Milk and School Fruit Schemes effective?', paragraph 53 (<http://eca.europa.eu>).

<sup>(26)</sup> Special Report No 3/2011 'The efficiency and effectiveness of EU contributions channelled through United Nations organisations in conflict-affected countries', paragraphs 23, 24 and 48 (<http://eca.europa.eu>).

## THE COURT'S OBSERVATIONS

10.28. The Single Payment Scheme of the common agricultural policy (CAP) was designed to encourage farmers to respond to market demand and to promote more environmentally-friendly agricultural practices. However, there is a contradiction in the design of the scheme: while it is intended to support individual income, in practice the way that financial assistance is distributed takes little account of the specific circumstances of the recipient, with the result that the distribution of subsidies to individual farmers remains essentially based on the surface of land farmed and thus a high proportion of Single Payment Scheme aid still goes to large farms as was the case under the previous system <sup>(27)</sup>.

10.29. The Geographical Indications Scheme (GIS) is a scheme intended to protect names that identify agricultural products whose given quality, reputation or other characteristic are essentially attributable to their geographical origin (e.g. 'prosciutto di Parma', 'Bayerisches Bier', etc.). The success of the GIS depends, inter alia, on its usage by producers. Potential exists for attracting further producers to join the GIS especially in Member States where there is a low take-up. However, the measures available and procedures applied do not encourage these producers to participate <sup>(28)</sup>.

## THE COMMISSION'S REPLIES

**10.28.** The Single Payment Scheme (SPS) has proven to be a very effective tool to grant basic income support while allowing the farmer to make production decisions on the basis of market signals. This is because payments are decoupled from production and do not interfere with production decisions. To be eligible for payments, beneficiaries, parcels and activities must match clear conditions set up in the Council Regulation that are compatible with WTO rules, i.e. not linked with production factors.

The needs for basic income support of 'large farms' should not be considered systematically lower than those of other farms as income in general depends strongly on types of production, input and output costs, farm labour, etc.

The value and number of entitlements were calculated, using historical references of production and surfaces so as to ensure a smooth transition towards decoupling. Hence, the current distribution of direct payments between farms is simply a reflection of the fact that agricultural land and agricultural production are not shared equally among the farms in the EU.

Nevertheless, the issue of redistribution of support between farmers and Member States is considered in the legal proposals for CAP post-2013, and should also lead to improved targeting of the SPS aid. As to add value and quality in spending, the Commission has proposed to improve and add also some other elements, thus covering some of the issues mentioned by the Court in its special report: redesign and better targeting of support.

**10.29.** The scheme is primarily an intellectual property protection scheme. The appropriate instruments and legal means are in place and producers are invited to join the scheme on a voluntary basis. This is also confirmed by the clear interest in the scheme shown by producers: a significant number of product names has been registered (above 1 000), accounting for a market value of 14,5 billion euro (in 2008).

The Member States that have joined the EU since 2004 are still picking up on speed in relation to the scheme. A series of initiatives, including information campaigns, trade fairs, thematic international exhibitions and/or preparation of guides for applicants for geographical indications (PDO or PGI), have been launched to further attract potential applicants.

<sup>(27)</sup> Special Report No 5/2011 'Single Payment Scheme (SPS): issues to be addressed to improve its sound financial management', paragraph 44 (<http://eca.europa.eu>).

<sup>(28)</sup> Special Report No 11/2011 'Do the design and management of the geographical indications scheme allow it to be effective?', paragraph 61 (<http://eca.europa.eu>).

## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

10.30. Under the common fisheries policy, the Commission provides support for Member States to reduce the capacity of their fishing fleets with the ultimate goal of preserving fish stocks. Design problems are reducing the effectiveness of this support. For example, the eligibility and selection criteria for fishing vessel decommissioning schemes were poorly targeted, with the result that some fishing vessels were scrapped with little or no effect on targeted fish stocks <sup>(29)</sup>.

**EU added value: justification for the EU intervention**

10.31. The Commission has defined EU added value as 'the value resulting from an EU intervention which is additional to the value that would have been otherwise created by Member State action alone' <sup>(30)</sup>. The Court has previously suggested that any definition of the term should draw on the principles set out in box 10.2, and has recommended articulating the concept of EU added value in order to provide guidance to the EU's political authorities when choosing expenditure priorities, and doing so in a suitable political declaration or in EU legislation <sup>(31)</sup>.

**10.30.** *The cases analysed by the Court have been revised and discussed with Member States. Corrective actions — including the recovery of wrongly paid amounts — are being taken by Member States where necessary.*

**10.31.** *The Commission underlines that the concept of EU added value may be used in many different contexts, such as in academic reflections on the EU budget, for defining goals and/or criteria for project selection in specific EU programmes, in provisions of the Financial Regulation and in evaluation of existing programmes but it also considers that the added value of a political project goes beyond simply referring to figures.*

*One of the purposes of the mentioned staff working paper was to explain the added value of having an EU budget and to present many examples of how this works in practice in the Member States, thus providing the EU's decision-making bodies with the necessary guidance to prioritise expenditure.*

*Moreover, the Commission Impact Assessment process prepares evidence for political decision-makers on the advantages and disadvantages of possible policy options by assessing their potential impact. In so doing, the process also deals with the issue of the added value of Commission proposals.*

<sup>(29)</sup> Special Report No 12/2011 'Have EU measures contributed to adapting the capacity of the fishing fleets to available fishing opportunities?', paragraphs 51-58 and 76 (<http://eca.europa.eu>).

<sup>(30)</sup> Commission Staff Working Paper, *The added value of the EU budget*, SEC(2011) 867 final section 1.1, accompanying the document *A budget for Europe 2020* (COM(2011) 500 final).

<sup>(31)</sup> Opinion No 1/2010 'Improving the financial management of the European Union budget: Risks and challenges', paragraph 18 (<http://eca.europa.eu>).

## THE COURT'S OBSERVATIONS

**Box 10.2****Court's suggested principles underlying the concept of EU added value:**

- Expenditure from the European Union budget within the Union must offer clear and visible benefits for the EU and for its citizens which could not be achieved by spending only at national, regional or local level, but could rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.
- Expenditure with trans-frontier effects of common interest is *prima facie* a stronger candidate for EU action than expenditure with limited geographical effects.
- Reasonable concentration of expenditure is *prima facie* likely to support the objective of adding value.
- For expenditure outside the Union, such as on development assistance, value added is also likely to be enhanced by a selective approach: for example, focusing on the coordination of development assistance in areas where there is global donor endorsement and focusing on activities for which specific EU expertise is of particular value <sup>(32)</sup>.

## THE COMMISSION'S REPLIES

**Box 10.2**

The Commission considers that the added value of a political project should be a key test to justify spending at the EU level.

The Commission tested the added value of proposed expenditure in all policy areas when making its proposals for the EU budget for the period 2007-2013, using the following criteria:

- Effectiveness: where EU action is the only way to get results.
- Efficiency: where the EU offers better value for money.
- Synergy: where EU actions are necessary to complement, stimulate, and leverage actions.

The Commission designed both the new Multiannual Financial Framework and the sectoral instruments and programmes in a way that:

- the delivery of objectives can better be achieved through spending at EU level,
- the contribution of the expenditure at EU level is made obvious,
- the EU added value is prominent,
- pooling resources at EU level do generate economies of scale and better results.

The Commission Agenda for Change communication of October 2011 and its subsequent Council Conclusions of 14 May 2012 recommend a better targeting on countries that need help most and a focus on a limited number of sector where impact can be maximised and EU added value is clear.

10.32. The Court has stated that expenditure programmes which do not add EU value are by definition unlikely to be an efficient and effective use of the EU taxpayer's money <sup>(33)</sup>. In its 2011 special reports, the Court found examples where the existence of EU added value was at best questionable:

- the EU added value of the Small and Medium-sized Enterprise Guarantee (SMEG) facility had not been demonstrated, as the results arising from the facility might also have been achieved by funding under national schemes <sup>(34)</sup>,

**10.32.** The Commission considers that the evaluation of the added value of the expenditure programmes has to be done in relation to the objectives set and in relation to the criteria used when testing initially the added value of the Commission proposals (see Box 10.2).

- The Commission is already taking the observation into account in the discussions and planning for the next generation of financial instruments in the post-2013 Multiannual Financial Framework, where 'ensuring EU added value' is one of the key principles that must be respected by all proposed instruments.

<sup>(32)</sup> Response by the European Court of Auditors to the Commission's communication 'Reforming the Budget, Changing Europe', paragraph 8, April 2008.

<sup>(33)</sup> Opinion No 7/2011, paragraph 9.

<sup>(34)</sup> Special Report No 4/2011 'The audit of the SME Guarantee facility', paragraph 104 (<http://eca.europa.eu>).

## THE COURT'S OBSERVATIONS

- for tourism projects co-financed by the ERDF, in the absence of a suitable system for setting objectives and monitoring performance against them, it was difficult to assess the extent of EU added value secured <sup>(35)</sup>, and
- in the case of the EU support provided for nuclear decommissioning in three Member States, the Court concluded that the policy framework was relatively loose and recommended that the EU should base any decision about providing further financial assistance on an evaluation of the EU added value of such an intervention <sup>(36)</sup>.

10.33. Recent Court opinions have referred to the Commission weaknesses in defining policy objectives in terms of results — what the EU funding is designed to achieve <sup>(37)</sup>. Without clear targets for expected results, it will continue to be difficult for the Commission to demonstrate that its expenditure achieves EU added value — and thus difficult to provide assurance that its spending is efficient and effective.

## CONCLUSIONS AND RECOMMENDATIONS

### Conclusions

10.34. The process by which the annual activity reports are prepared by Commission DGs is evolving. Compared with the previous year, there were welcome signs of improvement (paragraph 10.7).

10.35. Relevance remains an issue, in particular concerning the internal coherence of the objectives and indicators, the setting of meaningful quantified targets and the annual measurement of progress. As was the case last year, the three DGs assessed by the Court did not report on economy and efficiency in part 1 of the annual activity reports (see paragraphs 10.8 to 10.12).

<sup>(35)</sup> Special Report No 6/2011 'Were ERDF co-financed tourism projects effective?', paragraph 46 (<http://eca.europa.eu>).

<sup>(36)</sup> Special Report No 16/2011, paragraph 42(b).

<sup>(37)</sup> Opinion No 7/2011, paragraph 10, and Opinion No 1/2012, paragraphs 8 and 151.

## THE COMMISSION'S REPLIES

- *The Commission notes that the Court's performance audit found high employment effects for the examined tourism projects.*
- *The Commission considers that the EU added value of the programmes was clear: without them, reaching the overall goal of significantly improving EU nuclear safety, as well as helping Member States mitigate the effects of early closure, would have been extremely difficult.*

*On 24 November 2011 the Commission proposed a Council regulation on Union support for the nuclear decommissioning assistance programmes in Bulgaria, Lithuania and Slovakia (COM(2011) 783) for the period 2014-2020. This was accompanied by a comprehensive impact assessment that includes an evaluation of the EU added value.*

**10.33.** *An increased focus on performance and results is one of the main goals of the Commission in its proposals 'A budget for EU2020' for the delivery of the long-term strategic objectives of the Union with the budget available for the next seven years.*

*In this line, all programmes and instruments included in the Multi-annual Financial Framework proposal have been designed to ensure that their outputs and impacts substantially contribute to the achievement of the key policy objectives of the EU, thus emphasising expected results and performance.*

**10.34.** *The Commission strives to continuously improve the quality and clarity of its accountability reports.*

**10.35.** *The Commission strengthened the standing instructions for the 2011 AARs, in terms of efficiency and effectiveness, and requested the directorates-general to add indicators on voluntary basis on sound financial management in Part 3. A number of DGs did report on this in 2011.*

## THE COURT'S OBSERVATIONS

10.36. Objectives, indicators and targets set in the management plans of DG AGRI and DG REGIO were generally those used for reporting in the annual activity reports, and were generally consistent with last year. However, where changes were made, explanations were not always provided (see paragraphs 10.13 to 10.16).

10.37. Legal limitations and practical constraints impaired the reliability of the information collected by the DGs from Member States regarding programmes under shared management. Some steps are being taken to provide Member States with incentives to supply relevant, comparable and reliable performance data for the CSF funds in the next programming period, and it may be that valuable lessons can be drawn from this in the future. There is an additional problem of timing (see paragraphs 10.17 to 10.18).

10.38. In its 2011 special reports, in terms of the three specific areas analysed, the Court found that:

- (a) good quality needs assessments are often not present although they are key to ensuring that EU expenditure is targeted on the areas (geographical or by topic) most in need (paragraphs 10.22 to 10.24);
- (b) there are weaknesses in the design of programmes which affect negatively the Commission's ability to establish and report on the results and impacts of EU spending (paragraphs 10.25 to 10.30);
- (c) it is a challenge for the Commission to demonstrate the EU added value of EU spending (paragraphs 10.31 to 10.33).

## THE COMMISSION'S REPLIES

**10.36.** *The Commission agrees that changes in comparison to Annual Activity Report of the previous year deserve explanation. It is however of the view that sufficient information has been provided in this respect.*

**10.37.** *The Commission's quality checking of the data supplied by the Member States for the current programming period will be continued and intensified. However, the Commission does not consider the timeliness of the data as challenging.*

*Given the seven-year programming period, data available 16 months after the end of the year is still of use to adjust programmes for which the data suggests a lack of performance (see reply to paragraph 10.18).*

**10.38.**

- (a) *The Commission agrees that a sound needs analysis forms an important part of the programme cycle and is analysing carefully the cases in which the Court found that a needs analysis had not been carried out sufficiently.*
- (b) *The Commission acknowledges the importance of project design but does not agree with all assessments made by the Court with regard to the cases mentioned in paragraphs 10.25 to 10.30. However, the Commission analyses carefully the Court's assessments in this regard and adapts its practice whenever appropriate to achieve further improvements in project design.*
- (c) *In the design of the next Multiannual Financial Framework the Commission has implemented the principles outlined in the 2010 budget review, namely focusing on added value of the EU budget.*



## THE COURT'S OBSERVATIONS

## THE COMMISSION'S REPLIES

**Recommendations**

10.39. Following the review and the findings and conclusions for 2011, the Court recommends that:

— **Recommendation 1:** The Commission should, in the design of new spending programmes, seek to focus its activities on the results and impacts it wants to achieve. If results and impacts cannot be readily measured, the Commission should put in place indicators and milestones, based on 'SMART' <sup>(38)</sup> objectives that would demonstrate that its activities support its desired goals.

— **Recommendation 2:** The Commission should work with Member States with a view to improving the quality and timeliness of the data submitted. In particular, it should draw on any lessons to be learned from the steps being taken in the CSF funds to provide Member States with incentives to supply high quality performance data.

— **Recommendation 3:** For the next programming period, 2014-2020, the Commission should demonstrate and report how it secures EU added value.

**10.39.**

*The Commission agrees with the Court's recommendation and — as outlined — has already taken action in this regard.*

*In the design of the next Multiannual Financial Framework, the Commission has implemented the principles it had presented in the 2010 budget review:*

— *focus on delivering key policy priorities,*

— *focus on EU added value,*

— *focus on impacts and results,*

— *delivering mutual benefits across the European Union.*

*The Commission agrees that cooperation with Member States is important to improve the quality and timeliness of the data. Following a verification exercise with Member States to confirm the correctness of the indicators submitted electronically, the Commission is confident that improvements in data quality will continue. However, under the reporting arrangements in the current and proposed future regulations, data for the previous year will not be available until April of the following year.*

*All specific proposals presented by the Commission to the Legislative Authority define general and specific objectives whose achievement will contribute to sustain the EU added value of the financial instruments proposed.*

<sup>(38)</sup> Specific, measurable, achievable, relevant and timed. See the Court of Auditors' Annual Report concerning the financial year 2010, paragraph 8.33.

