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**EN**

I

*(Information)*

# COURT OF AUDITORS

## SPECIAL REPORT No 1/2003
## concerning the prefinancing of export refunds, together with the Commission's replies

*(pursuant to Article 248(4), second subparagraph, EC)*

(2003/C 98/01)

**CONTENTS**

**SUMMARY**

I. Many agricultural products cost more inside the EU than outside. A subsidy is paid to exporters to compensate for the difference between the EU price and a 'world market' price. In 2001, 3 394 million euro was paid in the form of these export refunds.

II. Prefinancing was introduced in 1969 in order to maintain Community preference for EU products over those from third countries temporarily imported for storage or processing prior to re-exportation. Approximately 11 % of all refund payments are made under the prefinancing regime, whereby an advance payment is made to the exporter up to 240 days prior to physical export (180 days for prefinancing plus 60 days as for exports not subject to prefinancing). Prefinanced goods are held in customs control prior to export, during which time they may be processed into other goods or remain in storage in the same state.

III. The audit examined the operation of the prefinancing regime as part of the export refund system in eight Member States as well as the management of the regime by the Commission.

IV. Of the refunds paid in 2000 around 11 % of all refunds, estimated at around 600 million euro, were under the prefinancing regime. There is no additional cost to the EU budget of the prefinancing arrangements. There are however certain costs associated with the arrangements (financing costs in terms of interests on refunds paid in advance of when they would normally be paid, and administrative costs) which are born by Member States.

V. The regime has proved to be problematic. The last extensive check by the Commission, in 1997, revealed weaknesses in the checks made by national authorities, and financial corrections of over 166 million euro were imposed by the Commission on the Member States. No in-depth review of procedures was subsequently carried out.

VI. The regulatory framework covering the prefinancing regime is complex to interpret and control provisions are less than transparent. The checks on prefinanced refunds are not specified (number, scope and timing). Wide differences were found both between Member States, and within different regions inside Member States, in the type and depth of controls carried out on prefinanced exports.

VII. The records used for control purposes in respect of processing under prefinancing did not reflect reality, the result is a waste of time and money for the parties concerned and a risk that reliance is placed on checks carried out on records that are not reliable.

VIII. The way in which large quantities of beef are placed under prefinancing and then exported in many separate shipments mixed with other refund claims makes the audit trail extremely complex and control procedures become cumbersome, costly and excessively time consuming.

IX. The original aims of prefinancing are no longer the only ones for which the regime is used. It is now used primarily to increase control over beef exports and in the cereals sector to extend the period during which export licences can be executed.

X. The Court recommends that a complete review of the prefinancing regime be made and consideration should be given to its removal.

**INTRODUCTION TO PREFINANCING AND DESCRIPTION OF THE AUDIT**

***The reasons for paying export refunds***

1. In general, prices for agricultural products are higher inside the EU than outside. In order to allow EU produce to be exported at a competitive price a subsidy is paid to compensate for the difference between the EU price and a 'world market' price.

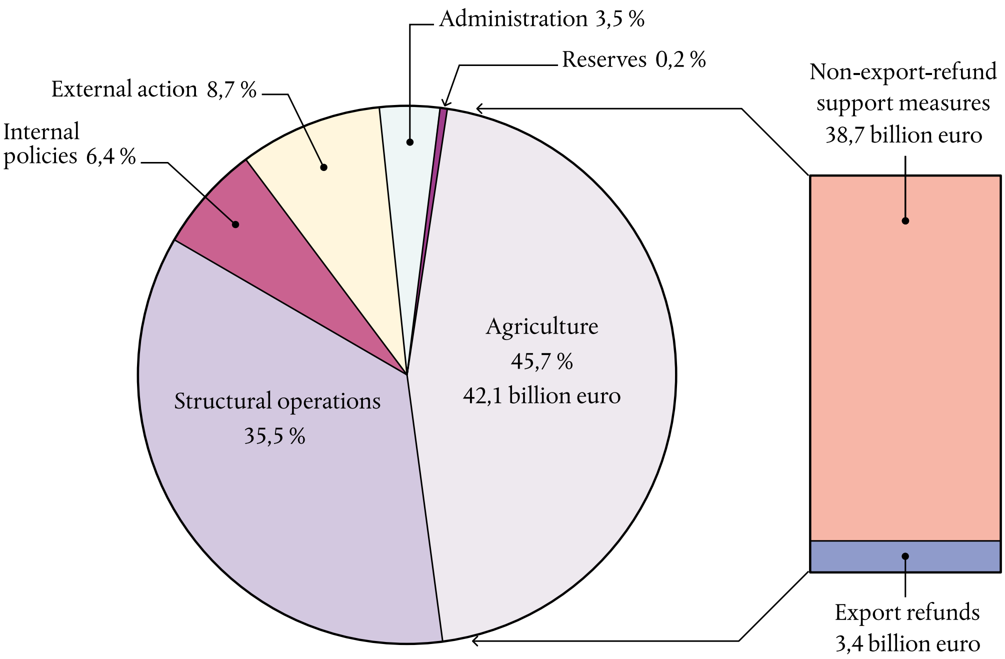
2. These payments are known as export refunds and around 8 % of agricultural subsidies, making up 3,7 % of the total EU budget (3,4 billion euro), was spent on this type of support in 2001. Of the refunds paid in 2000 (the last year for which detailed information was available), around 11 % of all refunds, estimated ([1]) at around 600 million euro, was under the prefinancing regime whereby refunds can be paid up to 240 days in advance of the actual export (180 days for prefinancing plus 60 days as for exports not subject to prefinancing).

3. The rate of refund payable is calculated by the Commission and varies depending upon the product concerned and the difference between the prevailing EU and a, sometimes theoretical, world price for that product. For certain products the amount of refund payable depends upon the final destination of the product exported.

4. The refund is paid to the company or person exporting the product from the customs territory of the EU under a licence granted by the Commission. Each payment is the subject of a separate claim and these claims are administered by the national authorities competent in each Member State (generally the Customs service and the paying agency ([2])).

*Illustration 1*

**The importance of agriculture in general and export refunds in particular, to the EU budget**




*Source:* Budget outturn 2001 from draft budget 2003.

([1]) Not all Member States provide the information to identify prefinanced refunds, of the Member States where information was provided, 11 % was prefinanced.

([2]) The paying agencies are the organisations set up by each Member State to administer the payment of agricultural subsidies under the common agricultural policy (CAP).

### *Refunds may be paid in advance of the actual export*

5. The export refund is payable when the goods concerned have left the customs territory of the EU. Refunds may be paid in advance of the actual export where the beneficiary lodges a guarantee covering the amount of the payment plus a certain percentage. This guarantee is released when all conditions for payment have been met. There are two types of payment in advance:

— advance payment, where the payment is made to the beneficiary when the declaration of export is lodged (this can be up to 60 days prior to physical export). This payment is made subject to a 110 % guarantee),

— prefinancing of the refund, where payment is made as soon as the basic products to be exported are placed under customs control for storage or processing for a period of up to 240 days prior to removal for export (180 days for prefinancing plus 60 days as for exports not subject to prefinancing). In reality this means that the goods are placed in an approved place or store (which can be the exporters' own premises) and are subject to the possibility of physical checks by national authorities. Payment is made against a prefinancing (payment) declaration and is subject to a guarantee equal to 115 % of the payment.

### *Why was prefinancing introduced?*

6. Export refunds have existed since 1968, and the possibility of prefinancing the refund payment was introduced in 1969 [1]. The reason given for the introduction of prefinancing was to put goods of EU origin on an equal price footing with cheaper non-EU goods temporarily imported or imported for processing and re-export (inward-processing arrangements — IPR).

### *Responsibility for prefinancing legislation is shared*

7. The Customs Code and its implementing provisions lay down the detailed rules for goods held under customs control including those placed under prefinancing arrangements. Where another regulation specific to an agricultural market differs from the Customs Code then the specific regulation takes precedence.

8. The Commission management of the regime is primarily the responsibility of the Directorate-General for Agriculture (DG AGRI) which has responsibility for export refunds in general and for the market specific measures applicable to exported goods. DG TAXUD draws up and interprets the Community Customs Code under which goods are held in customs control.

### *The cost of prefinancing*

9. There is no additional cost to the EU budget of the prefinancing arrangements. There are however certain costs associated with the arrangements (financing costs in terms of interests on refunds paid in advance of when they would normally be paid, and administrative costs) which are borne by Member States.

### *The audit*

10. The audit covered the application of prefinancing in respect of beef and cereal export refund payments at the level of the Commission and on the spot in Member States at paying agencies, Customs services, beneficiaries, ports, stores and warehouses. Beef and cereals were selected because they account for 90 % of prefinanced payments. The Member States and beneficiaries visited were also selected on the basis of the importance of prefinancing payments. The audit examined the management of the regime by the Commission, the implementation of the regime by the national authorities and the legality and regularity of a sample of 117 payments from the 1999 EAGGF year.

11. The following questions were set for the audit of the prefinancing regime.

(a) Were the reasons for the introduction of the regime still valid?

(b) Are the aims of the regime being achieved?

(c) Could the regime be usefully simplified, removed or replaced?

## PREFINANCING IN PRACTICE

### *Prefinancing has been found to be problematic in the past*

12. The last major review by the Commission of prefinancing of export refunds was carried out in 1997 (on EAGGF payment years 1993 and 1994) [2]. The study, made by the clearance of

(1) Council Regulation (EEC) No 565/80 (OJ L 62, 7.3.1980, p. 5).

(2) Commission document VI/5210/96, consolidated, of 15 April 1997. Summary report on the results of inspections concerning the clearance of the EAGGF Guarantee Section accounts for 1993.

accounts unit, covered seven Member States examining the beef and cereals sectors and found significant weaknesses in the operation of the prefinancing regime. In general, the Commission made flat-rate corrections of 10 % in respect of cereal export refunds and 5 % in respect of beef export refunds in the majority of the Member States they visited. In total, Member States had to repay over 140 million euro to the Commission (see *Table 1*). A later audit in Spain uncovered irregularities in the prefinancing regime and as a result the Commission imposed a financial correction of 26 million euro. Despite these negative findings, no further review of the regime or its controls was carried out and, at the time of audit, none was foreseen by the Commission services.

*Table 1*

**Clearance decisions taken in 1997 as a result of the prefinancing audit by the Commission on financial years 1993 and 1994**

These corrections were proposed on a flat-rate basis, i.e. the Member State was fined a percentage of the total prefinanced refunds it had claimed from the EAGGF budget for that year. Certain Member States appealed against these decisions and the Court of Justice has yet to decide on the outcome in one case (*).

| Member State | 1993 | | 1994 | | Amount (EUR) |
|---|---|---|---|---|---|
| | Beef | Cereals | Beef | Cereals | |
| Belgium | 10 % | 10 % | 10 % | 10 % | 19 635 473 |
| Germany | 5 % | 10 % | 5 % | 10 % | 37 103 644 |
| France | 5 % | 10 % | 5 % | 10 % | 59 948 684 |
| Italy | 5 % | No audit | 5 % | No audit | 11 361 336 |
| (*) Netherlands | 5 % | 10 % | 5 % | 10 % | 14 821 602 |
| **Total** | | | | | 142 870 739 |

*Source:* Commission Decision 97/333/EC (OJ L 139, 30.5.1997).
Commission Decision 98/358/EC (OJ L 163, 6.6.1998).

***How much prefinancing takes place***

13. The Commission was initially unable to provide any information relating to the extent to which refunds are prefinanced. Statistics are not kept on the quantity or value of products exported under the prefinancing regime, or for the amount of time that the exported goods are held under the prefinancing procedure prior to export. An analysis of the 2000 EAGGF payment data forwarded by the paying agencies (the last year for which the auditors had the data available at the time of audit), indicated that some 600 million euro, 11 % of total refunds, was prefinanced. However, this data is not complete and an obligation to provide sufficient detail did not come into force until the start of the EAGGF year 2002. The analysis of transactions tested in Member States, relating to 1999, shows the length of time the goods in question remained under prefinancing (see *Tables 2 and 3*).

*Table 2*

**Table showing extent of prefinancing of beef in the Member States audited**

| Member State | Refunds paid (EUR) | Percentage prefinanced | Average time under prefinancing as per the Court's sample |
|---|---|---|---|
| Denmark | 10 281 015 | 25 | 54 days |
| Germany | 113 439 015 | 31 | 39 days |
| Spain | 14 945 513 | 44 | 25 days |
| France | 47 020 119 | 60 | 12 days |
| Ireland | 294 632 062 | 82 | 74 days |
| Italy | 32 763 912 | 70 | 38 days |
| Netherlands | 56 455 398 | 22 | 36 days |
| **Total** | 569 537 034 | 61 | |

*NB:* No beef was exported from the United Kingdom.
*Source:* Paying agencies for the EAGGF year 1999.

*Table 3*

**Table showing extent of prefinancing of cereals in the Member States audited**

| Member State | Refunds paid (EUR) | Percentage prefinanced | Average time under prefinancing as per the Court's sample |
|---|---|---|---|
| Denmark | 37 619 784 | 15 | 118 days |
| Germany | 120 038 104 | 18 | 61 days |
| Spain | 35 401 709 | 10 | 58 days |
| France | 389 885 096 | 6 | 59 days |
| Italy | 52 196 669 | 19 | 61 days |
| Netherlands | 38 084 267 | 37 ([1]) | 38 days |
| United Kingdom | 86 282 834 | 1 | Only one export in year |
| **Total** | 759 508 463 | 11 | — |

([1]) The data received from the Dutch paying agency for cereals and processed products (HPA) were found to contain errors, therefore the accuracy of this figure cannot be guaranteed.
*NB:* Cereals exports from Ireland were not audited.
*Source:* Paying agencies for the EAGGF year 1999.

### *A complex system of administration and control*

14. Export refunds in general are complex, the legislation is detailed, the paperwork onerous. Because of the amounts of money and the risks involved, the physical and documentary checks need to be thorough. Previous work done by the Court of Auditors has shown the export refund system in general to be a high risk area [1]. Concerning the extracts from previous Court's reports set out in the box, the Commission at the time undertook to take corrective action where this was not already in progress. Prefinancing adds a further layer of complexity to the export refund system since it requires customs controls to be carried out while the goods are stored or processed in the period prior to export (see paragraphs 1 and 2 of the *Annex*).

*Extracts from previous Court reports on export refunds in general.*

(i) The suspected irregularities identified in this report involve more than 100 million euro. (Special Report No 7/2001, paragraph 90).

(ii) Control of payments by national authorities provides insufficient safeguard against exploitation of the complex export refund system by fraudulent operators. (Special Report No 2/90, paragraph 4.7(c)).

(iii) The low level of irregularity detection by physical control can be read in different ways. It could imply that, generally speaking, operators do comply with Community legislation or that the controls are an effective deterrent. Conversely, it could also suggest that physical checks are inadequately targeted or executed and, as a result, ineffective. The Commission's findings on the adequacy of Member States' checks and the findings of this report in respect of targeting of checks, all point to the latter (Special Report No 20/98, paragraph 3.28).

### *The regulatory framework is not clear*

15. The regulatory framework covering the prefinancing regime is complex to interpret and control provisions are less than transparent. The provisions are contained in several different pieces of legislation often with a particular check not specified but being by reference to other regimes (notably inward processing and warehousing). The Commission's administration of the scheme has also been marked by a lack of coordination between DG AGRI and DG TAXUD on the common interpretation of provisions relating to prefinancing.

16. Despite the fact that specific articles were introduced into a redrafted regulation by the Commission [2] in 1999 to clarify the control arrangements, the legislative framework for the carrying out of checks on prefinanced refunds still fails to specify the number, scope and timing of these checks.

17. Member States customs services are required to check physically 5 % of all export refund consignments at the time the export declaration is presented [3]. There is, however, no obligation to check goods at the time they are placed in prefinancing (intake checks). If Member States carry out intake checks, they may be counted towards the 5 % requirement provided that there are also physical checks during the period the goods are in prefinancing control, checks on the accounting and checks on exit.

18. It is not surprising therefore that wide differences were found both between Member States and within a Member State (Denmark, France, Italy) in the type and depth of controls carried out on prefinanced exports. In certain Member States (Germany, France) prefinancing transactions are given a higher risk and are checked more frequently. In some Member States all of the checks itemised at paragraph 17 above were carried out, in others either an unspecified number of checks were made or there were simply no checks except at exit (see *Table 4*).

19. Certain practices have been penalised by the Commission clearance-of-accounts unit or effectively outlawed by written opinion of the Commission division responsible for the management of a particular market. An example of this is the practice seen in the case of common storage of bulk products.

(1) Eight special reports have been published since 1990 dealing directly or indirectly with the control of export refunds.
(2) Articles 26 and 28 of Commission Regulation (EC) No 800/1999 (OJ L 102, 17.4.1999, p. 11).
(3) Council Regulation (EEC) No 386/90 of 12 February 1990 on the monitoring carried out at the time of export of agricultural products receiving refunds or other amounts (OJ L 42, 16.2.1990, p. 6).

*Table 4*

**Table to show rate of specific checks carried out on prefinanced refund transactions in the Member States**

*(in %)*

| Member State | Intake checks | During storage checks | Exit checks |
|---|---|---|---|
| Denmark | 2 (since mid-1999) | No percentage specified | 5 |
| Germany | 100 | 0 | 5 |
| Spain | 0 | 0 | 5 |
| France | 5 | 5 | 5 |
| Ireland | 5 | 2 | 5 |
| Italy | 100 | No percentage specified | 5 [1] |
| Netherlands | 2 | 1 | 5 |
| United Kingdom | No percentage specified | No percentage specified | 5 |

[1] At least one exit checked per prefinancing payment declaration.

*NB:* The exit checks are those made under Regulation (EEC) No 386/90 covering all export declarations and are given as a minimum. In some Member States there is a customs presence at every exit from prefinancing (e.g. Germany); in other Member States particular customs offices increase the rates of check according to local risk analyses.

*Source:* Member States.

20. Common storage is a practice whereby goods under prefinancing are stored together physically with those from different customs regimes. For example wheat under customs control for processing for which a refund has been paid in advance stored in the same physical store as wheat for domestic consumption or for export outside the prefinancing regime. It is in the operator's interest to do this as separate storage is expensive, complex and time consuming. The Customs Code however explicitly rejects common storage for prefinanced goods [1]. Common storage is treated differently in different Member States and the Commission has not been consistent in ensuring that this requirement is respected.

21. In France the interpretation of the rules has been strict and prefinanced goods are physically separated from those in other regimes by means of locks and chains or by sealing storage areas and silos. This interpretation was made following a financial penalty applied by the Commission in relation to lax controls. In others (Germany, Spain, Netherlands), normal commercial practices make the control effectively impossible. Where the regulations are most strictly interpreted certain operators abandoned prefinancing due to the costs, both administrative and financial, outweighing any advantage gained.

[1] See Article 534(2) of Commission Regulation (EEC) No 2454/93 (OJ L 253, 11.10.1993).

***Processing causes further complication***

22. Where basic products are processed whilst under prefinancing (grain into flour, beef into tinned beef, etc.) the quantity of the processed product on which the refund is based is calculated on theoretical yields applied to the basic products. Theoretical yields are provided for either by legislation (cereals) or by the requirement to place a quantity of the basic product under customs control sufficient to manufacture the declared quantity of processed product (beef conserves).

23. The theoretical yields applied are those laid down for inward processing and they include yields for by-products in order to ensure that all products manufactured under the IPR arrangements are either re-exported or duty is paid. For example when wheat is processed into flour, bran is produced as a by-product. The by-products are of no direct financial importance for prefinancing as refunds are paid only for the main product exported and the by-products remain in free circulation in the EU (see also paragraph 7 of the *Annex* in respect of cereals in Germany).

24. Exporters are required to keep accounting records in respect of processing to allow a subsequent check on the export operation. These records were audited during the visits on the spot. Without exception it was found that the records held in respect of the regulations were an exact reflection of the customs declarations and the yields achieved matched exactly the theoretical yields laid down. These records, drawn up solely to facilitate customs control, were in fact a virtual set of stock accounts that did not match the reality of processes that vary in yield depending on a range of outside factors.

25. Where possible, attempts were made to reconcile these records to the commercial accounts and stock records of the companies concerned. The result being that variations were found, with more or less of the basic product being required to achieve the required quantity for export than was declared (see also paragraph 6 of the *Annex*).

26. The accounting records used for control purposes in respect of processing under prefinancing did not reflect reality and did not allow the requirements of the regulation to be checked properly. The keeping of a separate set of 'virtual' stock accounts specifically for customs control was not the intention of the prefinancing legislation. The result is a waste of time and money for the parties concerned as no reliance can be placed on checks carried out on records that do not reflect reality.

***Commercial reality has caused the regime to become unwieldy***

27. The intention of export refunds is to allow EU goods to compete successfully on world markets. In facilitating the exporters' needs, the regime has become more convoluted and unwieldy. Storage and transport are expensive, therefore in order to minimise costs for exporters, whilst retaining customs control over goods, equivalence is allowed. This allows basic products to be stored in one place, under prefinancing, whilst the actual processing and export of goods takes place elsewhere. Customs have to check that the goods are of equivalent quality and when the export is successfully completed the equivalent goods are released from customs control. Obviously the paperwork and control measures covering this type of operation are more complex than a direct export or even a normal prefinancing operation.

28. In the case of grain processed into flour the industry is geared to continuous milling of grain, often 24 hours a day. The strict regulatory requirements mean that the prefinanced grain and flour should be separately identifiable in the records and physically stored separately from product under other customs regimes. Where this rule has been strictly interpreted (certain regions in France) the cost to exporters has proved prohibitive and certain operators have discontinued prefinancing and export directly.

29. Elsewhere (e.g. Spain, Italy and certain regions in France), where the regulations have not been interpreted so strictly, the authorities aim to ensure that grain of Community origin and correct quality enters the process and that the processed product exported is produced from grain of an equivalent quality. The operations continue but the authorities cannot follow the prefinanced product through the entire process to export. In reality therefore the controls required by the regulation cannot be carried out.

**A SCHEME THAT NO LONGER MEETS ITS OBJECTIVES**

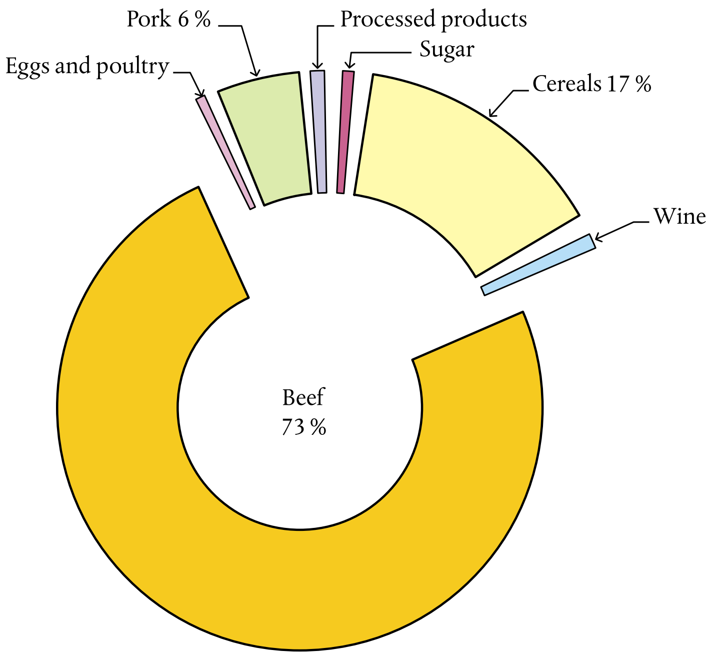
30. The original objective for the introduction of prefinancing was to put EU products on an equal price footing with cheaper non-EU products temporarily imported or imported under the inward-processing arrangements with suspension of duty.

31. The majority of prefinanced refunds are paid for beef at the rate applicable to its condition at the moment of entry into the prefinancing regime, i.e. fresh or chilled, although it is actually exported frozen. There are virtually no imports of chilled meat for processing under the inward-processing arrangements. Approximately 7 % of beef export refunds is for processed beef products. Figures for the total amount of processed prefinanced goods are not held by the Commission.

32. Exporters use the regime primarily in respect of beef, pork and cereal exports (these three groups make up 96 % of prefinanced refunds). Wine, sugar, processed products and eggs and poultry make up the remaining 4 % of prefinanced exports.

*Illustration 2*

**The breakdown of prefinanced refunds by product group**




*Source:* Data provided by the paying agencies.

***Beef***

33. For certain types of beef exports the Commission effectively obliges the exporters to use prefinancing by setting a higher refund rate for goods exported under the regime or setting a rate only for goods exported under prefinancing. This is to enforce customs control over high risk goods.

34. There are special high rates of refund for exports of beef from male animals in a fresh or chilled state. The rate for the same beef exported in a frozen state is lower. However beef placed under customs control in the prefinancing regime in a chilled state attracts the special high rate even though it is exported in a frozen state. The Commission does not set a specific equivalent rate for frozen male beef. As of the 12 January 2001 in respect of the refund code for the front part of the carcase of bovine animals, the rates set were as follows:

*(EUR/100 kg)*

| Destination code | Fresh and chilled, male animals | Frozen, all animals | Ratio frozen to fresh |
|---|---|---|---|
| B02 (mainly Asia and Africa) | 71,5 | 33,5 | 213,4 % |
| B03 (mainly eastern Europe) | 43,0 | 10,0 | 430,0 % |
| 039 (Switzerland) | 23,5 | 11,5 | 204,3 % |

*Source:* Commission Regulation (EC) No 66/2001 (OJ L 10, 31.1.2001, p. 12).

35. The beef exported under the special beef refund scheme often involves the placing of a large quantity of beef under a single prefinancing declaration and many subsequent exports are then made under separate export declarations. These exports often involve many different ships and beef mixed with product from other prefinancing operations, direct exports, and goods from other exporting companies. The reconciliation of the export documentation and proofs of arrival at destination (required for all beef exports) can become so complex that it is not auditable within a reasonable time.

36. Beef conserves, such as corned beef, can now only be exported via prefinancing i.e. manufactured from beef placed under customs control. The Commission's only justification for using the prefinancing regime in these cases is to ensure that the goods it considers as high risk are kept under customs control throughout the processing/manufacturing procedure [1] and until such time as they are exported.

37. The Court found significant weaknesses in the customs control procedures for prefinancing. In its 1997 clearance-of-accounts audit, the Commission also found such weaknesses. Therefore it is inappropriate to place reliance upon these procedures. The need to ensure tighter controls over high risk products is further not a justification for payment of refunds in advance under the prefinancing regime (see paragraphs 3 to 6 of the *Annex*).

***Cereals***

38. Refund rates may be fixed in advance. The normal period of validity of an advance fixing certificate is no more than six months. Where, however, the goods are placed in prefinancing and the unexpired period of validity of the advance fixing certificate is less than three months, the validity of the advance fixing period is set at three months [2]. This is effectively an extension of the advance fixing by almost three months for goods placed in prefinancing shortly before the expiry of the validity of the advance fixing certificate. In the sample of cereals prefinancing transactions tested 43 of 49 cases had the effect of extending the period of validity of the advance fixing certificate; in 37 of the 49 cases exports took place after the original period of validity. At present all certificates can be extended through prefinancing.

**CONCLUSIONS**

39. Prefinancing has evolved from its initial intention of putting EU goods on an equal price footing with cheaper non-EU goods temporarily imported under the IPR arrangements, into an overly complex and unwieldy system with different aims. The reasons for the introduction of prefinancing are not the prime reasons for its current uses. It is now used primarily to increase control over beef exports (see paragraphs 33 to 37). The need for increased controls is, in itself, not sufficient justification for payment of refunds in advance under the prefinancing arrangements. Further, the Commission's own services have imposed financial penalties on Member States because of inadequacies in the prefinancing control procedures (see paragraph 12). In the cereals

(1) See, for example, preamble to Commission Regulation (EC) No 1089/2001 (OJ L 149, 2.6.2001, p. 27).

(2) Article 28(6) of Commission Regulation (EC) No 800/1999 (OJ L 102, 17.4.1999, p. 11).

sector it is used in the main to extend the period during which export licences can be executed (see paragraph 38). The Commission should consider whether it is appropriate to use prefinancing to achieve these other aims.

40. The majority of payments are for exports of frozen beef which, logically, was not the intention of the regime given that it was designed to counterbalance inward-processing arrangements and temporary importation under warehousing. A higher rate of refund is paid based on the fresh state of the beef when it entered prefinancing. This has a higher cost to the EU budget than would be the case if the lower rate, calculated by the Commission, for frozen beef was applied (see paragraph 34).

**RECOMMENDATION**

41. In the light of the findings of the Court's audit and those of the Commission's own control service (clearance of accounts), the prefinancing regime should be reviewed and consideration should be given to its removal.

This Report was adopted by the Court of Auditors in Luxembourg at its meeting of 13 February 2003.

*For the Court of Auditors*

Juan Manuel FABRA VALLÉS

*President*

*ANNEX*

**OBSERVATIONS ON THE MEMBER STATES' IMPLEMENTATION OF PREFINANCING**

***Prefinancing contributes to delays in release of guarantees***

1. In some cases (notably beef refunds in Denmark but not exclusively) problems existed in respect of the timely release of the guarantees held covering the advance payment of the refund.

2. These delays were primarily caused by non-functioning administrative systems (Denmark) ([1]), but were also the result of the inherent complexity and excessive documentation required by the prefinancing system (certificates, laboratory analyses, etc.) and as noted in previous reports by the Court ([2]), the onerous requirement for proofs of arrival at the goods final destination to be forwarded and verified in the case of differentiated refunds (see paragraph 14).

***Checks over prefinanced beef exports***

3. Beef is the main product exported under prefinancing. The majority is exported as frozen beef under the special beef refund scheme with smaller amounts exported as other types of beef e.g. processed beef (tinned and corned beef for example).

4. The number and frequency of checks on beef are not uniformly applied (see paragraphs 16 to 18 in the report above). In certain specific cases checks were inadequate to ensure a continuous chain of control over the beef from slaughter to export. For example in Spain inadequate sealing of the boxes lead to a risk of substitution of the beef during the period prior to export. As a result of the Court's audit, improvements have been made to the Spanish national procedures in an effort to eradicate this weakness.

5. In Ireland the prefinanced beef exports are discharged at the port of exit rather than at the office where the prefinancing declaration was made. As a result of this practice, the strict rules laid down in the Community regulations ([3]) are not applied and a simplified national procedure is in operation. The checks required relating to identity of the product on dispatch and checks on substitution of the goods cannot be carried out correctly under these circumstances.

6. In France and Italy checks on processed beef products were not adequate. In order to comply with the regulations, registers had been introduced to monitor the production of the finished product from the basic product (beef) in store. These records, which were used for checks, were not based on reality and the actual quantities of beef used and quantities of finished product obtained could not be accurately monitored (see paragraphs 25 and 37).

***Different interpretations of the yield requirements***

7. In all Member States visited the beneficiaries used the standard rates of yield in order to calculate quantity of the basic product being put under customs control for prefinancing. Germany was the only Member State to carry out ex post checks on these yields. These checks revealed that the real rate of yield had been significantly lower than the standard rate used. This meant that an insufficient quantity of the basic product had been placed under customs prefinancing control. According to the IPR rules, which have to be followed for processing under the prefinancing regime, the real rates of yield must be

(1) The problem in relation to beef refunds has subsequently been 'normalised' according to a Danish Public Accounts Committee report of February 2002.

(2) See Special Report No 7/2001 concerning export refunds (OJ C 314, 8.11.2001, p. 1).

(3) Article 5(7) of Commission Regulation (EC) No 800/1999 (OJ L 102, 17.4.1999, p. 11).

used where they differ from the standard rates. The outcome of the exercise led to recovery orders of some 112 000 euro. However, they were remitted because the beneficiaries were acting in good faith. The real rate of yield is now used by one of the beneficiaries for its prefinancing operations. The strict but legally correct application of the rules has, however, an unwanted effect for export refund purposes. The purpose of export refunds is that the processed product, for which an export licence is issued, is to be exported in the quantity applied for and that the quality is in conformity with export refund code granted (see paragraph 23).

## THE COMMISSION'S REPLIES

### SUMMARY

IV. The Court estimates that EUR 600 million, i.e. some 11 % of total refund expenditure, was prefinanced. This estimate of the Court is close to the order of magnitude of the Commission's own estimate.

V. The Commission services conduct continuous audit of all aspects of EAGGF expenditure, including export refunds, on the basis of risk analysis. While they have not carried out an audit of the prefinancing arrangements per se since 1997, they have been actively examining matters related to export refunds. They have also been following the progress of the Court's audit, which began in 2000 and has taken an approach similar to that of the earlier Commission audit. They have taken account of the Court's findings in the risk analysis used to determine its future work programme.

VI. The Commission shares the Court's opinion concerning the complexity of the refund prefinancing arrangements. The Commission has made an effort to improve the implementation of physical checks in the Member States, and is planning to further harmonise checks on products subject to prefinancing.

VII. The Commission will, in response to the Court's comments, examine whether standard rates of yield should no longer be applied for prefinancing purposes. It would add that theoretical standard yields have never existed for beef.

VIII. The Commission services would agree, regarding prefinancing of beef, that control procedures for paying agencies are cumbersome and costly. The financial guarantee put up by an exporter cannot be liberated until the paying agency has reconciled the quantity placed under prefinancing with the quantity or quantities exported and placed in free circulation in a third country. This reconciliation is a routine and integral part of paying agency procedures.

IX. The initial objectives of the prefinancing, which are to allow the processing factories in the Community to use Community basic products on equal footing with third-country commodities processed under the inward-processing arrangement and to facilitate the storage of Community products intended for exports in the Community instead of storing them in third countries, are still valid today.

Furthermore, prefinancing by way of storage for unprocessed beef was initially introduced against the background of the very specific way most beef for export is produced and traded. This situation still prevails today.

Prefinancing has also been used to ensure better monitoring of certain processed beef products.

X. The Commission shares the Court's view that a review of the system is necessary.

### INTRODUCTION TO PREFINANCING AND DESCRIPTION OF THE AUDIT

2. The Commission would stress that this EUR 600 billion advance does not involve any additional cost to the Community budget.

5. The period of prefinancing for meat processing is limited to three months.

The maximum period of prefinancing for storage is 180 days.

### PREFINANCING IN PRACTICE

12. The Commission services conduct a continuous audit all aspects of EAGGF expenditure, including export refunds, on the basis of risk analysis. While they have not carried out an audit of the prefinancing arrangements per se since 1997, they have been actively examining other matters related to export refunds. They have also been following the progress of the Court's audit, which began in 2000 and has taken an approach similar to that of the earlier Commission audit. They have taken account of the Court's findings in the risk analysis used to determine its future work programme.

13. The Court estimates that EUR 600 million, i.e. some 11 % of total refund expenditure, was prefinanced. This estimate of the Court is close to the order of magnitude of the Commission's own estimate.

Since 2002, the Commission has been able to refer to information supplied by the Member States on the amounts of refunds granted on the basis of prefinancing.

14. The Commission agrees with the Court concerning the complexity of the export refunds system. In this respect, it has to be said that the Commission has always examined carefully the special reports drawn up by the Court of Auditors dealing with the control of export refunds and has taken whatever practical measures were possible in order to improve the effectiveness of controls in this area. For example, further to the Court's Special Report No 7/2001 on export refunds, the Commission immediately drew up an action plan to reduce risks. This plan has been put into effect by means of Commission Regulation (EC) No 1253/2002.

The Commission is surprised that eight special reports of the Court have been summarised in a fashion which is at the very least inadequate, and would point out that, of these eight reports, not one is about prefinancing.

15. Prefinancing facilitates the work of exporters, and this is why 11 % of expenditure is implemented via prefinancing despite the administrative complications also involved for exporters.

16 to 19. The Commission acknowledges that the prefinancing arrangements are more complex and cumbersome to manage than a system of direct export. This complexity is partly due to the fact that, in order to reduce the administrative workload, the control provisions of other legislative arrangements are used, in particular those of the inward-processing arrangements.

Nevertheless, the Commission has taken the initiative of clarifying the situation with regard to control arrangements.

Control provisions were laid down when the horizontal regulation for the export-refund arrangements was last codified (see Regulation (EC) No 800/1999). Moreover, a working paper of 22 December 1998 explaining how physical checks should be carried out was distributed to Member States in January 1999. Subsequently, in March 2002, another working paper dated 22 February 2002 was submitted to the Member States in the relevant management committee which further clarified the conditions for the verification of prefinancing.

In one individual case relating to the application of the standard rate of yield, the interpretation given by the two Commission services was different.

17. The Commission has made an effort to encourage Member States to improve the physical checks they carry out at the time of export. Nevertheless, in view of the Court's comments, it will examine with the Member States whether physical checks can be improved for prefinancing purposes.

18. It should be noted that at least six of the eight Member States mentioned in table 4 carry out checks on goods at the time they are placed in prefinancing (intake checks).

19. The Commission would refer to its reply to paragraph 17.

21 and 22. The Commission services will take account of these findings in its risk analysis and future work programme.

The Commission has taken various measures to prevent prefinancing being applied differently by Member States, particularly with regard to common storage (see the Commission's reply to paragraph 16). Nevertheless, the Commission will further clarify or supplement the interpretations given.

23 and 24. The standard rates of yield referred to in Annex 69 to Regulation (EEC) No 2454/93 apply to prefinancing. These rates are used to determine the quantity of basic products (e.g. wheat) to be placed under the prefinancing/processing arrangements in order to obtain the main processed product (e.g. flour). Under the export-refund arrangements, products processed with prefinancing receive the same refund as processed products which are exported directly (without the use of prefinancing).

The fact that standard rates of yield are used has no impact on refund expenditure given that the refund is paid on the processed product (flour) indicated in the export certificate.

23 to 27. The processing of meat into processed products is not based on theoretical yields. Even if provisional indications are given when the basic product to be processed is placed under the arrangements, these must be replaced by definitive data obtained once processing has been completed (Article 26(3) of Regulation

(EC) No 800/1999). These definitive data must correspond to economic reality (stocks entered in the accounts, quantities sold, etc.).

25 to 27. With regard to the keeping of accounting records, Article 28(3), third subparagraph, second indent, of Regulation (EC) No 800/1999 provides that stock records must be updated daily and permit comprehensive monitoring of the total quantity placed under the prefinancing arrangements.

The Commission will examine whether standard rates of yield should no longer be applied for prefinancing purposes..

28 to 30. There is across-the-board provision for using equivalent product for prefinancing in the area of processing (Article 28(3), second subparagraph, of Regulation (EC) No 800/1999). This arrangement can also be applied to intermediate products stored in bulk.

The use of equivalent products for prefinancing purposes is not permitted with regard to storage. However, Regulation (EEC) No 1776/92, designed to improve the management of storage capacities in the cereals sector, permits limited use of equivalent products for cereals placed under either the prefinancing arrangements for storage or the direct-export arrangements (Article 5 of Regulation (EEC) No 565/80 and Article 7 Regulation (EC) No 800/1999 respectively).

Given that Member States apply the relevant Community rules differently, the Commission will further clarify or supplement the interpretations given (see point 22).

29 and 30. The Commission services will take account of these findings in its risk analysis and future work programme.

**A SCHEME THAT NO LONGER MEETS ITS OBJECTIVES**

31. The initial objectives of the prefinancing, which are to allow the processing factories in the Community to use Community basic products on an equal footing with third-country commodities processed under the inward-processing arrangement and to facilitate the storage of Community products intended for exports in the Community instead of storing them in third countries, are still valid today.

Prefinancing has also been used to ensure better monitoring of certain processed beef products.

32. Generally speaking, meat can only be kept for direct consumption by freezing.

Freezing is not limited solely to cases in which the prefinancing arrangements are applied but is also permitted for products declared for direct export (meat may be frozen during the 60-day period, see Article 7(3) of Regulation (EC) No 800/1999). Freezing is not therefore linked to prefinancing.

34, 37. A distinction should be made between the economic and the technical aspect of the prefinancing system. As previously indicated, the economic objectives are valid in the light of the objectives on market management where the refunds play an important role to secure the fulfilment of those objectives. Non-application of prefinanced export refunds could lead either to increased refunds or to increased market support expenditure on other budget headings.

The technical aspect is linked to the processing of beef. Specific controls are necessary to ensure that the meat proteins are exclusively from beef and that the beef used is of the correct origin. The export refund for preserved products is based on the meat content of such products.

Meat content is determined by means of chemical analysis (Regulation (EEC) No 2429/86).

While analysis can indicate the quantity of animal proteins in the finished product, it does not say anything about their origin. Given that the refund does not apply to offal or additives (rich in animal protein) used but is limited to beef meat of Community origin, it is essential that, in addition to the chemical test, the processing operation be monitored.

Without monitoring of all the stages of processing, there is a very real risk of irregularities.

35. As already indicated in the reply to paragraph 33, the difference between the refund for fresh or chilled meat and frozen meat is not a consequence of the refund-prefinancing arrangements because freezing is not limited solely to products placed under those arrangements but is also authorised for products which are exported directly (freezing within the 60-day period, see Article 7(3) of Regulation (EC) No 800/1999).

In the context of market management, the term 'frozen meat' must be understood in its economic and commercial sense as being distinct from fresh/chilled meat, i.e. in conjunction with the date of slaughter and production, which is by definition more recent for fresh/chilled meat.

The refund for a product which is already frozen when presented at customs relates to production which might date back a long time. Consequently, the amount of the refund does not have an immediate effect on price formation in the Community. Moreover, since it will generally be meat intended for the processing industry, and largely from cows, it has a substantially lower commercial value.

The difference in rate is thus the result of considerations relating to the management of markets and is not limited solely to the preservation of the product or its physical presentation.

Therefore, the table annexed to the draft report demonstrating the relationship between the refund rates for fresh/chilled products and for frozen products does not have any major significance.

36. The Commission services share the Court's opinion on the complexity of dealing with the dossiers in question, and in particular the difficulties in reconciling the various documents making up the dossier. This aspect is being examined with a view to improving the situation.

The Commission services agree that the reconciliation of prefinancing declarations, export documentation and proof of arrival at destination is complex, perhaps excessively so, but do not accept that it is 'not auditable within a reasonable time'. The financial guarantee put up by an exporter cannot be freed until the paying agency has reconciled the quantity placed under prefinancing with the quantity or quantities exported and placed in free circulation in a third country. This reconciliation is a routine and integral part of paying agency procedures.

37. The Commission would refer to its reply to paragraph 34.

38. The Commission would stress the size of the corrections resulting from the 1997 audit. The Commission will follow up weaknesses found by the Court in an adequate manner and will furthermore strengthen the procedures in the case of the weaknesses identified by the Court.

39. Cereals exporters use the prefinancing arrangements:

— in order to compete on world export markets on terms similar to those enjoyed by their competitors,

— to participate on the world market in transactions which go beyond the validity of the export certificate,

— to solve specific commercial problems.

However, it is important to make a clear distinction between the period of validity of an export and its actual use.

The period of validity of a certificate guarantees that the quantity of cereals covered by it will no longer be available on the Community market when it expires. Placing goods under the prefinancing arrangements does not change what is a principal characteristic of an export certificate and, moreover, has no budgetary impact. It should be pointed out the extending the certificate's validity on the basis of the prefinancing arrangements has a neutral impact in terms of budgetary cost to the Commission (no monthly increases) and also makes it possible to limit a whole range of administrative problems which may result from unexpected situations at the time of export (strike, ship damage, late arrival of a letter of credit, etc.).

**CONCLUSIONS**

40. Prefinancing continues to be used for the purposes for which it was originally designed but is also used to strengthen checks.

The Court does not acknowledge the difference between, on the one hand, the economic/commercial value of the prefinancing and, on the other, the technical aspects of this scheme requiring technical verifications.

Because prefinancing, as the term itself says, generates working capital for exporters at a moment prior to the actual export (but with an irrevocable commitment to export the product which at the time of entering the scheme, has physically already been taken off the internal market) this advance payment has a positive impact on the cost structure for the goods to be exported. Withdrawing this payment increases the need to find working capital from commercial sources and will lead to an increased level of costs at the export stage.

41. The difference between the refund rate for fresh or chilled meat and for frozen meat is not a consequence of the refund-prefinancing arrangements but of a decision taken in the context of the management of the market.

**RECOMMENDATION**

42. The Commission will carry out a review, bearing in mind the observations and findings of the Court.