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SPECIAL REPORT No 10/2001**concerning the financial control of the Structural Funds, Commission Regulations (EC) No 2064/97 and (EC) No 1681/94, together with the Commission's replies***(pursuant to Article 248(4), second subparagraph, EC)*

(2001/C 314/02)

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GLOSSARY

BMF	Bundesministerium der Finanzen (The German Federal Ministry of Finance)
CICC	Commission interministérielle de coordination des contrôles (The French interministerial committee for the coordination of controls)
CSF	Community Support Framework
DG	Directorate-General
DG EMPL	DG Employment and Social Affairs
DG REGIO	DG Regional Policy
DG AGRI	DG Agriculture
DG FISH	DG Fisheries
ERDF	European Regional Development Fund
ESF	European Social Fund
EAGGF	European Agricultural Guidance and Guarantee Fund
FIFG	Financial Instrument for Fisheries Guidance
IGA	Inspection générale pour l'administration (French general inspectorate of administrative affairs)
IGAE	Intervención General de la Administración del Estado (Spanish general inspectorate for national expenditure)
IGAG	Inspection générale de l'agriculture (French general inspectorate of agriculture)
IGAS	Inspection générale des affaires sociales (French general inspectorate of social affairs)
IG	Inspection générale des finances (French general inspectorate of finances)
IGRUE	Ispettorato Generale per i Rapporti Finanziari con l'Unione Europea (Italian general inspectorate of financial relations with the EU)
OLAF	Office de lutte antifraude (The Anti-fraud Office)
SFAM	The Commission's management and control systems audit manual for the Structural Funds
UCLAF	Unité de coordination de la lutte antifraude (Unit for the Coordination of Fraud Prevention)

SUMMARY

I. The Court's audit concerned the implementation by the Commission and Member States of two Regulations which aim to improve financial control in the Structural Funds: Commission Regulation (EC) No 2064/97, which sets out a system of checks by Member States on expenditure incurred on projects co-financed by the EU, and Commission Regulation (EC) No 1681/94, which introduced a system of communicating information on detected irregularities by Member States.

II. The audit took place in OLAF and other Commission services and in Germany, Spain, France, Italy and the United Kingdom. A preliminary visit was carried out in Portugal.

III. The introduction of Regulation (EC) No 2064/97 represents an important initiative by the Commission to improve financial control of Structural Funds expenditure by Member States. The checks made and the resultant closure statements should help to avoid the EU co-financing ineligible expenditure. Although much good work is being carried out in Member States, the Court found many cases where Member States were not applying the Regulation correctly (paragraphs 42 to 80). Insufficient clear and timely guidance has been given by the Commission, despite the guidance given in two appendices of the audit manual distributed in October 1999 which provides a useful basis for the implementation of the Regulation. The Commission had carried out little assessment of Member States' efforts by the end of 2000 (paragraphs 20 to 36). Unless prompt action is taken to ensure correct application of the Regulation by Member States, there will not be sufficient, reliable information to form the basis upon which to close the forms of assistance.

- The Commission should carry out a detailed review of Member States' implementation of the Regulation and provide adequate guidance.
- The Commission must urgently and systematically issue advice to Member States on the adequacy of the checks undertaken and the reports made.

IV. According to OLAF's statistics detected irregularities are increasing in the Structural Funds. Weaknesses were found in the application of Regulation (EC) No 1681/94 at every level — regional, national, OLAF and other Commission services. Data on irregularities were incomplete, out of date and only of limited use, partly because the OLAF database was not working for three years in the period 1998 to 2000 and partly because the information available was not properly followed up by the Commission (paragraphs 88 to 126).

- The Commission should examine the operation of the systems for the detection and communication of irregularities within and by Member States, and then monitor them with a view to ensuring timeliness, completeness and relevance, and give guidance where necessary.
- Member States need to review their own systems to ensure that cases detected are communicated and progress reported.
- OLAF and the other Commission services should jointly define their respective responsibilities and determine whether a more effective follow-up would be ensured if communications were sent to and examined initially by the new financial units being set up in the Structural Fund DGs.
- The Commission should formulate proposals to combine the various aspects of both Regulations to provide effective and cohesive control and reporting systems on a clear and consistent basis throughout the EU.

INTRODUCTION

1. Structural Fund expenditure represents about 30 % of budgetary expenditure (153 038 million euro at 1994 prices for the six-year period 1994 to 1999). The administration of the Structural Funds under multiannual programmes is mostly undertaken by Member States which send declarations of expenditure to the Commission based on costs incurred by final beneficiaries. The Community co-finances a defined proportion of this. In its previous audits the Court has detected numerous errors in the underlying transactions and serious weaknesses in the control systems within the Structural Funds. These weaknesses relate to ineligible costs or activities, costs declared exceeding those actually incurred and insufficient supporting documentation. Many of these errors may have no direct effect on the Community payments of advances, but there is a real risk that they will have an effect when the programmes are closed. Improvement of financial control must be a key aim in the implementation of the new Community Support Framework 2000 to 2006 (CSF 3).

2. This report deals with the implementation of two Regulations which aim to improve the financial control of Structural Fund expenditure:

- (a) Commission Regulation (EC) No 2064/97, which established detailed arrangements for financial control by Member States of operations co-financed by the Structural Funds ⁽¹⁾, and
- (b) Commission Regulation (EC) No 1681/94 concerning irregularities and the recovery of sums wrongly paid in respect of structural policies and the organisation of an information system ⁽²⁾.

3. The Court has reported on the steps taken by the Commission to implement Regulation (EC) No 2064/97 in its 1998 and 1999 Annual Reports ⁽³⁾. A Special Report in 1998 ⁽⁴⁾ evaluated the management operations of UCLAF (the Commission's then anti-fraud unit which preceded OLAF, the recently established Anti-fraud Office).

⁽¹⁾ OJ L 290, 23.10.1997.

⁽²⁾ OJ L 178, 12.7.1994.

⁽³⁾ Annual Report of the Court of Auditors concerning the financial year 1998, paragraphs 3.14 to 3.19 (OJ C 349, 3.12.1999) and Annual Report of the Court of Auditors concerning the financial year 1999, paragraphs 3.69 to 3.74 (OJ C 342, 1.12.2000).

⁽⁴⁾ Special Report No 8/98 on the Commission's services specifically involved in the fight against fraud, notably the Unité de co-ordination de la lutte anti-fraude (UCLAF) (OJ C 230, 22.7.1998).

THE COURT'S AUDIT

4. The Court's audit examined the extent to which the Commission ensures the proper implementation of these two Regulations, thereby improving financial control and increasing assurance as to the legality and regularity of Structural Fund expenditure.

5. The audit was divided into two distinct areas:

- (a) the management by OLAF and other Commission services to ensure a complete and effective application of the requirements of the Regulations, and
- (b) the implementation of these Regulations by Member States.

6. The audit took place in OLAF and other Commission services and in Germany, Spain, France, Italy and the United Kingdom. A preliminary visit (with limited audit testing) had been carried out in Portugal in order to prepare the scope and objectives of the audit. The Member States were selected on the basis of financial importance and on their differing administrative structures. Information from Member States not visited was provided by answers to questionnaires. However, subsequent audit tests on some of the information supplied indicate that their accuracy and completeness cannot be relied on. The observations in this report are therefore mostly based on the results of the audits in the Member States mentioned above.

THE REGULATORY ENVIRONMENT

7. The governing provisions for financial control of the Structural Funds derive from Article 23 of Council Regulation (EEC) No 4253/88 (as amended by Council Regulation (EEC) No 2082/93) ⁽⁵⁾. This provides that Member States should take the necessary measures to verify that operations financed by the Community have been properly carried out, that they prevent and take action against irregularities and that they recover any amounts lost as a result of an irregularity or negligence. These provisions should be seen in the light of the Treaty which provides that the Commission is responsible for implementing the budget and that Member States should cooperate to ensure that appropriations are used in accordance with the principles of sound financial management.

⁽⁵⁾ OJ L 193, 31.7.1993.

Regulation (EC) No 2064/97

8. Commission Regulation (EC) No 2064/97 (the Regulation) came into force in November 1997 and was introduced in order to address criticisms of the quality of the financial management of the Structural Funds, where almost all expenditure is administered by Member States.

9. Until that time Member States carried out post-payment checks either on a relatively limited scale or not at all. Previous Court audits ⁽¹⁾ revealed that checks by the Commission on the closure of forms of assistance were limited.

10. Article 2 of the Regulation sets out the minimum requirements for Member States' management and control systems, including details of the elements necessary for a satisfactory audit trail.

11. Article 3 requires that Member States verify the effectiveness of the management and control systems in place and the expenditure declarations made at the various levels. The checks, which must be carried out before the closure of each form of assistance, must cover at least 5 % of the total eligible expenditure and be both representative and at the same time risk-based. (See paragraphs 19 to 21).

12. Article 8 requires that, no later than at the time of the request for the final declaration of expenditure in respect of each form of assistance, Member States shall present to the Commission a statement drawn up by a person or organisation functionally independent of the implementing service (the closure statement). This statement shall summarise the conclusions of the checks made and provide an overall conclusion as to the validity of the request for final payment and the legality and regularity of the operations underlying the final declaration of expenditure.

13. The Regulation came into force in the middle of the programming period 1994 to 1999, which continues in most cases until 31 December 2001, the last date for payments. Article 3(2) allows Member States to reduce the 5 % percentage proportionally for forms of assistance approved before the entry into force of this Regulation. Commission Regulation (EC) No 2406/98 ⁽²⁾ allows that the closure statement is not required where the final date for making commitments was before 1 January 1997.

14. Article 9 of the Regulation requires Member States to inform the Commission by 30 June each year of their application of this Regulation in the previous calendar year. As stated in the Court's 1999 Annual Report ⁽³⁾, these reports have been diverse in quality and in the type of information provided.

15. The Regulation also requires action to be taken in respect of irregularities. This is set out in Article 7, which states that Member States shall ensure investigation and satisfactory treatment of 'apparent irregularities'. In effect, this reinforces the requirements laid down in Regulation (EC) No 1681/94.

Regulation (EC) No 1681/94

16. Commission Regulation (EC) No 1681/94 provides a framework for the communication and follow-up of detected irregularities. Under Article 2(1), Member States' procedures for ensuring the regularity of Community-financed operations, the prevention of irregularities and the recovery of amounts lost must be communicated to the Commission, along with descriptions of current management control systems. Article 2(3) requires the Commission to study this information and inform Member States of the conclusions it intends to draw therefrom.

17. The primary responsibility for communicating irregularities lies with the designated authorities for each Structural Fund in the Member States. This responsibility involves: (Article 3) each quarter, communicating to the Commission (in practice to OLAF) details of detected irregularities having a financial impact exceeding 4 000 euro and (Article 5) providing updates of such cases each quarter.

18. Article 8 requires that the Commission shall maintain contacts with Member States in order to disseminate information of the lessons to be learned and where there is a risk of similar irregularities occurring.

THE OBJECTIVES OF REGULATION (EC) No 2064/97

19. Member States are required to organise checks on an appropriate sampling basis in order to verify the effectiveness of the management and control systems and to verify, on the basis of risk analysis, expenditure declarations made at the various levels. The existence of errors may cause loss to the Community budget and is therefore prejudicial to the interests of the European taxpayer. As such, the objectives of the Regulation and the theoretical and practical effectiveness of the control procedures included are of critical interest.

20. The method by which the checks provided for in Regulation (EC) No 2064/97 should be applied was not clearly defined at the time the Regulation was issued. Advice was subsequently given on selection of the sample in Appendices 2 and 5 of the Commission's Structural Fund audit manual. These checks are required by the Regulation to be based on a sample which is both risk-based and representative. This led to questionable practices in the Member States.

⁽¹⁾ Annual Report 1998, paragraph 3.33; Annual Report 1999, paragraph 3.75.

⁽²⁾ OJ L 298, 7.11.1998.

⁽³⁾ Annual Report 1999, paragraph 3.74 (OJ C 342, 1.12.2000).

21. One approach could be to combine the two methods in a logical framework in which a risk analysis is undertaken, identifying items for exhaustive checking, in order to detect and correct errors, complemented by the checking of a representative sample from the remaining population which would show whether or not this is indeed low risk and unaffected by a material incidence of error. The Commission should provide additional guidance to the Member States on the selection method as well as on how the results of the work are to be used, notably in the context of the closure statements.

THE ROLE OF THE COMMISSION IN THE IMPLEMENTATION OF REGULATION (EC) No 2064/97

22. The essential role of the Commission is to ensure the correct application of the Regulation in all Member States and across all Funds, so that the closure statements are based on audit conclusions which are the result of rigorous and reliable audit work.

23. Until July 2000 DG AUDIT was the coordinating DG for matters relating to the Regulation. In the period January 1998 to June 2000 DG AUDIT adopted the remaining bilateral administrative arrangements (the protocols with Member States) for which a legal basis was provided under Article 10, analysed the reports compiled under Article 9 and organised the bilateral meetings held with the Member States. In parallel, a limited number of verifications were made on the spot by DG AUDIT of the application by Member States of certain aspects of Regulation (EC) No 2064/97. This activity however was insufficient to assess the implementation of Regulation (EC) No 2064/97 by the Member States. Furthermore, until mid 2000 the four operational DGs concerned (Regional Policy (REGIO), Employment and Social Affairs (EMPL), Agriculture (AGRI) and Fisheries (FISH)) did not consider it to be their responsibility to assess the implementation of the Regulation.

24. Since July 2000 DG REGIO has taken over the coordination role, although the other three operational DGs are responsible for the implementation of the Regulation in respect of their Funds.

The Commission's audit manual

25. The Commission issued an audit manual entitled 'Management and control systems audit manual for the Structural Funds — Financial controls in the Member States' (SFAM) on 19 April 1999 (some 18 months after the Regulation came into force). Although this manual is not legally binding on Member States, the introduction to its Appendix 2 (which is directly addressed to Member States and which covers their implementation of the Regulation) states that its purpose is 'to set out the requirements for Member State controls and to provide guidance on how these requirements will be interpreted and verified by the Commission services'. The Court considers that this appendix provides a useful basis for implementing the Regulation.

26. However, it was not sent to Member State authorities in the appropriate languages until October 1999, which was too late in practice to have a major impact on the methods of implementing the Regulation in some of the Member States audited by the Court. For example, no Member State's risk analysis identified the relevant inherent and control risks as set out in the SFAM. Moreover, the Court's audits in Member States in 2000 revealed that some bodies responsible for implementing and coordinating the Regulation and the checkers themselves were unaware of the SFAM's existence largely due to coordination problems within the Member States themselves ⁽¹⁾.

27. Despite the distribution of the SFAM, the interpretation of some elements of the Regulation remained unclear to Member States, notably concerning the proportional reduction of the 5 % target for checks (see paragraphs 75 to 79). The Commission had not issued common guidance to Member States on this key issue by the end of 2000.

28. The SFAM states that the Commission will assess compliance with the Regulation's requirements, i.e. the planning and progress of Member States' checks to ensure that these are adequate and sufficient to meet the 5 % target. Such an assessment cannot be satisfactorily carried out using only the reports compiled under Article 9 and the information obtained from the annual bilateral meetings held with the Member States. Thus further assessment is necessary, notably at Member State, central and regional levels, in order to provide the Commission with sufficient information on the quality and quantity of these checks.

Assessment by the Commission of compliance with the Regulation

29. DG AUDIT carried out a limited number of verifications on certain aspects of the Regulation. A review of DG EMPL and DG AGRI reports for 1999 and 2000 on visits to Member States revealed that, while references were made to the Regulation, these were ad hoc comments and descriptions of Member States' systems. In no case did an examination of compliance with the Regulation figure in the audit objectives. DG REGIO had carried out very few audits of the implementation of this Regulation by the end of 2000.

30. Neither DG REGIO nor DG EMPL have the resources to fully assess compliance with the Regulation, in view of the many forms of assistance, particularly as the control units of each Structural Fund DG are also committed in 2001 to carrying out important work on compliance with the rules governing the new programming period 2000 to 2006. DG EMPL informed the Court that its audit and control unit is facing an important lack of human

⁽¹⁾ France: CICC, DATAR, Ministère de l'intérieur, DGEFP. United Kingdom Department of Trade and Industry, GOWM.

resources and that this unit's level of activity in 2001 may well be compromised.

31. DG FISH carried out an on-the-spot audit in October 2000, having received a closure statement relating to the closure of an Operational Programme. The report assessed the compliance of the national system with Article 2 of the Regulation (the proper operation of adequate management and control systems) but not the quality of the Article 3 checks (quality of checks, their content, follow-up of findings, attainment of 5 %, respect of appropriate mix of projects, etc.). Whilst it is encouraging that the DG did carry out an on-the-spot audit in respect of this closure, the above issues should be examined and reported on in all such audits.

32. The four operational DGs plan to carry out a series of visits to assess the implementation of the Regulation in 2001. In the Court's opinion, starting this work in 2001 does not leave sufficient time to properly evaluate the work of the wide range of checkers and closure statement providers. Moreover, it may well be too late to correct any serious weaknesses by June 2002, such as the quality of the checking, the composition of the samples or the validity of the work carried out by the closure statement provider.

33. There have also been delays in the execution of the 5 % checks by Member States. For example, in Italy only four out of 36 Ministries/regions had started the 5 % checks by 30 June 2000, and, in some cases, the checking body had not even been selected by the end of 2000. As all checking must be completed before 30 June 2002 (the final date for closure), it is a matter of concern that Member States may not be able to carry out the checks of sufficient quality in the time remaining. The Commission should identify and urgently follow-up all Member States that are late in starting their checks.

34. The absence of on-the-spot assessment of the Member States' implementation of this Regulation has led to the Commission only becoming aware of problems of interpretation in the Member States at a late stage. This has meant that Member States have been carrying out checks which are not in accordance with the Regulation. Had the Commission carried out such assessments earlier, not only would it have been able to cover a wider range of regions and forms of assistance, it would also have been able to identify misunderstandings and misinterpretations promptly and inform all Member States of the correct interpretation in good time.

Coordination within the Commission

35. There is a need for the Commission DGs to provide a co-ordinated response on interpretative issues concerning the Regulation. Member States address questions primarily to the DG responsible for the Fund concerned and conflicting advice and interpretations were sometimes given to Member States, such as in the case of the reduction of the 5 % target (see paragraphs 75 to 79).

36. Another example of differing interpretation occurred when DG FISH informed the Italian authorities that the signatory of the closure statement must be a public official. All other Commission guidance on this issue stated that this need not be the case. To avoid such cases, replies to Member States should be agreed by DG REGIO, the coordinating DG, and any guidance of a general nature should be copied to a central contact point in each Member State.

THE STANDARDS TO BE APPLIED

37. Article 3 of the Regulation does not set out in detail how Member States should carry out the checks. The Court's audit evaluated the checking procedure and the checks carried out by Member States, based on the SFAM and generally accepted auditing standards. In the Court's view these criteria can be considered to be the minimum requirements of an Article 3 check, although the nature of the detailed work to be carried out on the spot by Member States should be tailored to each type of support. The following paragraphs set out how the checks could be organised in the Court's view.

38. Those undertaking the checks should be independent of the implementation of the project. There should be checklists covering the basic aims of such checks, adapted to suit the different risks presented by each type of project. The check should examine the physical reality of the project on-site and include an examination of all aspects of the expenditure declaration back to source documents. This should involve testing the reality of operations, the financial aspects and compliance of the underlying expenditure with the legislation. The Court believes that only expenditure so checked may be counted towards the 5 % target. A checking team may need to comprise an appropriate technical expert (such as an engineer) as well as a financial/auditing expert.

39. Article 3(1)(a) requires that the checker should verify the effectiveness of the management and control systems in place. This work should be carried out by an independent body, such as the one providing the closure statement. Project managers should not verify the effectiveness of their own management and control systems in this context.

40. The checks should be fully documented and there should be a written report on the results of the work undertaken. It should explain the way in which the project was selected and detail the audit work carried out, including identification of eligible expenditure checked. The value of errors/irregularities detected should also be recorded, in order to allow the provider of the closure statement to comply with Article 8(2) of the Regulation by deciding whether they are material.

41. In cases where it is not possible to check 100 % of the expenditure items in a project, normal audit practice allows a representative sample of adequate size to be selected for audit, in order to help come to a conclusion as to the eligibility of the whole. In the context of the Regulation, the total project expenditure to date may be considered as checked provided it can be demonstrated that the sample tested is representative. Other substantive audit procedures such as analytical review may also be used to provide evidence of the legality and regularity of a project. Thus, when a 100 % check is not undertaken, details of the sample and justification of its representativeness and sufficiency should be set out in the report.

IMPLEMENTATION BY THE MEMBER STATES

42. The following paragraphs summarise the audit findings for those Member States visited. It must, however, be borne in mind that final responsibility for verifying the correct application of the Regulation lies with the Commission.

Current arrangements

43. In *France* the Article 3 checks for the ERDF, the EAGGF Guidance and the FIFG are carried out by officials of the service that administers the expenditure, under the authority of the Préfet of the region. The checks for the ESF are carried out by a separate regional control service.

44. The closure statement will be provided by the Commission interministérielle de coordination des contrôles (CICC). This body has representatives of the Inspection générale des finances and of the Inspection générale of each ministry responsible for a Fund. It is functionally independent of the bodies implementing the co-financed expenditure and thus complies with Article 8(1).

45. In the *United Kingdom* for the ERDF the Article 3 checks are carried out by officials of the regional government office (or for Scotland and Wales, the Scottish Executive and the Welsh Assembly respectively) who manage the project. To ensure independence, a separate unit in the Finance division is responsible for the checking. This is also the case for the ESF, although there is, in addition, an independent central unit which carries out some of the checks. For the EAGGF-Guidance a separate corps of checkers is used. The closure statements will be provided in each case by the internal audit service of the national ministry concerned. This guarantees independence and thus complies with Article 8(1).

46. In *Spain*, responsibilities for carrying out Article 3 checks are divided between the Intervención General de la Administración del Estado (IGAE), for nationally administered measures, and the 17 Intervenciones Generales of the autonomous communities, for

measures administered by those autonomous communities. The closure statements will be provided for all Funds by these same bodies, which are functionally independent of the implementing service.

47. In *Italy* the definitive structure had not been determined at the time of the Court's audit in October 2000. Each national ministry and each region responsible for implementing forms of assistance will be free to determine its own arrangements. The Article 3 checks will be performed either by an internal committee set up by the ministry/region or by private external auditors. In general, the checking body will also provide the closure statement. Thus independence would be ensured.

48. In *Germany* the *Bundesländer* also have autonomy, with Article 3 checks mostly carried out by the operational departments of the *Länder* ministries which manage the Funds and the closure statements provided by independent departments, such as the *Beauftragte für den Haushalt* of that ministry.

49. The German authorities sought advance agreement from the Commission that their existing administrative arrangements met the requirements of the Regulation. DG AUDIT and representatives of the Federal Ministries signed an agreement (the Agreed Conclusions) in 1998, confirming that the systems in place in the Federal Government and the *Länder*, as described in the systems description provided by the German authorities, already fulfilled the requirements of the Regulation. The very limited testing which the Commission carried out on the German management and control system gave rise to reservations about key issues such as the independence of the provider of the closure statement. Nevertheless, the Commission granted unqualified approval to the German authorities. Therefore the basis on which the Commission decided that the German management and control system was compatible with the requirements of the Regulation is not clear. Furthermore the Court's audit revealed that for ERDF the system applied did not meet the requirements of the Regulation.

50. In *Portugal* the checks are carried out partly by control bodies independent of the administering departments, and partly by the provider of the closure statement, which is part of the Ministry of Finance. This guarantees independence and thus complies with Article 8(1).

Coordination within Member States

51. In Member States there are a number of bodies that carry out the checks. The Court therefore considers that a coordinating body would facilitate the implementation of the Regulation, by establishing guidelines and best practice, giving advice and being the focal point for communication with the Commission. One of the particularities of the implementation of ERDF measures by Member States is the intervention of a large number of bodies. This makes the standardisation of procedures and the production of common instructions difficult but important.

52. In *France* the CICC has been very active in recommending best practice to the regions for carrying out the Article 3 checks. This body visits all regions and assesses the pertinence (compliance of the sample with Article 3(3)), quantity (attainment of the required coverage) and quality of the Article 3 checks and has an overview of all forms of assistance in that Member State. It also assesses the adequacy of the management and control systems. The CICC returns to each region to ensure that its recommendations for improvement have been implemented.

53. In *Portugal* the Inspecção-Geral de Finanças has a similar overview of all forms of assistance and of the work carried out under Articles 2 and 3. In addition this body carries out its own checks. In the *United Kingdom* the internal audit body of the respective Ministries carries out similar work to the CICC in France, but each is only concerned with one Fund ⁽¹⁾.

54. In *Italy* there is no single body responsible for the closure statements, but there is a coordination body, the Ispettorato Generale per i Rapporti Finanziari con l'Unione Europea (IGRUE) of the Ministry of Treasury. IGRUE carries out little coordination of audit methodology and there are no detailed practical guidelines on issues such as what constitutes an Article 3 check and what work the provider of the closure statement should perform. Similarly, there are no centrally issued checklists to ensure basic consistency and minimum standards between ministries/regions with similar types of expenditure. IGRUE allows each managing body to determine the provider of the closure statement. Owing to the autonomy of the regions each body remains responsible for its own work and is free to establish its own methodology. Thus there is no guarantee of consistency of audit standards or treatment of errors between the various bodies or within the same Fund.

55. IGRUE is not the only interlocutor with the Commission in Italy for the Regulation, with enquiries often being sent directly from the ministry or region to the DG responsible for the Fund concerned. IGRUE is not always informed of such correspondence, nor the replies.

56. In *Germany* the 16 *Bundesländer* are responsible for their compliance with the Regulation and the Federal Ministry of Finance (BMF) coordinates the implementation of the Regulation for all Structural Funds. However, there is no overview or quality control of its implementation. The federal level has no information concerning the organisational decisions the *Länder* have taken in respect of the execution of the Article 3 checks nor the appointment of the closure statement provider.

57. In *Spain* the regions are also independent of the national authorities. However the advantage of the Spanish arrangements is that, because the body providing the closure statement is the same as the one carrying out the Article 3 checks, there is an inherent quality overview of these checks across all Funds. Although IGAE issued standard instructions and checklists to all autonomous communities, compliance with these instructions and consistency of interpretation between regions is not ensured for those forms of assistance which are the sole responsibility of an autonomous community ⁽²⁾ because of the Spanish constitutional organisation.

58. Thus in these three latter Member States with devolved constitutional and administrative organisations, the central responsible authority does not review the work of the regional authorities nor, except in Spain, does it set out how the audits should be carried out, as these are the exclusive responsibility of those regional authorities. With little contact between the regional authorities to discuss methodology and treatment of cases detected, there is no guarantee as to the consistency of treatment, nor consistency in the application of the same minimum standards of checking by each regional authority. Action should be taken by the Commission, in partnership with the Member States concerned, to address this, for example by setting up coordinating committees.

59. The provision of a combined closure statement requires significant coordination between the national and the regional bodies concerned. Nevertheless, where a form of assistance contains both national and regional expenditure and where national and regional bodies carry out separate checks, a single closure statement should be provided. This is because, firstly, the Regulation itself requires one such statement for each form of assistance and secondly, because the provision of multiple closure statements, with perhaps differing conclusions, would be unmanageable for the Commission.

60. The monitoring of the attainment of the target 5 % required by Article 3 of the Regulation was found to be insufficient at national level in some of the Member States visited by the Court. Such monitoring was only found in Spain and Italy. In France, in respect of the ESF only, the responsible national ministry constantly monitors progress towards the target. It is recommended that this practice is adopted by the national authorities for each Fund in each Member State. The information should also indicate any irregularities arising which need to be communicated to the Commission in accordance with Regulation (EC) No 1681/94.

⁽¹⁾ However, the Internal Audit Body of the UK Ministry of Agriculture, Fisheries and Food covers both EAGGF Guidance and FIFG.

⁽²⁾ Spain: IGAE has no power to review and enforce changes in the work of the 17 regional Intervenciones Generales.

Responsibility for carrying out the checks

61. The Commission has stated that a clear separation of functions between managing and paying authorities and the checking bodies is vital to achieving the aims of Article 3 of the Regulation ⁽¹⁾, but in October 2000 and March 2001 the Commission was still discussing with Member States the issue of the independence of the organisations which are undertaking the Article 3 checks for the 1994 to 1999 period. This should have been settled by the Commission at the time of the introduction of the Regulation. Although Article 3 does not explicitly require such independence, the new control Regulation ⁽²⁾, which governs the programming period 2000 to 2006, introduced the principle that there should be a clear separation between checker and manager.

62. In Brandenburg the persons responsible for managing the ERDF projects, including approval for payment, also carry out the Article 3 checks. In France (Nord-Pas-de-Calais) it was not always possible to ensure that the checker was not the project administrator. Both regions have informed the Court that they have taken steps since the Court's audit to ensure adequate separation. In another instance, the Commission approved that the internal audit units of two private sector companies (which were implementing bodies) be authorised to carry out both Article 3 checks and the Article 8 closure statements. The bodies were also final beneficiaries of a number of measures, thus compromising independence. In such cases where there is an absence of an external public audit review the independence of the checks may be compromised.

Sample selection

63. The audit uncovered serious problems with sampling procedures in three Member States as regards the representativeness of the audit sample and the lack of risk analysis, both of which are required by the Regulation.

64. In Germany (Brandenburg), no mechanism was applied to ensure that the sample was representative, with an appropriate mix of types and size of projects. In Germany (ESF, federal level), only projects with total eligible expenditure of more than 500 000 euro were selected, and in Brandenburg the 5 % sample to be tested was based on 5 % of the number of ERDF projects co-funded, rather than 5 % of total eligible expenditure as required by the Regulation. In addition, in the United Kingdom, ERDF and EAGGF closed projects were excluded from the selection procedure.

⁽¹⁾ Letter from the Commission to the United Kingdom of 28 September 2000.

⁽²⁾ OJ L 63, 3.3.2001 — Regulation (EC) No 438/2001.

65. In Italy for the ESF and Germany (Brandenburg, ESF and EAGGF-Guidance), the risk analysis criterion was ignored in selecting the sample, while in other instances the sample was selected solely on a risk basis taking account of errors already identified in the related projects. The latter selection procedure is unrepresentative as it does not provide a true picture of the overall error rate and does not comply with the requirements in Article 3(2) and (3).

Content of the checks

66. In the United Kingdom (Scotland) checks in respect of the ERDF were found by the Court to be checks on the operation of systems rather than substantive checks of individual expenditure declarations of projects. Thus in effect the Member State was only complying with Article 3(1)(a), which concerns the verification of management and control systems and not Article 3(1)(b), concerning the verifications of expenditure declarations. In the same Member State in respect of ESF expenditure, the checks carried out only assessed whether there were systems in place to ensure correct declarations of expenditure and thus the reports examined by the Court's auditors included only limited substantive testing of projects.

67. The opposite case was found for ESF measures in Germany, both at the national and regional level, where the efficiency of the existing management and control systems did not form part of the checks. As no other checks on the systems were carried out, Article 3(1)(a) was not being fulfilled.

68. In France, the centrally-issued instructions concerning the checks to be carried out at regional level meet the requirements of Article 3. However, in Nord-Pas-de-Calais, for all Funds except the ESF, many of the checks counting towards the target coverage were found to be routine checks before final payment, which existed before the introduction of this Regulation. As such they did not normally include an in-depth financial audit of expenditure. Thus, the obligation to carry out the checks on 5 % of expenditure was not being satisfactorily implemented at the time of the audit in February 2000. The French authorities have since informed the Court that this weakness has been dealt with.

69. Shortcomings were found in the content of audit reports. In general it was rare that the reports gave quantified results of the checks, although this information is necessary when drawing up the closure statement. In France (Nord-Pas-de-Calais) the reports examined for the ERDF and the EAGGF consisted of a one-line certification of the work carried out and a recommendation for the final payment to be made to the project promoter. Since the Court's audit, new instructions have been given to remedy this. In Brandenburg, Germany (ESF and EAGGF-Guidance), and at the national level (ESF), no details were given of what had been tested or whether, and how, representative samples had been drawn.

Eligible expenditure checked

70. Articles 3(1)(b) and 4(d) and (e) of the Regulation and the Commission's SFAM ⁽¹⁾ require testing of the underlying expenditure ⁽²⁾. Only expenditure that has been paid, declared and subjected to substantive audit testing can be considered as checked under the Regulation. However, such testing was not carried out in many cases examined.

71. In the United Kingdom, ESF expenditure recorded as checked included expenditure claims in relation to years prior and subsequent to the year actually checked, without any actual examination of the underlying documentation. In another case, projects were considered to have been substantively audited on the basis of a financial system review ⁽³⁾.

72. A common weakness encountered during the audit was the inclusion of expenditure which had not been incurred at the time of the check, particularly in the case of ERDF expenditure where projects were checked at an interim stage. In such cases, Member States counted the entire authorised eligible expenditure as checked. In one case in Germany, expenditure relating to a project that was checked twice was included twice towards the 5 % target.

73. The authorities in Spain and the United Kingdom reported that they had already attained the target percentage for certain forms of assistance, in some cases as early as in 1998. Further expenditure will need to be checked in the ensuing years to ensure coverage over the whole period as the Regulation requires checks to be spread evenly over the period concerned.

74. Despite beliefs to the contrary on the part of a number of Member States, Court and Commission audits cannot be included in the 5 % total, as the Regulation states that 'Member States shall organise controls of projects ...'. (Article 3). In any case the methods of selection of projects for audit and the objectives of the tests

carried out by EU auditors may not meet the same criteria. However, international audit standards require that the closure statement providers should take the results of EU audits into account.

Reduction in the 5 % target

75. The Commission has not properly explained the provision which allows a reduction of the 5 % audit target and confusion was found in Member States as to its implementation. Furthermore, the SFAM does not give any indication on the matter, other than to state that the reduction is calculated on the basis of the final date for payments (31 December 2001).

76. One interpretation, promulgated by DG EMPL, is that the 5 % sample should only be taken from expenditure over the period 1998 to 2001 (i.e. since the introduction of the Regulation), with no expenditure needing to be checked for the period 1994 to 1997. Another interpretation (recommended by DG AUDIT ⁽⁴⁾) is that a reduced percentage of expenditure be checked in respect of each year 1994 to 2001 ⁽⁵⁾.

77. As the results of these checks will be a key component of the conclusions in the closure statement the Court considers that they, like the final declarations of expenditure, should cover the whole programming period. However, a calculation made on a pro rata profile of expenditure, rather than *pro rata temporis*, as recommended by DG AUDIT, would be more appropriate.

78. In February 2001 the Commission's (DG REGIO) first monitoring visit specifically for this Regulation revealed that the Irish authorities were not covering expenditure incurred before the introduction of this Regulation. The Court itself found a similar interpretation in Italy and Sweden in the course of its financial audit in respect of 2000. Earlier assessment of the implementation of the Regulation would have alerted the Commission to the varying interpretations. It is essential that the Commission give urgent guidance on this to all Member States.

79. Regulation (EC) No 2406/98 only applies to the drawing-up of the closure statement. The requirement to verify 5 % (or the reduced percentage) of the total eligible expenditure remains for all forms of assistance, which includes, for example, Objective 2, 1994 to 1996. The audit revealed that no Member State had carried out the 5 % checks in respect of the 1994 to 1996 programming period. The Commission should either take action to ensure that Member States apply the Regulation in full or propose an amendment to this Regulation.

⁽¹⁾ The SFAM refers to 'an in-depth check on-site of all aspects of the expenditure declaration back to source documents and other records held by final recipients of Structural Fund support' and to 'substantive tests to determine whether particular transactions are correct' (section B of Appendix 2) and 'the controls which count towards the 5 % of total eligible expenditure must involve on-the-spot checks of individual expenditure declarations'. Finally, section A states that 'the verification of expenditure declarations will only provide assurance on those declarations actually checked'.

⁽²⁾ Article 3(1)(b) requires that Member States verify selectively on the basis of risk analysis expenditure declarations made at the various levels concerned.

⁽³⁾ For example, the 1998 final claims of two ESF co-financed courses were checked, yet all 28 ESF co-financed courses were counted as checked, on the basis that the same systems applied, even though the eligibility and reality of the other 26 claims were not tested. Although the authorities correctly applied the conclusions of the results of the two training courses to the remaining 26, in cases where an audit reveals no systems weaknesses or substantive errors, it is not justifiable to extrapolate this absence of errors to claims which have not been examined.

⁽⁴⁾ Letters to Denmark and Finland.

⁽⁵⁾ For example, for an Operational Programme 1994 to 1999, payments may be made over an eight-year period. The Regulation came into force with approximately four eighths of the period remaining (November 1997) and thus the percentage to be checked would be four eighths of the 5 %. Thus, a minimum 2,5 % of each year's expenditure (1994 to 2001) would be checked.

The closure statement

80. Few forms of assistance had been closed at the time of the Court's audit. The audit did not identify any cases where the closure statement provider did not have the required independence (except in the cases in paragraph 62). However, in a subsequent audit for the ERDF in Greece, the Court found that the provider did not review the work carried out by the checkers, which will make the provision of a meaningful closure statement difficult.

81. The audit highlighted Member States concern that by carrying out thorough checks and systems audits and reporting a high frequency of irregularities ⁽¹⁾, they might be penalised by a reduction in EU co-financing. Such action might discourage Member States from issuing critical statements. The Commission indicated to the Court that only irregularities known to be remaining in the final declaration of expenditure would be excluded from EU co-financing. Moreover, the Commission would only extrapolate irregularities and make financial corrections in cases where the Regulation had not been correctly applied. It is not clear to the Court what legal basis would be available to the Commission to do this.

82. A high frequency of irregularities in the population checked cannot be ignored, even if the detected errors are corrected. Although the sample should take into account any risk factors, it should also be representative. Thus, if the sample reveals a high frequency of irregularities, it would indicate that a significant level of irregularities still remained in the untested part of the population. If the irregularities identified during checks are systemic, Article 7 of the Regulation requires Member States to correct those cases which have not been individually identified by these checks. It is essential that the use to which the Commission will put the closure statements should be addressed now and Member States informed, particularly in respect of the irregularities found which are non-systemic.

83. The Commission has not issued guidelines as to what constitutes a high or low frequency of irregularities. This leads to the risk that what is deemed 'high' in one Member State may be deemed 'acceptably low' in another. The Commission should ascertain the criteria being applied by Member States in making such a distinction and set guidelines. It should also adopt a common policy to be followed by the operational DGs upon receipt of a closure statement, to ensure equality of treatment between Member States and between Structural Funds.

84. Furthermore, the term 'frequency' is not sufficient in itself to judge the effect of irregularities on an expenditure declaration. Irregularities may be frequent (in which case the cause should be investigated) but the effect on the expenditure declaration may

be minimal. Frequency of irregularity does not measure the financial impact of these irregularities and without this an accurate assessment of the reliability of an expenditure declaration is difficult. Therefore a quantification of irregularities is also needed to reflect the true extent of their impact in the underlying expenditure.

Audit trails

85. An audit trail consists of the individual expenditure records and supporting documents at the various administrative and beneficiary levels. The Commission employed a firm of consultants to carry out a study of control and management systems of Structural Fund expenditure in selected Member States. This resulted in a set of flow charts and systems descriptions for the selected Member States per Fund. Similar information was compiled by the remaining Member States on the basis of a model designed by the consultants. The entire study was to be regularly updated.

86. The composition of a sufficient audit trail is described in Article 2(2) and Annex I to the Regulation. The audit trails resulting from the Commission's study set out the responsibilities but did not allow a judgement to be made on the adequacy of the management and control systems in place, nor identify risk areas. Neither did they ensure that the audit trail complied with the model annexed to the Regulation.

87. The wide diversity of projects and Member States' administrative systems for managing and controlling the Structural Funds (in particular the ERDF) makes it rare that each audit trail is applicable to all forms of assistance for that fund in a Member State. Indeed, the value obtained from the contract ⁽²⁾ is doubtful as the Court found no evidence that these audit trails were being used, or indeed, updated either by Commission officials, who prefer to rely on their own knowledge of the systems, or by Member States.

THE OBJECTIVES OF REGULATION (EC) No 1681/94

88. The main purpose of this Regulation is to allow the Commission to be better informed of the relevant legal and administrative provisions in Member States, the nature and level of irregularities occurring in the Structural Funds, their financial effects and the corrective and preventive measures taken by the national authorities in this regard, as provided for in Article 23 of Council Regulation (EEC) No 2082/93. To this end it envisages the organisation of an information system concerning irregularities and the recovery of sums wrongly paid.

⁽¹⁾ Article 8 of the Regulation only uses the word 'irregularity'. In this context the Court considers that 'irregularities' should include the concept of errors.

⁽²⁾ Contract cost 300 000 euro.

89. The Regulation does not define how the term irregularity should be interpreted by the Member States (this was not done until the introduction of Regulation (EC, Euratom) No 2988/95 ⁽¹⁾), nor does it set out the objectives of the Commission in requiring the creation of such an information system. In particular, the Regulation is silent on the use to which such information might be put, for example, the application of risk analysis and the monitoring of the recovery of sums wrongly paid.

THE ROLE OF OLAF AND THE OTHER COMMISSION SERVICES IN THE IMPLEMENTATION OF REGULATION (EC) No 1681/94

The management systems

90. In December 1993, UCLAF was established as part of the Secretariat-General of the Commission. One of its responsibilities was to ensure the implementation of Regulation (EC) No 1681/94, including the receipt and management of irregularity communications from Member States. However, the normal financial management responsibilities of the Commission for the implementation of Structural Funds' actions under Article 23 of Council Regulation (EEC) No 2082/93 remained with the relevant Commission Directorates-General (DG).

91. UCLAF's (latterly OLAF's) system for the management and recording of Member States' irregularity reports in the area of Structural Funds has been hampered since 1997 by technical difficulties and a lack of staff resources. All communications ceased to be entered on UCLAF's irregularities database from the end of 1997 ⁽²⁾, as the database, which was located in Luxembourg, was closed and its contents were transferred to the main IRENE ⁽³⁾ system in Brussels. Owing to an absence of software, data were not processed nor was new information registered on this system. The closure of the database meant that the DGs access also ended. Thus, while UCLAF continued to receive quarterly irregularity reports from Member States, there was no regular or systematic transfer of irregularity communications from UCLAF to the other Commission services after 1997 ⁽⁴⁾.

⁽¹⁾ Article 1(2) of Council Regulation (EC, Euratom) No 2988/95 (OJ L 312, 23.12.1995) states that an irregularity shall mean any infringement of a provision of Community law resulting from an act or omission by an economic operator, which has or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly on behalf of the Communities, or by an unjustified item of expenditure.

⁽²⁾ OLAF's Activity Report 1 June 1999 to 31 May 2000 of 23 May 2000 stated with regard to Member State communications, that all information notified under Regulation (EC) No 1681/94 was entered in the Office's database IRENE (paragraph 1.1.1).

⁽³⁾ IRENE (irregularities, enquiries, exploitation) has been in operation since 1 December 1992.

⁽⁴⁾ For example, of the 14 cases communicated by Member States in the period 1997 to 1999 to OLAF, concerning FIG, only four of these had been notified to DG FISH prior to the latter's request for updated information to OLAF in May 1999.

92. Only DG REGIO and DG FISH had a system for the management, recording and follow-up of irregularity communications, although even these were found to contain weaknesses. Any matters relating to the financial management of Structural Funds were retained on individual financial files, making full control and use of the information difficult. As a result of the Court's audit, the Commission's services stated that they were instigating improvements in this area.

93. In conjunction with the establishment of OLAF on 1 June 1999 ⁽⁵⁾, a new database information system is being designed to take account of the numerous information needs of the new organisation and is due to be operational in 2001. The Court has been informed that the proposed system will allow electronic communication and consultation of irregularities by Member States and Commission DGs.

94. Under the Commission's White Paper on Reform ⁽⁶⁾ of March 2000, and in the context of the current strengthening and reorganisation of the Commission's internal audit function, the Commission plans to ensure better coordination and interaction between OLAF and the Commission's DGs, the optimisation of the central early warning system concerning beneficiaries of EU funds (which allows the Commission accounting system to identify high-risk beneficiaries prior to payment) and more effective management of the recovery of unduly paid funds. To this end, OLAF and the other Commission services should consider whether an initial verification of irregularity reports should be carried out by the Structural Fund DGs. This would facilitate a timely and direct follow-up of irregularities with Member State authorities and ensure that corrections to future payments were properly made by the Commission.

The Commission's guidance

95. A definition of an irregularity is contained in Article 1(2) of Council Regulation (EC, Euratom) No 2988/95, the Regulation on the protection of the European Communities' financial interests. It states that an irregularity is:

'any infringement of a provision of Community law resulting from an act or omission by an economic operator, which has or would have, the effect of prejudicing the general budget ... by an unjustified item of expenditure'.

96. As Regulation (EC) No 1681/94 does not contain a definition of an irregularity, the above definition is referred to by OLAF in its guidance to Member States on the detection and reporting of irregularities. In general terms, the distinction between fraud

⁽⁵⁾ On 28 April 1999, the Commission adopted Decision 1999/352/EC, ECSC Euratom establishing the European Anti-fraud Office (OLAF) (OJ L 136, 31.5.1999).

⁽⁶⁾ White Paper on Reform, COM(2000) 200 final of 1 March 2000 and COM(2000) final/2 of 5 April 2000.

and irregularity is that fraud is an intentional act and a criminal offence, whereas an irregularity is any infringement of Community law resulting from an act or omission.

97. OLAF's role has been to provide information and guidance on the interpretation and implementing provisions of Regulation (EC) No 1681/94. This has been done through seminars organised in Member States, bilateral meetings with national authorities and at meetings of the Advisory Committee for Coordination of Fraud Prevention (Cocolaf⁽¹⁾). While these initiatives have, in some cases, resulted in improvements in the number of reported cases and the quality of the information therein, the audit showed that OLAF⁽²⁾ did not have detailed information as to the extent of each Member State's compliance with the terms of the Regulation, in particular the definition of irregularity being applied, so as to enable it to evaluate the quality and quantity of the information being reported.

98. The lack of clear guidance from the Commission services and the national coordinating authorities⁽³⁾ contributed to many different interpretations being used by Member States and regions and even between the managing authorities of each Structural Fund. For example, contradictory guidance received by Italy from Commission services initially limited reportable irregularities to cases resulting in penalties, but later included even cases which did not prejudice the Community budget⁽⁴⁾. In Italy (Lazio), the audit revealed that no instruction or guidance had been received by the relevant regional authorities since 1995.

99. This difficulty in the definition and interpretation of a reportable irregularity by Member States was referred to by the Commission in its 1999 annual report on the fight against fraud. The report, which included the results of a research study⁽⁵⁾ based on Member States' irregularity reports in the period 1993 to 1997, concluded that, 'Member States' reports differed from one another' with the result that, 'Member States' current practice was not in line with the objectives of securing equivalent protection of financial interests throughout the EU'.

⁽¹⁾ The 'Advisory Committee for Coordination of Fraud Prevention' (Cocolaf) was established in 1994 and is made up of representatives from the Member States and is chaired by OLAF.

⁽²⁾ However, OLAF stated in its Activity Report of 23 May 2000 (1 June 1999 to 31 May 2000) that, 'procedures for reporting by Member States are harmonised', and 'that a uniform presentation (of communications) is imposed to facilitate computer processing' in relation to Regulation (EC) No 1681/94 communications (paragraph 1.1.1).

⁽³⁾ Italy: The Department for Community Policy within the Office of the Prime Minister did not define a communicable irregularity, thus each administration interpreted it differently.

⁽⁴⁾ Letter from DG Employment April 1995, revised by the subsequent letter 1319 of 16 January 2000 to the Italian Ministry of Labour.

⁽⁵⁾ Joint Research Centre Study 1993 to 1997.

100. Some reporting authorities (owing perhaps to the primary role of UCLAF/OLAF as a fraud prevention agency) incorrectly interpreted their reporting obligation as being restricted to fraud and suspected fraud cases, despite the fact that this narrow interpretation of irregularities was rejected on 4 October 1995 at the meeting of Cocolaf as not compatible with Regulation (EC) No 1681/94.

101. In cases where non-fraudulent irregularities were recognised as reportable under the Regulation, confusion also existed as to whether a payment or a claim was necessary before an irregularity could be recognised. In the United Kingdom, this resulted in three different interpretations being applied, in respect of three Structural Funds, in Germany (Brandenburg), the same implementing body responsible for the management of two Structural Funds applied a different interpretation to each without apparent reason, and in Spain only cases for which a recovery procedure had been initiated were reported.

102. The criterion that all irregularities subject to initial administrative or judicial investigations be communicated was also the subject of different interpretations by national authorities. In many cases, the issuing of a recovery order or judicial proceedings was considered a prerequisite by the authorities to reporting an irregularity, rather than its detection and analysis. In France and Italy, this resulted in a significant number of suspected frauds which were the subject of investigation not being communicated to OLAF or the other Commission services.

103. Under Article 3(3) of the Regulation, and where provided for in national laws, communication of irregularities may be subject to the authorisation of the competent court or tribunal. The due application of this provision resulted in delays of up to two years in some cases⁽⁶⁾, while the authorities awaited the outcome of administrative and judicial procedures. In contrast, the procedures adopted in Spain and the United Kingdom often allowed for the early reporting of irregularities.

104. The Regulation was interpreted in both Germany (Bavaria) and Italy as not applying to cases of irregularities committed by the bodies managing the funds. This interpretation is of particular significance where the managing body, owing to its independent legal status is not subject to audit by the authorities certifying the funding, with a higher risk thus attaching to its EU-funded operation.

105. In many instances⁽⁷⁾ the managing authorities corrected detected irregularities by a reduction of the grant paid, without communicating the irregularity. This practice, along with the interpretation of the aforementioned issues, contributed in the case of some managing bodies to the relatively low numbers of reported irregularities in Belgium, France and the Netherlands,

⁽⁶⁾ France, Belgium, Netherlands and Italy.

⁽⁷⁾ Netherlands, Germany, United Kingdom, Italy.

and the total absence of reported irregularities in some instances ⁽¹⁾, in relation to some Structural Funds. On the basis of a full application of the irregularity definition, an initial analysis by one managing body ⁽²⁾ visited estimated that thousands of irregularity cases would now have to be reported annually. *Annex 1* shows the number and value of irregularity cases reported in the period 1994 to 2000 by Structural Fund and by Member State.

106. The application of several definitions of an irregularity by Member States' authorities and the failure to keep information updated result in the reporting of incomplete, unreliable, misleading and out-of-date data which are of little value for financial management purposes. Although joint information seminars have been organised between the national authorities and OLAF, further efforts are necessary on the part of the Commission and Member States to overcome the national legal and administrative obstacles, so as to ensure a more coherent approach to reporting. A summary of the Member States' systems for complying with the Regulation is shown in *Annex 2* for those Member States visited.

The monitoring by OLAF and the other Commission services of Regulation (EC) No 1681/94

107. While primary responsibility for dealing with irregularities detected and for making financial corrections lies with Member States, responsibility for monitoring the system and the irregularity communications at Community level is shared between OLAF, DG AUDIT and the operational DGs of the Commission. The Commission's monitoring of this Regulation was found to be deficient in a number of areas. First, the Court has found no evidence that the Commission has made an analysis and assessment of the disparate information provided by Member States about their management and control systems and their arrangements for detecting and reporting irregularities. OLAF is the lead authority in respect of the implementation of Regulation (EC) No 1681/94 and receives Articles 3 and 5 communications from Member States. DG AUDIT (in its role as auditor of Member States' financial systems) receives reports of Member States' administrative and legal provisions as required under Article 2 of the Regulation and Article 23(1) of Regulation (EEC) No 4253/88. Contrary to the intention of the Regulation, this information does not include specific details of Member States' information systems for detecting and reporting irregularities and neither OLAF nor the

Commission DGs had specific details or analysis of Member States' procedures or systems for reporting irregularities.

108. Secondly, none of the Commission's services had carried out on-site visits to the Member States to specifically review their systems in this area. The necessity for this is illustrated by the results of the Court's audit which revealed many shortcomings in the systems for the detection, recording and communication of irregularities, at both central and subsidiary authority levels. OLAF and the other Commission services were unaware of these problems.

109. For example, the individual authorities responsible for the management of Structural Funds at national and regional level did not have instructions or written procedures for verifying the interpretation or quality of the irregularity information received. In spite of the lack of monitoring at Community and national level ⁽³⁾ as to how each reporting body interpreted the term 'irregularity', no Member State authority validated the nature of the information being received, but merely passed it on unchecked to the Commission.

110. Furthermore, in most cases the national coordinating authorities did not have records providing a summary overview of all reported cases and their current situation, nor did they carry out any completeness checks or reasonableness tests by analysing which of the reporting bodies or regions submitted what volume of irregularities. In the case of the French Ministry of the Interior, no records were maintained of the irregularity communications received, and in the United Kingdom one ministry was unable to provide a listing of all cases in the period 1994 to 1999 owing to the fact that it deleted closed cases from its database. The Court considers that such information should be retained for use in applying risk analysis in the context of Regulation (EC) No 2064/97 and other audits.

111. The obligation on Member States, under Article 5 of the Regulation, to submit quarterly updated information about judicial or administrative action taken on irregularities previously notified, is not generally complied with, owing principally to the lengthy investigation periods. Such delays impede the efficiency and transparency of follow-up procedures. Similarly, the requirement to confirm the non-detection of irregularities each quarter (nil returns) is often ignored.

112. The audit revealed that the quality of the records maintained by the managing authorities on irregularities was poor, with many errors and inaccuracies uncovered in the records maintained by the authorities at each level. For example, OLAF rejected all French irregularity cases reported in the period 1997 to 1998, owing to incomplete information. In many cases ⁽⁴⁾, the

⁽¹⁾ UK: FIFG; France: ERDF, FIFG, EAGGF.

⁽²⁾ Germany: MASGF. Because of the hitherto very restrictive interpretation of an irregularity in all *Länder*, it can be assumed that a general application of the BMFs' criteria will now require the BMA to declare several thousand cases each quarter, which will create a quite different situation from the past, with only 42 irregularities reported in the five and a half years to 31 December 1999.

⁽³⁾ United Kingdom: DTI (Department of Trade and Industry); France: CICC; Italy.

⁽⁴⁾ France: MI (Ministry of the Interior); United Kingdom: DTI, DETR (Department of the Environment, Transport and the Regions); Spain; Italy: Ministry for Industry.

absence of important details on the irregularity forms submitted to OLAF, such as project name, irregularity amounts or a unique reference number and the use of non-standard forms, made any meaningful analysis of the information difficult.

113. The communication in some cases of meaningless data, and their acceptance without follow-up action, demonstrates the need for a clearer and workable definition of what needs to be communicated. Furthermore, proper records (on electronic media) should be maintained to ascertain quickly what irregularity communications have been received or are outstanding, the general content of the reports and the follow-up and correspondence on each case. These records should be periodically validated with the records of other authorities in the reporting system, so as to eliminate errors in the compilation of reports.

114. Lastly, the reporting system in most Member States examined did not ensure that all irregularities detected were in fact finally and correctly communicated to OLAF ⁽¹⁾. In many instances the central managing authority's records of open and closed irregularity cases did not fully correspond to that of the originating Structural Fund bodies and complete breaks in the reporting trail and inaccurate and delayed reporting were observed. In Italy ⁽²⁾, a number of parallel communication channels were used for reporting irregularities, which resulted in irregularities not being communicated to OLAF and intermediate authorities being bypassed and excluded from taking the necessary measures to safeguard Funds.

Follow-up of irregularities by OLAF and the other Commission services

115. Under the Structural Funds' Regulations, if Member State authorities report a detected irregularity prior to the final date for financial commitments under the Operational Programme, they may substitute other project expenditure for the ineligible amounts. In the absence of this, and where OLAF and the other Commission services subsequently become aware of the irregularity, a procedure under Article 24 of Council Regulation (EEC) No 2082/93 to reduce, suspend or cancel Community aid may be

⁽¹⁾ For example, in the case of one region, six cases of irregularity recorded by the regional managing authority were not communicated to either the national authorities or OLAF.

⁽²⁾ In Italy, despite an instruction that each managing body communicate a detected irregularity to the Department for Community Policy, some bodies communicated them directly to the Treasury Ministry, while others sent them directly to their lead ministries and the Commission DGs.

instituted. For example, in 1999 some 75 recovery orders were issued under Article 24, amounting to 82 million euro ⁽³⁾.

116. Very few of OLAF's investigations result from Member State communications. This is primarily due to the fact that the Commission services expect Member States to follow-up irregularities they themselves have detected and to automatically correct, recover and/or re-programme the amounts concerned. Accordingly, OLAF prioritises its own investigations and high-risk areas for attention, while the managing DGs give priority to the recording and the follow-up of irregularity cases arising from the Commission's own audit missions, those of the Court of Auditors and those arising from OLAF investigations.

117. Frequently, the incompleteness of Member States' communications ⁽⁴⁾ and their lack of significance from a risk viewpoint also lead to their low prioritisation. Thus, OLAF stated in its annual activity report 1999 to 2000 ⁽⁵⁾ that it could not 'be content with the information received from traditional sources' and that it had yet to carry out an analysis to determine whether 'irregularities detected ... constituted the bulk of the irregularities actually committed or just a small part'.

118. According to data supplied by OLAF concerning ⁽⁶⁾, the period 30 June 1994 to 31 December 2000 a total of 3 244 communications of irregularities were reported by Member States under Regulation (EC) No 1681/94 in respect of the four Structural Funds (ERDF, ESF, EAGGF and FIFG), amounting to 433,9 million euro. At the end of 2000, the total amount still to be recovered in respect of these cases was 317,3 million euro. Thus the amount effectively recovered in respect of those same reports was 116,6 million euro, or just over one quarter of the amounts declared to be affected by irregularities.

119. The *Table* shows the number and value of irregularity cases communicated by Member States in 2000. In 2000 the number of cases reported increased by over 74 % on the previous year. The

⁽³⁾

Structural Fund	No of recovery orders	Amount issued
ERDF	22	63 303 281
EAGGF	33	12 224 957
ESF	12	1 557 709
FIFG	8	5 172 100
Total	75	82 258 047

Source: Commission.

⁽⁴⁾ Furthermore, Member State communications were submitted in many different formats, owing to the fact that the Regulation provides no prescription in this area. This situation created additional difficulties in inputting and analysing the information.

⁽⁵⁾ OLAF Activity Report of 23 May 2000 (1 June 1999 to 31 May 2000) paragraph 5.1.2.

⁽⁶⁾ It should be noted that this information varies from that in 'Protecting the Community's financial interests and the fight against fraud' Annual Report 1999 (COM(2000) 718 final of 8 November 2000 due to updating of the information.

largest proportion of cases reported (in terms of both number of cases, 55 % and the amount involved, 51 %) concerned the Social Fund. While the significant increase in the number of reported

cases reflects the greater effort on the part of Member States to report irregularities, the figures still mask the enormous variations between Member States and between regions.

Table

Fraud and irregularities communicated by Member States under Regulation (EC) No 1681/94 (year 2000)

(1 000 EUR)

Member State	ERDF		EAGGF-Guidance		FIG		ESF		Grand total	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Belgium	0	0	0	0	0	0	0	0	0	0
Denmark	8	123	4	173	0	0	0	0	12	296
Germany	40	12 034	83	3 070	0	0	20	2 173	143	17 277
Greece	2	2 359	3	165	0	0	9	130	14	2 654
Spain	11	985	27	799	4	207	141	9 282	183	11 273
France	69	2 387	9	113	1	445	207	7 018	286	9 963
Ireland	75	8 170	8	82	0	0	5	505	88	8 757
Italy	21	8 895	51	4 902	16	2 824	29	6 305	117	22 926
Luxembourg	0	0	0	0	0	0	0	0	0	0
Netherlands	0	0	0	0	0		223	23 736	223	23 736
Austria	0	0	44	1 363	0	0	0	0	44	1 363
Portugal	10	786	23	576	2	296	15	1 835	50	3 493
Finland	2	271	5	32	0	0	6	56	13	359
Sweden	3	87	2	25	1	0	13	1 152	19	1 264
United Kingdom	51	4 461	0	0	0	0	28	6 196	79	10 657
Total	292	40 558	259	11 300	24	3 772	696	58 388	1 271	114 018

120. As the principal objective in communicating irregularities is to enable the information to be taken into account by the Commission when authorising payments on individual Structural Fund programmes, the accuracy and timeliness of the information are of the utmost importance. However, the absence of an agreed and documented system, both within the Structural Fund DGs and between OLAF and the DGs, for the follow-up of irregularities communicated by Member States hinders the proper and efficient utilisation of this information.

121. For example, in February 1997, OLAF sent to the Structural Fund DGs a list of all the irregularities received up to that date. However, in many instances, owing to the inadequacy of the information provided by Member States, the cases could not be followed up by the DGs⁽¹⁾. Furthermore, in DG EMPL, despite having three files of copied 1998 communications, no analysis or follow-up of the documents took place. Similarly, DG REGIO had 17 cases which had been referred to the relevant geographic units for follow-up action, which were still shown as outstanding after two years.

⁽¹⁾ DG REGIO — In 35 cases (33 % of 107 cases) the final situation was that it was not possible for the DG to identify the beneficiary/action/OP, etc.

122. In many instances, the flow of information and enquiries between OLAF and the other Commission services proved most tortuous. DG REGIO sent queries through OLAF to Member States for reply, although direct communication with Member State authorities would have obtained immediate results. Instead, voluminous and at times needless correspondence was generated, resulting in inefficiencies.

123. The veracity and accuracy of all significant expenditure items submitted for grant aid should be independently or directly verified by reference to the original underlying documents. Furthermore, a horizontal analysis of 'over-claimed' grants (i.e. grants requested compared with final approved amount) should be considered by managing authorities, to identify ineligible expenditure and irregularities in excess of 4 000 euro and to be included in risk profiles.

124. While some Member States had reported large numbers of irregularities each quarter, many of these cases remained unresolved for long periods. For example, in one instance⁽²⁾, following a 16-month delay in taking initial action, a further five years

⁽²⁾ Germany: Brandenburg; ILB (Investition Landesbank).

passed in which numerous requests to the beneficiary for repayment of the grant aid went ignored. Although the case was identified as outstanding in quarterly reports to the coordinating body, no follow-up action was taken by this body, OLAF or the other Commission services.

125. The nature, trend or frequency of the reported irregularities were not systematically analysed by OLAF nor by the other Commission services for risk analysis purposes (e.g. the identification of high-risk areas for specific audit attention), or as a source of information for improving or targeting financial checks. Furthermore, OLAF's computer database IRENE, owing to its configuration and design, did not allow for the production of analytical reports on irregularities across geographic areas or sectors, nor was it generally used as a tool for risk analysis. Indeed, for the period September 1997 to late 2000 it was non-operational. The non-systematic follow-up and the lack of analysis of irregularities across Operational Programmes and Member States reduce the effectiveness of financial management and seriously call into question the usefulness of this reporting mechanism.

126. In general, in the Member States, the information was not being fully utilised, with no statistical analysis being carried out to compare the irregularity history of the different sectors. Nor were the Court and Commission audit findings found to be included in the irregularity reporting system examined. If the irregularities reporting exercise is to be worthwhile, prompt follow-up action is needed to protect EU funding in individual cases and an analysis must be carried out of audit results from all relevant sources, so as to draw conclusions for control systems and risk in general.

CONCLUSIONS AND RECOMMENDATIONS

127. The introduction of Regulation (EC) No 2064/97 is a positive step in the improvement of the financial control by Member States, as the checks made and the closure statements given should help to reduce the level of error in expenditure co-financed by the Community. The Commission should give increased priority to guidance and to assessment of the implementation of the Regulation, thereby improving the verification of the legality and regularity of expenditure declared as eligible by Member States, either at the intermediate stages or at closure (paragraphs 22 to 36). The Court's audits have repeatedly shown that a significant amount of error exists in the final declarations of expenditure after payment of the final balance and the closure of the form of assistance (paragraph 1).

128. The Court's audit revealed that much good audit work is being carried out in the Member States but the quality is variable, even within regions (paragraphs 42 to 84). It is essential that the Commission ensures that there are satisfactory levels of control across the Union.

129. The audit identified delays in the implementation of the Regulation (paragraph 33) and widespread incorrect application on the part of national and regional administrations in fundamental details of its implementation (paragraph 78, for example), due, in part, to insufficient guidance from the Commission (paragraphs 22 to 36). The audit revealed that none of the Member States visited fully complied with the Regulations. In general the Member States visited during this audit have indicated to the Court that they will review procedures and undertake improvements. Given the diverse nature of the Structural Fund organisations in Member States, all Member States should review their implementation of the Regulation, and the Commission urgently needs to carry out an extensive assessment of the systems used, and give guidance where necessary.

130. The audit of the implementation of Regulation (EC) No 1681/94 has shown that irregularities detected are not being communicated and progress not reported, resulting in differences in the volume and type of cases being communicated by Member States (paragraphs 98 to 106 and 111 to 114). The failure of OLAF to maintain an adequate database for a substantial period (paragraphs 91 and 125) and the lack of systematic follow-up by the Commission's Structural Fund DGs (paragraphs 92 and 121) have weakened the usefulness of the Regulation. Given that OLAF's role to date with regard to this Regulation has been that of an intermediary in the communication system, OLAF and the other Commission services should review the current procedures with a view to having communications immediately examined and followed-up by the managing Structural Fund DGs (paragraph 94).

131. The Court notes the continuing increase in reported irregularities in the year 2000. Nevertheless, the Commission should carry out a series of comprehensive on-the-spot checks in Member States. This would identify shortcomings in the national systems for the detection, reporting and follow-up of irregular expenditure. The Commission should give Member States clear written instructions on the nature of the required control and communication systems and on the timing and format of reports on irregularities. It should also make recommendations and requests for corrective measures, as provided for in the new Structural Funds' Council Regulation (EC) No 1260/1999⁽¹⁾ (paragraphs 107 to 108).

⁽¹⁾ Council Regulation (EC) No 1260/1999 laying down general provisions on the Structural Funds (OJ L 161, 26.6.1999).

132. Both Regulations should provide a means for OLAF, the other Commission services and Member States to identify and correct weaknesses in management and control. In addition, the Commission should formulate proposals to combine the various

aspects of both Regulations to provide effective and cohesive control and reporting systems on a clear and consistent basis throughout the EU.

This report was adopted by the Court of Auditors in Luxembourg at the Court meeting of 19 July 2001.

For the Court of Auditors

Jan O. KARLSSON

President

ANNEX 1

COMMUNICATIONS IN ACCORDANCE WITH ARTICLE 3 OF REGULATION (EC) No 1681/94

(Period 30.6.1994 to 31.12.2000)

Number of cases

Funds	EAGGF Guidance	ESF	ERDF	FIFG	Total
Member States					
Austria	44	1	0	0	45
Belgium	5	14	7	0	26
Denmark	10	14	14	1	39
Germany	258	62	93	3	416
Greece	19	198	8	1	226
Spain	91	416	88	9	604
Finland	7	12	3	1	23
France	10	407	80	1	498
Ireland	16	8	128	3	155
Italy	100	128	40	21	289
Luxembourg	0	0	0	0	0
Netherlands	0	258	3	0	261
Portugal	211	103	65	7	386
Sweden	17	42	5	2	66
United Kingdom	7	69	134	0	210
Total	795	1 732	668	49	3 244

0: no irregularity cases to report.

Source: OLAF.

Amount declared by Member State

(EUR)

Funds	EAGGF Guidance	ESF	ERDF	FIFG	Total
Member States					
Austria	1 363 000	0	0	0	1 363 000
Belgium	273 725	233 969	745 503	0	1 253 197
Denmark	225 213	363 251	418 823	104 719	1 112 006
Germany	13 113 144	23 760 810	29 275 297	137 548	66 286 799
Greece	4 742 229	9 340 305	2 906 187	15 258	17 003 979
Spain	4 543 382	18 928 581	30 280 447	921 081	54 673 491
Finland	51 424	157 530	301 819	37 541	548 314
France	122 681	10 978 239	4 718 833	445 000	16 264 753
Ireland	202 160	590 549	14 012 838	179 244	14 984 791
Italy	19 211 671	49 149 226	29 639 564	3 360 807	101 361 268
Luxembourg	0	0	0	0	0
Netherlands	0	25 691 540	49 371	0	25 740 911
Portugal	10 111 667	15 141 298	23 743 101	1 733 509	50 729 575
Sweden	68 959	2 256 557	202 936	4 954	2 533 406
United Kingdom	791 778	37 034 596	42 329 768	0	80 156 142
Total	54 821 033	193 626 451	178 624 487	6 939 661	434 011 632

0: no irregularity cases to report.

Source: Commission.

ANNEX 2

SUMMARY OF COMPLIANCE WITH REGULATION (EC) No 1681/94 IN MEMBER STATES SUBJECT TO AUDIT VISITS

Member State	Definition of irregularity compliant/non-compliant	Reporting and control systems	Central coordination review, audit trail
Germany	<p><i>Evidence of non-compliance</i></p> <ul style="list-style-type: none"> — only serious irregularities were reported — conclusion that thousands of irregularities cases would have to be reported if properly defined — reporting obligation restricted to fraud and suspected fraud cases — same implementing body responsible for two Structural Funds, applied two different irregularity definitions 	<ul style="list-style-type: none"> — National coordinating authorities did not have records providing a summary overview of all reported cases and their current situation, nor did they carry out any completeness checks or reasonableness tests by analysing which of the reporting bodies or regions submitted what volume of irregularities. The federal authority for EAGGF, however, collated and registered irregularity reports received from all <i>Länder</i> 	<ul style="list-style-type: none"> — No coordination between the three federal ministries responsible for the implementation of the Structural Funds and the federal coordinating ministry — Many of the notified irregularity cases remained unsolved for long periods. For example, in one case, following a 16 month delay in taking initial action, a further five years passed in which multiple requests to the beneficiary for repayment of the grant aid went ignored. Although the case was identified as outstanding in quarterly reports to the coordinating body, no follow-up action took place on the part of either this body or OLAF
Spain	<p><i>Evidence of non-compliance</i></p> <ul style="list-style-type: none"> — irregularities only reported in cases where recovery procedure initiated 	<ul style="list-style-type: none"> — Absence of important details on the irregularity forms submitted to OLAF, such as name of beneficiary 	<ul style="list-style-type: none"> — Lack of coordination between central and regional reporting authorities
France	<p><i>Evidence of non-compliance</i></p> <ul style="list-style-type: none"> — authorities await final outcome of administrative and judicial procedures — irregularities corrected without communicating (total absence of reported irregularities for ERDF, FIFG, EAGGF) 	<ul style="list-style-type: none"> — No records were actually maintained by Interior Ministry of the irregularity communications received — Poor quality of the records maintained by the managing authorities (cases in the period 1997 to 1998 were rejected by OLAF) 	<ul style="list-style-type: none"> — Lack of monitoring at national level on interpretation of irregularity
Italy	<p><i>Evidence of non-compliance</i></p> <ul style="list-style-type: none"> — different interpretations by each administration — recovery order or judicial proceedings is a prerequisite to reporting an irregularity — authorities await outcome of administrative and judicial procedures — irregularities corrected without communicating — Regulation not applied to irregularities committed by the bodies managing the Funds 	<ul style="list-style-type: none"> — One national coordinating authority did not have records providing a summary overview of all reported cases and their current situation, nor did they carry out any completeness checks or reasonableness tests by analysing which of the reporting bodies or regions submitted what volume of irregularities — Absence of important details on the irregularity forms submitted to OLAF, such as project name, irregularity amounts or a unique reference number and the use of non-standard forms, made any meaningful analysis of the information difficult 	<ul style="list-style-type: none"> — Lack of monitoring at national level as to how each reporting body interpreted the term 'irregularity' — A number of parallel communication channels were used for reporting irregularities, which resulted in irregularities not being communicated to OLAF and intermediate authorities being bypassed and excluded from taking the necessary measures to safeguard Funds
Portugal	<p><i>Evidence of non-compliance</i></p> <ul style="list-style-type: none"> — The Portuguese authorities do not systematically communicate updates of the initial Article 3 communications. In particular details of recoveries made are not always conveyed to the Commission 	<ul style="list-style-type: none"> — No material non-compliance noted at the preliminary audit stage 	<ul style="list-style-type: none"> — No material non-compliance noted at the preliminary audit stage
United Kingdom	<p><i>Evidence of non-compliance</i></p> <ul style="list-style-type: none"> — different definition for the three Structural Funds (ERDF, EAGGF and FIFG) — irregularity restricted to grants paid only — irregularities corrected without communicating 	<ul style="list-style-type: none"> — The authority responsible for ERDF in England was unable to provide a full listing of all irregularity cases in the period 1994 to 1999 due to the fact that it deleted closed cases from its database once they were resolved — Absence of important details on the irregularity forms submitted to OLAF, such as project name, irregularity amounts or a unique reference number and the use of non-standard forms, made any meaningful analysis of the information difficult 	<ul style="list-style-type: none"> — Lack of monitoring at national level (UK) as to how each reporting body interpreted the term 'irregularity' — The coordination body carries out no completeness checks or analysis as to which ministries or regions are submitting irregularities — No control or monitoring as to how each government office interprets the Regulation

THE COMMISSION'S REPLIES

SUMMARY

Both Regulations are part of a process aiming to improve the financial control by Member States of Structural Funds expenditure. This process has entailed many changes in the Member States' administrative arrangements as well as a need for resources, in order to meet the new requirements. Many of these changes have taken place gradually over the past three years and some specific issues are becoming more visible as programmes are being wound down and closed.

The experience gained will contribute to increasing the efficiency of control systems for the 2000 to 2006 programming period.

III. The adoption of Regulation (EC) No 2064/97 at the end of 1997 was the culmination of a lengthy procedure which involved detailed discussions with Member States in the Structural Funds committees which had to be consulted on the Commission's proposal. The implications of the principal obligations laid down had therefore been the subject of scrutiny and explanation prior even to the adoption of the Regulation.

Since the entry into force of Regulation (EC) No 2064/97, the Commission has made great efforts to give detailed guidance to Member States on the implementation of its provisions, notably through the Structural Funds audit manual, first presented in June 1998 and through the systematic treatment of questions relating to the Regulation in the framework of the bilateral coordination meetings with Member States, at the annual meeting of EU Financial Controllers in 1998, 1999 and 2000 and on other occasions.

As regards assessment of the application of the Regulation, since 1999, a number of audit missions have been carried out by Structural Funds services covering compliance with certain aspects of the Regulation. In preparation for the closure of programmes from the 1994 to 1999 period, at the beginning of 2001 a full enquiry started into the implementation by all Member States of the Regulation. Where problems are identified in the course of this enquiry, the national authorities are informed so that they are able to take remedial action.

The continued action to improve the quantity and the quality of the information received under Regulation (EC) No 1681/94, has been successful as is reflected in the increased number of communications received from Member States. OLAF works closely with other Commission departments and Member States in order to improve persistent weaknesses. Since December 2000, OLAF has been using the new software that was developed for communication under Regulation (EC) No 1681/94. The new software has been tested by some Member States and is ready for deployment in all Member States.

The Commission's White Paper on reforming the Commission details a series of measures regarding protecting the Community's financial interests and aimed at improving the systems of detection and cooperation. Furthermore, cooperation among Commission departments and between the Commission and Member States, particularly in the area of the Structural Funds, will need to be better defined to ensure that more effective action is taken to improve the prevention and detection of irregularities, fraud and corruption. This objective for the Structural Funds is then translated into Action 97 'Improving monitoring of Structural Funds' of the action plan of the White Paper. A Commission communication on this subject is in its final stages of adoption.

As regards the cooperation between OLAF and the Structural Funds DGs, the Commission's newly adopted 'Action plan for 2001 to 2003' for 'Protecting the Communities financial interests — Fight against fraud' clearly recognises the need for clarification of the different departments' responsibility as regards follow-up of reported irregularities and fraud cases and recovery of amounts unduly paid. The action plan provides that protocols will be drawn up between OLAF and the DGs responsible for the Structural Funds with regard to the follow-up of irregularities notified by the Member States under Regulation (EC) No 1681/94. It is foreseen that these protocols will be concluded before the end of 2001.

Coordination between OLAF, Member States and the Structural Funds DGs has also been ensured in the annual control coordination meetings held previously under the responsibility of DG Audit, and from July 2000 under the responsibility of DG REGIO. These meetings always include a discussion of irregularity cases reported by the individual Member States.

A systems audit on the application of the control provisions of Regulation (EC) No 2064/97 is currently being undertaken in all Member States, which includes an assessment of compliance with Article 7 of that Regulation concerning the treatment of irregularities.

Article 2(5)(b) of Commission Decision 1999/352/EC lays down that OLAF is responsible for ensuring the collection and the storage of the Member States' reports on irregularities. It is important that any database holding information on irregularities allows for a global view. Decentralised databases kept by the spending departments could not meet that objective. However, since March 2001 it has again been possible for the operational departments to have on-line access to the Member States' communications in the electronic communications registry (ECR).

The procedures for reporting by the Member States have been harmonised at Commission level for all sectors. A uniform presentation is imposed to facilitate computer processing. All information notified on the basis of Regulation (EC) No 1681/94 is entered in OLAF's database. OLAF will be in a position to derive maximum benefit from the deployment of the new software across the Member States. The new Regulation (EC) No 448/2001 links the application of financial correction to the reports made available within the framework of Regulation (EC) No 1681/94. It is therefore not considered necessary to combine the two Regulations.

INTRODUCTION

1. The closure of a programme on the basis of the final declaration of expenditure by the national authorities is a formal process. If it is established that the declaration of expenditure is incorrect, the ineligible amount will be excluded. The legislation applicable to the 2000 to 2006 programming period, notably Council Regulation (EC) No 1260/1999, and Commission Regulations (EC) No 438/2001 and (EC) No 448/2001, significantly reinforce the financial control measures.

THE REGULATORY ENVIRONMENT

Regulation (EC) No 2064/97

9. Checks of co-financed operations are a requirement by virtue of Article 23 of Council Regulation (EEC) No 4253/88. The Member States have been the subject of audits by the Commission during the course of the multiannual implementation periods. The

Commission has not concentrated its audit activity at the moment of programme closure. Following the transfer in the Commission of July 2000 of control units from the Financial Control Directorate-General to the Structural Funds Directorates-General, and the subsequent allocation of additional posts for certain services, the auditing capacity in relation to the Structural Funds has increased.

14. The Commission has given guidance in its last progress report on the implementation of Regulation (EC) No 2064/97 of June 2000 on the minimum information which should be included in the reports.

THE OBJECTIVES OF REGULATION (EC) No 2064/97

21. In view of the need to give more guidance the Commission is reviewing its audit manual and will discuss with the Member States the detailed methodology.

THE ROLE OF THE COMMISSION IN THE IMPLEMENTATION OF REGULATION (EC) No 2064/97

23. The Commission considered that it would be premature to undertake an audit of the application of the Regulation before the end of 1999. It was in fact started at the beginning of 2001. However in 1998, 1999 and in 2000, the annual meetings of the Financial Controllers discussed the implementation of the Regulation based on Commission and Member States presentations and the Article 9 reports, and the application of the Regulation was also treated in the high level group of personal representatives of the Ministers of Finance.

24. The coordination role of DG REGIO was taken over in July 2000 following the decision of the Commission transferring from DG Audit to DG REGIO the two units responsible respectively for the control of regional expenditure and the coordination of controls for the Structural Funds.

The Commission's audit manual

25 and 26. The Structural Funds audit manual was presented to Member States at a seminar in London on 2 and 3 June 1998 for their financial control bodies. It was presented again at a seminar in Budapest on 15 and 16 October 1998 to a combined audience of financial controllers of the Member States and candidate countries. Accordingly the concerned bodies of the Member States should have been fully aware of the guidance contained in the manual even if the formal distribution in all the Community languages did not take place until October 1999. At least one Member State undertook the translation itself. Even on the basis of the formal distribution in all the Community languages in October 1999, Member States should still have been able to adapt their procedures, for example in relation to risk-analysis methods, with over two years before closure of the majority of programmes.

27. The Regulation allows the proportional reduction to be applied in different ways and does not specify whether it should be *pro rata* expenditure or *pro rata temporis*. Accordingly, the Commission cannot impose one uniform basis for applying the reduction. The Commission has issued guidance as to its preferred approach bilaterally to Member States which have raised the issue of proportional reduction of the 5 % requirement from checks.

28. The Article 9 reports and the information obtained from the bilateral coordination meetings are a useful basis for monitoring the application of the Regulation, and the Commission has taken measures to complete its assessment by undertaking systems audits in 2001 in all Member States on the implementation of the control provisions of the Regulation.

Assessment by the Commission of compliance with the Regulation

30. The primary responsibility for control of the regularity of expenditure rests with Member States. Through its audits on a selection of programmes during the life of the programming period, the Commission seeks to give assurance as to the adequacy of the national control systems. The provisions of Article 8 of the Regulation reinforce the obligations of Member States in this respect through the requirement of a closure statement.

DG EMPL Audit and Control Unit is currently facing an important lack of human resources but is also endeavouring to fill the current vacancies with a view to ensuring that its work programme for 2001 is not compromised.

31. The audit report of DG FISH states clearly that the financial control system set up as well as the checks carried out by the Austrian authorities are in line with the requirements of Regulation (EC) No 2064/97.

All those requirements (content of the systems, attainment of 5 %, appropriate mix of checks and respect of any risk factors, content and quality of checks, follow up of findings) were of course checked through interviews with the responsible officials, and the supporting documentation (especially audit reports) was examined.

Since all was in order, it did seem not necessary explicitly to describe the steps in the audit and the results in detail.

Nevertheless, the recommendation of the Court of Auditors concerning the detailed reporting on the quality of the Article 3 checks will be followed in the future.

32. A systems audit on the application of the control provisions of Regulation (EC) No 2064/97 is currently being undertaken in all Member States. It is the view of the Commission that it will be possible to reach valid conclusions as to the compliance with the Regulation on the basis of the work done in 2001. Since the checks by Member States can be carried out up to the date of closure of the programme, it should still be possible to take some remedial measures. Where the Commission services identify shortcomings in the performance of checks in the course of their audit work, they inform the responsible national authorities in order that remedial action can be taken.

33. It is a matter of concern if the clear requirements of the Regulation have not been fulfilled in a Member State. Member States must ensure that the control provisions of the Regulation are complied with before closure, and if necessary they must apply

for an extension of time for this purpose. In cases where delay is identified by the Commission in the course of its current audit on the application of the Regulation, the attention of the national authorities is drawn to the consequences for the closure.

34. In addition to the positions taken in the protocol meetings and in replies to written enquiries the Commission has reacted on issues of interpretation arising from its audit activity.

The main problem with regard to checks found in the Commission's audit work so far appears to be that insufficient checks have been carried out, rather than that the checks done are not in accordance with the Regulation.

Coordination within the Commission

35 and 36. In July 2000 the Commission decided that the Regional Policy Directorate-General should coordinate the response to all questions of interpretation of Regulation (EC) No 2064/97, and consult the legal service where necessary, before replies are given to national authorities.

36. In its letter to the Italian authorities, DG FISH wanted to stress the subsidiary responsibility of the Member State and the independence of the certifying body.

As regards the person or body that must sign the declaration provided for in Article 8 of Regulation (EC) No 2064/97, the Italian authorities have been informed that the information sent by DG FISH was incorrect.

THE STANDARDS TO BE APPLIED

37 to 41. The Commission agrees that the standards indicated by the Court based on the Structural Funds audit manual represent the best practice which it would like to see followed by national control bodies. Nevertheless, it is necessary to draw a distinction between the legally binding requirements of the Regulation, and the guidance given in the audit manual.

For example, it would be difficult to discount checks on the sole ground that no checklists had been prepared.

While the Commission agrees with the importance of ensuring the independence of the checker, the possibilities for independence have to take account of the administrative structures in the Member State, the resources available having regard to the size of the programme, and the risks involved.

IMPLEMENTATION BY THE MEMBER STATES

42 to 87. The Commission only received all the replies of the Member States to the sector letters of the Court in mid June 2001. Of the Member States covered by the Court's audit, the Commission services have so far visited France, Germany, Spain and Portugal in the framework of their audit activity on the Regulation in 2001. The Commission will take into account the findings of the Court and will follow up failings identified when it undertakes its own audit work.

Current arrangements

49. The agreement concerned the relationship between the federal and regional authorities and accepted that the checks required by the Regulation could be carried out under existing administrative structures. Due to the weaknesses in the management and control systems identified by the Commission, a provision was included in the agreement which stated that the Commission, the *Bund* and the *Länder* will agree in partnership to resolve any potential problems in the implementation of the Regulation. Consequently, the agreement did not prejudice the results of verifications of the actual application of the control provisions of the Regulation to ensure compliance with the requirements laid down.

Coordination within Member States

58. The Court criticises the fact that particularly in States with a federal structure, there is no central coordination, nor a central quality control of the implementation of the Regulation. The Commission shares the Court's concern that there is no guarantee as to the consistency of treatment, nor consistency in the application of the same minimum standards of checking by each regional authority. The Commission will continue its efforts to convince the Member States concerned to build up a central coordination function, and for example to foresee the representation of regions during the bilateral coordination meetings.

59. There will generally be a single closure statement per programme or a closure statement for each fund in a multifund programme. However, in particular cases (for example Interreg programmes) it may be necessary for more than one closure statement to be provided.

Responsibility for carrying out the checks

61. The issue as to which organisations would undertake checks for the 1994 to 1999 programming period has been a continuous subject of discussion with Member States since the adoption of the Regulation. It will be taken into account as a risk factor when closing programmes.

62. The two private sector implementing bodies were considered by the Commission as suitable to carry out the Article 3 checks and the Article 8 closure statement. Since these bodies were also final beneficiaries of some measures, the Court puts into question their independence. The Commission takes the view that since the respective internal audit departments are completely, functionally and hierarchically, independent within the company structure from the management structures including the structure responsible for certification of expenditure, the overall issue of separation of functions has been resolved in a satisfactory way.

The two bodies are responsible for the day-to-day running of the operational programmes while the overall responsibility lies with the two respective public bodies (ministries) and the Commission made it clear in its written guidance to the Member State in question that a clear mandate should be given to the private sector bodies by the public authorities, that an audit methodology conforming to Structural Funds should be used and that the conclusions of the private bodies should be validated by the same public authorities.

Reduction in the 5 % target

75 to 77. The Regulation allows the proportional reduction to be applied in different ways and does not specify whether it should be *pro rata* expenditure or *pro rata temporis*. Accordingly, the Commission cannot impose one uniform basis for applying the reduction. However, the Regulation does not permit pre-1998 expenditure to be excluded from all checking. This is now the common position of the Commission which is applied for the audit of the implementation of the provisions of the Regulation currently being undertaken.

79. While it is correct that Regulation (EC) No 2406/98 refers only to Article 8 of Regulation (EC) No 2064/97, the provisions of Article 3 must be applied in relation to the Objective 2 programmes 1994 to 1996, on the one hand taking into account the faculty for reducing the percentage of expenditure to be checked, and on the other to the principle of proportionality. At the date of entry into force of the Regulation, these programmes were only 12 months from closure, while in many Member States a considerably longer period was required to put in place new structures capable of carrying out checks in compliance with the provisions of Article 3. Consequently, the Commission will examine whether further action is required.

The closure statement

81. The body designated under Article 8 of the Regulation is required to indicate in the closure statement any irregularities which have not been satisfactorily treated and the amount of Community aid affected. The Commission will therefore have a basis for excluding such amounts from co-financing. If the irregularity is systemic, Member States should have extended checks to

cover all operations likely to be affected as provided by Article 7 of Regulation (EC) No 2064/97. However, the Commission considers that Article 24 of Regulation (EEC) No 4253/88 provides a legal base for extrapolated or flat-rate financial corrections as indicated in the internal guidelines on financial corrections of 15 October 1997.

82. The body providing the closure statement has to give its opinion, on the basis of all the checks carried out and the corrective measures taken under Article 7, as to the validity of the request for final payment and the legality and regularity of the underlying operations. It is expressly foreseen in Article 8(2) of the Regulation and in the indicative model for the closure statement that if the frequency of errors found is high, the Article 8 body will indicate that it is not in a position to express an unqualified opinion even if such errors have been satisfactorily treated.

In such a case, the Commission service will discuss with the national authorities the measures to be taken. Article 8(2) second subparagraph provides that the Commission may require further checks to be carried out and the Commission has the responsibility to make financial corrections.

83. The body providing the closure statement will have to define and indicate its approach having regard to generally recognised audit standards. The Commission services will ensure that there is a consistent approach by coordinating their position with regard to different cases arising.

84. The Regulation refers to 'frequency'. In the Commission's opinion, it is the frequency of errors which is the key indicator with reference to the reliability of the system. In any event the Article 8 body has to take account of all irregularities and be satisfied that a correct treatment has been applied.

Audit trails

85 to 87. The study referred to which covered all Member States and all Funds was intended as a means to facilitate verification of compliance with the audit trail requirement. The study itself was not intended to be as such a verification.

The result of the study is available to the Commission's auditors as well as national authorities. The possibility of updating the study in the context of the application of Article 38(1) of Regulation (EC) No 1260/1999 is under examination.

THE OBJECTIVES OF REGULATION (EC) No 1681/94

89. Since no exact definition of the term 'irregularity' appears in the text of Regulation (EC) No 1681/94, this was the subject of a statement entered in the minutes at the time of their adoption. The Commission considers that it is vital to ensure that one singular definition of the term 'irregularity' is used by all parties and has therefore found it should be defined only once, namely in Regulation (EC) No 2988/95.

On the basis of the new system for on-line communication, it will be much easier to carry out a detailed risk analysis and take the appropriate financial management action.

THE ROLE OF OLAF AND THE OTHER COMMISSION SERVICES IN THE IMPLEMENTATION OF REGULATION (EC) No 1681/94

The management systems

90. In December 1993, the Commission reorganised and centralised its anti-fraud services and has formed a special unit within UCLAF to deal with Structural Funds, direct expenditure and anti-corruption.

91. Due to the phasing out of the mainframe in the Computing Centre in Luxembourg, the IRENE database holding information on all irregularities reported by the Member States had to be moved to Brussels. Given the increasing number of cases reported by the Member States, in parallel with the introduction of the new relational database, the way in which information received from the Member States was entered into the database was changed. However, due to technical and staffing problems, the software that allows for on-line communication by the Member States in electronic format was not available at the time (it will be installed in the Member States during the second half of 2001). It is correct and the Commission regrets that during a transitional phase (1998 to 2000), the most relevant information contained in the Member States' communications was entered into a separate database that was accessible only within UCLAF/OLAF. However, in this transitional period it has been possible for the Commission services to request information from the database. A possibility which has been used to provide a basis for the discussion of reported irregularities at the annual control coordination meetings with Member States. Since early 2001, all communications received from the Member States are stored in the electronic communications registry (ECR) that replaced IRENE. This includes the cases reported for the years 1998 to 2000 (the data contained in the separate database have been migrated to ECR). Since March 2001 it has been possible for the other Commission services in charge of managing or controlling the Funds to have access to the ECR.

92. The Commission's newly adopted 'Action Plan for 2001 to 2003' for 'Protecting the Communities financial interests — Fight against fraud' ⁽¹⁾ recognises the need for clarification of the different departments' responsibility as regards follow-up of reported irregularities and fraud cases and recovery of amounts unduly paid. The action plan provides that protocols will be drawn up between OLAF and the DGs responsible for the Structural Funds with regard to the follow-up of irregularities notified by the Member States under Regulation (EC) No 1681/94. It is foreseen that these protocols will be concluded before the end of 2001.

The Commission is prepared to examine and follow up in detail any irregularities brought to its attention. The shortcomings that surfaced in recent years in the information system where the monitoring of Member States' notifications of irregularities is concerned should have already been resolved as a result of the recent introduction of the new database. This will record all notifications from the Member States and the entire Commission will have access to it.

93. Since December 2000, OLAF has been using the new software that was developed for communication under Regulation (EC) No 1681/94. All irregularities reported by the Member States for the year 2000 have been introduced into the newly created electronic communications registry (ECR). The (summary) data on the irregularities reported for the previous year have migrated from the Excel spreadsheet to the ECR. The new software has been tested by some Member States and is ready for access by all Member States. Submission of irregularities by Member States will be done using the AFIS system, for which a special module has been developed and was released to Member States in March 2001. However, a shortage of resources in OLAF has not allowed its immediate promotion for use in Member States (training of users, installation support), which should be completed before end 2001. From March 2001, it has been technically possible to access ECR from other Commission DGs.

94. As regards the Structural Funds DGs the White Paper on reform has been translated into Action 97 'Improving monitoring of Structural Funds' of the action plan. A Commission communication on this subject is in its final stages of adoption. The relevant main preliminary results of Action 97 have been the adoption of Commission Regulations (EC) No 438/2001 on management and control procedures and (EC) No 448/2001 on the application of financial corrections, and the reorganisation and strengthening of certain Commission control services responsible for Structural Funds.

As regards the cooperation between OLAF and the Structural Funds DGs, see the answer to point 92 as regards the protection of financial interests action plan 2001 to 2003.

⁽¹⁾ COM (2001) 254 final adopted on 15 May 2001, in particular point 1.2.2.

All irregularities reported by the Member States are entered into the ECR. It is now technically possible for the Commission services in charge of managing or controlling the Funds to access the ECR.

The Commission's guidance

96. Article 3 of Regulation (EC) No 1681/94 clearly defined what has to be communicated to the Commission by the Member States. The definition of 'irregularity' is harmonised in Council Regulation (EC) No 2988/95, as specified in the report. As stated in point 89, it is a policy of the Commission to stick to one definition of the term 'irregularity'.

97. OLAF follows up whether the Member States report all irregularities in conformity with Regulation (EC) No 1681/94. In particular, it insists (e.g. in the coordination meetings with the Member States) on receiving detailed and accurate information on each case as well as information on the follow-up action taken. This information serves as a basis for deciding on OLAF's own investigative or follow-up activities and for suggesting to the managing DG to apply financial sanctions where appropriate.

OLAF has, during the meetings with the Member States, taken every opportunity (seminars, Cocolaf, bilateral meeting) to improve the quality and the quantity of the information. This continued action has been successful as is reflected in the increased number of communications received from Member States.

The Commission wishes to underline that the management of Structural Funds is done in partnership with the Member States. The primary responsibility for reporting irregularities in accordance with Commission guidelines lies with the Member States (see also the Court of Auditors remarks in point 107). OLAF will promote a uniform standard for the reporting of irregularities.

98. After the adoption of Regulation (EC) No 1681/94 the Commission's services (UCLAF) designed a transmission form and an explanatory guide on how this form should be completed. Moreover, after requests from certain Member States in 1997, UCLAF prepared a working document ⁽¹⁾ in order to facilitate the implementation and clarify the term 'irregularity'. This document concerns the types of irregularities in connection with the application of Commission Regulations (EC) No 1681/94 and (EC) No 1831/94 and was the subject of a discussion with Member States in the framework of the Cocolaf meeting of 12 December 1997. In particular, concerning Italy, UCLAF organised several bilateral meetings in order to provide guidance and to clarify the implementation of the abovementioned Regulation

⁽¹⁾ SEC(97) 9445.

99 and 100. The problems were reported at different moments and in different reports as the Court states. Guidance was given by the Commission, but the Member States took much time to understand and accept the scope of their responsibility or even, in some cases, simply did not make any follow-up to OLAF's regular demands.

101. Article 3 first paragraph and subpoint 3, clearly state that Member States are obliged to report any irregularities even before any payment has been made except where the error or negligence detected before payment does not result in any administrative or judicial investigation. The Commission is aware of coordination problems at national level.

102. Article 3(1) clearly states that any irregularities subjected to an initial administrative or judicial investigation must be reported. In addition Article 5 reinforces this interpretation and imposes on Member States the duty to report 'with reference back to any previous report made under Article 3':

- the amounts which have or are **expected to be recovered**,
- the judicial and administrative procedures instituted with a view to recovering sums wrongly paid.

Therefore, it is clear that the issuing of recovery orders or judicial proceeding is not a prerequisite to reporting an irregularity.

103. Even if this provision is being applied, some elements of the case (reference number of the programme, the amount involved) may be communicated without the required authorisation and without infringing the right of confidentiality covered by Article 3(3). However, the national provisions must be respected.

104. During the adoption of Regulation (EC, Euratom) No 2988/95 on the protection of the European Community's financial interests, which defined the term 'irregularity', the Council introduced in the minutes at the time of their adoption a declaration to the effect that the Member States, acting within the prerogatives of a public authority, would not be considered 'economic operators' within the meaning of that Regulation.

The interpretation given by the two Member States concerned is not appropriate since the bodies managing the funds were not acting within the prerogatives of a public authority.

105. OLAF organised a bilateral meeting with the three Member States concerned, in order to facilitate implementation of the Regulation.

Indeed, the three Member States have encountered some problems in the application of the abovementioned Regulation.

The statement made by one managing body in Germany that the strict application of Regulation (EC) No 1681/94 would result in thousands of irregularities being reported appears to be exaggerated. Even with a relatively high number of final beneficiaries receiving support from the Social Fund, only a small fraction of the payments are expected to be irregular. Only irregularities having an impact of more than EUR 4 000 need to be reported.

106. Since the implementation of Regulation (EC) No 1681/94 there have been ever increasing levels of cooperation and communication between Member States and the Commission services, particularly OLAF. It is envisaged that this momentum will be reinforced.

The monitoring by OLAF and the other Commission services of Regulation (EC) No 1681/94

107. DG Audit considers the reports received under Article 2 of the Regulation as one of the elements available to it when assessing Member States control systems. The Commission considers that in the context of the Reform, in particular improving the monitoring and control procedures for the Structural Funds, it is taking steps to ensure that the Commission will be informed about the procedures in place in the Member States. As regards the cooperation between OLAF and the operational DGs the Commission's newly adopted 'Action plan for 2001 to 2003' for 'Protecting the Communities financial interests — Fight against fraud' clearly recognises the need for clarification of the different departments' responsibility as regards follow-up of reported irregularities and fraud cases and recovery of amounts unduly paid. The action plan therefore foresees that protocols will be drawn up between OLAF and the DGs responsible for the Structural Funds with regard to the follow-up of irregularities notified by the Member States under Regulation (EC) No 1681/94. It is foreseen that these protocols will be concluded before the end of 2001.

108. DG Audit was in charge of the examination of the Member States' system, a task which they have carried out. The systems audit of the application of Regulation (EC) No 2064/97 currently being carried out by DG REGIO (taken over from DG Audit) includes an assessment of compliance with Article 7 of that Regulation concerning the treatment of irregularities. Furthermore, the annual control coordination meetings have included discussions of the irregularity reports from Member States.

110. The Commission departments are aware of the situation and for this reason, the new Regulation (EC) No 448/2001 ⁽¹⁾ links the application of financial correction to the reports made available within the framework of Regulation (EC) No 1681/94.

111. The Commission department (OLAF) agrees with the Court observations and draws Member States' attention to the lack of application of Article 5. However, we have to take into account that most of the delays concerning cases are related to national judicial proceedings.

112. The quality of information given by Member States still needs to be improved. During the meeting with Member States, OLAF has taken every opportunity (seminars, Cocolaf, bilateral meetings, letters) to improve the quality of information. The Office sees the creation of new software for on-line communication, coupled with the appropriate training, as an important step forward.

113. Article 3 of Regulation (EC) No 1681/94 defines very clearly the information to be communicated. However, the new system for on-line case communication will facilitate the treatment of the communication for the appropriate follow-up of each case.

114. Each time the Commission's services were informed of the existence of an irregularity case not having been reported, or not having been correctly reported, they asked the Member States concerned to fulfil the obligations of Regulation (EC) No 1681/94.

Follow-up of irregularities by the Commission and OLAF

116. In fact, in the field of Structural Funds, where part-finance operations are the common pattern, priority is given to cases with a major economic impact and to those that were exemplary in one or other way.

The follow-up of the cases will be centralised within OLAF to ensure more effective action.

⁽¹⁾ Commission Regulation (EC) No 448/2001 of 2 March 2001 laying down detailed rules for the application of Council Regulation (EC) No 1260/1999 as regards the procedure for making financial corrections to assistance granted under the Structural Funds (OJ L 64, 6.3.2001, p. 13).

118. Member States that discover an irregularity during the course of the operational programme can redress the financial situation at the latest at the time of the final payment (recovery of the undue payment already made or reduction of a later payment) and, if there is time, reallocate the funds thus freed to another project not affected by any irregularity. OLAF has been restructured with the aim of improving administrative and financial follow-up .

120. It is now technically possible to give access to the ECR to the other Commission services and so such an 'agreed and documented system' is provided for. This will be strengthened by the interdepartmental protocols to be drawn up (see answer to point 92).

However, concerning the old period, on 29 September 1994, within the framework of an interdepartmental meeting, chaired by UCLAF, the role of each Commission service was agreed concerning the implementation of Regulation (EC) No 1681/94 and the follow-up of cases reported. Coordination was also ensured in the annual control coordination meetings with Member States.

121. With regard to 17 requests not being replied to by the geographical units to the DG REGIO Financial Control Unit, a final reply had not been forwarded to UCLAF (now OLAF) as a meeting on 6 May 1998 between DG REGIO (Financial Control Unit) and UCLAF had determined that UCLAF had already received this information directly from the Member States. No further action was thus required from DG REGIO.

122. Depending on the urgency, the nature and the national structures, the Commission services contact the competent national authorities directly or via OLAF.

123. The Commission services are currently carrying out a preventive systems audit of the management, payment and control procedures implemented by the Member States for the new programming period. This audit includes verification of the control procedures in place at managing and paying authorities in respect of payment claims from final recipients of aid and payment declarations to the Commission.

124. As mentioned in point 116, follow-up will be reinforced by the newly created structure of OLAF.

125. See reply to points 91 and 94.

126. The new Regulation (EC) No 448/2001 links the application of financial correction to any lack of reports made available within the framework of Regulation (EC) No 1681/94 or of any follow-up by the Member State. As a result, the Member States will have more incentive to make maximum use of the available information

CONCLUSIONS AND RECOMMENDATIONS

127 to 129. Since the adoption of the Regulation in 1997, the Commission has given a high priority to ensuring that its provisions were being correctly implemented by Member States. It has devoted significant resources to the various information activities — the preparation, presentation and distribution of the Structural Funds audit manual, the organisation of annual bilateral meetings with Member States under the financial control protocols, the organisation of seminars and the provision of replies to queries raised. Checks on the application of provisions of the Regulation have increasingly been included as a component of the normal audit missions of Commission services. The Commission services are currently undertaking a systems audit of the application of the control provisions of Regulation (EC) No 2064/97 in order to verify that the Regulation is being applied correctly, thus ensuring an adequate level of control throughout the Community. Recommendations are transmitted to Member States on the basis of these audits where issues of non-compliance are identified. The Commission has given a considerable volume of guidance and will address further questions as they arise.

It is intended to carry out closure audits in 2002 which will be directed at checking the accuracy of final declarations of expenditure and the accompanying closure statements.

130. The Commission considers that the interdepartmental protocols to be drawn up in line with the protection of financial interest action plan 2001 to 2003 (point 92), along with the actions taken to improve the monitoring and control of the Structural Funds for the new programming period 2000 to 2006 (point 107), will ensure an improved proper reporting and follow-up of irregularity cases.

131. The Commission has given clear written instructions on the timing and format of reports on irregularities. The fact that some Member States have encountered some problems in the application of Regulation (EC) No 1681/94, is not related to this issue. During the adoption of Regulation (EC) No 2064/97, the Commission also adopted internal guidelines concerning the application of Article 24 of Regulation (EEC) No 4253/88 (financial corrections).

Nevertheless, in the framework of the protocols between OLAF and the DGs responsible for the Structural Funds, foreseen in the action plan for 2001 to 2003 for 'Protecting the Communities financial interests — Fight against fraud', it will also be clearly set out which departments are responsible for undertaking the checks on the national systems for the detection, reporting and follow-up of irregularities. Furthermore, OLAF is to put in place measures to minimise the disparity in the differing interpretations of the term 'irregularity' across the Member States.

As stressed in the reply to point 107, the Commission considers that the actions taken in the context of the Commission reform for the new programming period clearly set out the guidelines for

the Member States and ensure that the national systems for reporting irregularities are defined and described.

See also reply to points 127 to 129.

132. The question of coherence has been addressed under Action 97 improved financial monitoring and control of Structural Funds detailing actions to be taken, and for which a communication is in preparation. Significant steps have already been taken by the adoption of Commission Regulations (EC) No 438/2001 and (EC) No 448/2001, the latter providing a clear link to Regulation (EC) No 1681/94.