

Official Journal

of the European Communities

ISSN 0378-6986

C 336

Volume 27

17 December 1984

English edition

Information and Notices

Notice No

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Court of Auditors

84/C 336/01

Special Report of the Court of Auditors on the implementation of Directive 77/435/EEC of 27 June 1977 on scrutiny by the Member States of transactions forming part of the system of financing by the EAGGF (Guarantee Section)

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I

(Information)

COURT OF AUDITORS

SPECIAL REPORT OF THE COURT OF AUDITORS

on the implementation of Directive 77/435/EEC of 27 June 1977 on scrutiny by the Member States of transactions forming part of the system of financing by the EAGGF (Guarantee Section)

(Observations, Article 206 (a) of the EEC Treaty)

(84/C 336/01)

This report was adopted by the Court of Auditors at its meeting of 11 October 1984 in accordance with the provisions of Article 206 (a) of the EEC Treaty. It had previously been forwarded on 13 June 1984 to the Commission for its comments. The Commission's replies are attached.

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INTRODUCTION

1.1. The scrutiny of transactions financed by the EAGGF, Guarantee Section, is the initial responsibility of the Member States by virtue of Council Regulation (EEC) No 729/70 of 21 April 1970⁽¹⁾. The Commission, from its own point of view, found itself responsible for supervision, motivation and coordination in this field. It was thus led to have adopted by the Council, Directive 77/435/EEC of 27 June 1977⁽²⁾ which aimed to harmonize, from 1979 onwards, certain conditions governing the scrutiny of transactions financed by the EAGGF, Guarantee Section, by providing for the application and standardization throughout the Member States of the scrutiny of the commercial documents of undertakings receiving or making payments from or to the EAGGF, Guarantee Section.

1.2. Since its inception in 1977 the Court's attention has been drawn to the importance of this legislation which is presented as the cornerstone of the fight

against fraud and irregularities. In 1981, the Court made an observation on the Commission's failure to follow up the implementation of the Directive in the Member States (paragraph 4.38 of the annual report for the financial year 1980 published in OJ No C 344 of 31 December 1981, page 64). In view of the unsatisfactory reply by the Commission, from 1981 to 1982 the Court of Auditors undertook an enquiry in the 10 Member States in order to find out the conditions under which controls relating to the EAGGF, Guarantee Section, had been strengthened. The Court updated the information obtained during subsequent enquiries. The purpose of this report is to:

- (a) show the main weaknesses found in the Member States;
- (b) determine the extent to which the Commission could have contributed to a more satisfactory implementation of the Directive.

DIRECTIVE 77/435/EEC

The main considerations behind the adoption of the Directive

2.1. It was found that a limited number of commercial operators were directly involved in a considerable share of the subsidies paid, or of revenue collected under the EAGGF, Guarantee Section, and that, moreover, most of the irregularities declared to the Commission by the Member States had been discovered by scrutinizing firms' commercial documents.

2.2. The method of scrutiny of commercial documents, which had already proved itself, had not developed in the same way in all the Member States. The Commission therefore proposed in 1976 to standardize this system in all the Community countries by means of a Community Directive.

2.3. The choice of this legal instrument is the direct result of the current system whereunder the organization and implementation of controls as well as the detection and fight against fraud and irregularities is the responsibility of the Member States themselves. This choice makes it possible, in accordance with

Article 189 of the EEC Treaty, to define the results to be achieved, which are binding upon the Member States while leaving the latter the choice of methods to be used.

The content of the Directive

2.4. The content of the Directive (text of the articles clarified by the text of the preamble) may be summarized in the following way:

- (a) The main objective of the Directive is to have the Member States check on the basis of the commercial documents of those receiving or making payments referred to in the Directive as 'undertakings' (Article 1 (1)), whether the transactions forming part of the system of financing by the EAGGF, Guarantee Section, have actually been carried out and executed correctly.
- (b) The scrutiny carried out should be:
 - (i) *systematic*, the scope and frequency to be determined by the Member States themselves (Article 2 (1));
 - (ii) *representative* of the transactions financed by the EAGGF, Guarantee Section (fifth paragraph of the preamble);

⁽¹⁾ OJ No L 94, 28. 4. 1970, p. 13.

⁽²⁾ OJ No L 172, 12. 7. 1977, p. 17.

- (iii) *significant* by covering each year 'a number of undertakings which may not be less than half the undertakings of which the receipts or payments, or the sum thereof, within the system of financing by the Guarantee Section of the EAGGF, amounted to more than 100 000 units of account⁽¹⁾ in the year preceding that of the scrutiny' (Article 2 (2));
 - (iv) *supplementary* to the other inspections already carried out by the Member States, particularly the direct inspection of transactions while they are being carried out and in certain cases the scrutiny of book records of stock (second paragraph of the preamble).
- (c) The Directive also defines the concept of commercial documents and provides for obligations with regard to the comparison of particular book records of stock kept by undertakings with their commercial documents, the keeping of commercial documents for at least three calendar years, the rights of those persons responsible for their scrutiny and the possibility that, in accordance with the relevant national provisions, the documents may be seized where an irregularity is suspected.
- (d) The Directive provides for mutual assistance between the Member States, stresses the confidential nature of the information obtained in the

course of its implementation and requires the Member States to make an annual report on the application of the Directive to the Commission.

- (e) A period of two years, running until 1 July 1979, was fixed for its entry into force. For the first two years following 1979, i.e. 1980 and 1981, the systematic checks could be limited to half the minimum number arising from the normal application of the Directive.

Responsibility for its implementation

2.5. As soon as the Directive had been adopted by the Council, its implementation in the Member States within a period of two years implied two types of responsibility:

- (a) the Member States had to organize themselves in order to be able to carry out, from 1 July 1979 onwards, systematic checks on commercial documents in their own country in compliance with the provisions of the Directive;
- (b) the Commission had to ensure that the Directive was being properly introduced in the Member States by supervising the measures taken by the latter, assisting in the adoption of these measures, if necessary, and keeping itself informed of the initial concrete results arising from the execution of the controls provided for by the Directive.

THE IMPLEMENTATION OF THE DIRECTIVE BY THE MEMBER STATES

Slow application of the Directive by the Member States

Difficulties in applying the Directive from 1979 onwards

3.1. In 1979, the position differed greatly from one Member State to another. Some (United Kingdom, Germany) appeared to have fulfilled their obligations under the Directive. One other could claim to have partially implemented it (Denmark) and the remaining majority was generally at the preparatory stage of aiming to set up the legal and administrative framework required to satisfy the obligations of the Directive.

3.2. This does not necessarily mark a distinction between the 'diligent' Member States and the others:

- (a) it rather serves to highlight the many difficulties encountered by the Member States in setting up a new system of control or amending existing systems. The only Member States which were in a position to apply the Directive on 1 July 1979 were those which declared that they had applied it *de facto* before the date of its adoption;
- (b) the slowness with which the Directive was, or is still, being implemented in the Member States would be subject to less criticism if it turned out that the systems of control ultimately introduced offered definite guarantees of quality and efficiency.

⁽¹⁾ 100 000 u. a. = 120 895 ECU.

3.3. One cannot, however, ignore the fact that some Member States appear to have only become aware at a late stage of the obligations imposed upon them by the Directive and of the Community interest in its implementation. A failure to act on the part of the Commission during the period 1980 to 1981 has not encouraged some Member States to become aware of these obligations more quickly.

The first apparent results

3.4. From 1981 onwards the Directive had, apparently, begun to be applied in the majority of the Member States. With the exception of Greece, which forms a special case due to its recent accession (⁽¹⁾), Italy (⁽²⁾), and the Netherlands (⁽³⁾), all the countries informed the Commission that a number of audit visits had taken place in compliance with the provisions of the Directive (cf. Table 1). The audit results, i. e. the irregularities found, are so far of little significance and in particular vary greatly according to the Member States which have actually entered into an operational stage. Great care should be taken when analyzing them. These results, declared by the Member States themselves, are difficult to compare with the information given within the framework of Regulation (EEC) No 283/72 (⁽⁴⁾), mainly because the Member States do not always have the same concept of fraud and irregularities.

3.5. Nevertheless, it was found that:

- (a) In some Member States the scrutiny laid down under the Directive leads only to very few cases of rectification.
- (b) On the other hand, in other Member States the results are greater from a quantitative point of view (in Germany, this type of inspection had made it possible to detect 60 % of the irregularities established by this country).

(⁽¹⁾) It should be noted, however, that on accession, this Member State undertook to implement the Community Directive in its territory (Articles 143 and 145 of the Accession Treaty, OJ No L 291, 19. 11. 1979, pp. 49 and 169) and thus in 1982 had to face the same legal obligations as its partners. In 1983, the law amending the statute of the YDAGEP, the Greek paying agency, finally entrusted this organization with the responsibility of carrying out the inspections provided for in the Directive.

(⁽²⁾) Italy was not in a position to apply the Directive until 1983.

(⁽³⁾) The Netherlands considered that since it was still in the initial stages, it could limit the field of inspection to half its normal size (cf. paragraph 2.4 (e)).

(⁽⁴⁾) This Regulation concerns irregularities and the recovery of sums paid in error, OJ No L 36, 10. 2. 1972, p. 1.

3.6. It is difficult to explain this difference, but the national authorities questioned gave the following response:

- (a) In Member States where few irregularities are declared under the Directive, this situation is explained by stating that there are two levels of scrutiny of a different kind (the first taking the form of preventative type inspections and the second, inspections performed in accordance with the Directive) and it is considered that the first level of control is so effective that the second only represents a safety net.
- (b) In the other Member States, where more irregularities are declared, it is explained that there are also two levels of control, both of an accounting nature, and that the experience acquired in this field is such that the inspections effected under the Directive give very fruitful results.

3.7. An assessment of the results obtained cannot be based as such on one or other of these statements. What should be done is to examine under which specific circumstances the inspections provided for by the Directive are carried out in the Member States and to identify all the factors which characterize the various systems of scrutiny used.

Weaknesses in the systems of control set up by the Member States

3.8. The Court observed that in the systems of control set up by some Member States there were weaknesses which affect the scope of the Directive to varying degrees.

Limitation of inspection to large undertakings only

3.9. Some Member States consider that the Directive only imposes the obligation to carry out inspections on undertakings which exceed the threshold of 100 000 u.a.:

- (a) According to this approach only those undertakings should be inspected and then once every two years.
- (b) Such an approach corresponds partially to the text of the proposal for a Directive submitted to the Council on 2 August 1976. The proposal provided that the Member States should effect the scrutiny laid down in the Directive on the undertakings making or receiving payments as frequently as they themselves saw fit and that in any case those which exceeded the threshold of 100 000 u. a. should be audited once every two years.

TABLE 1

Main results of the application of the Directive for the years 1980 to 1982

(data supplied to the Commission by the Member States)

Member State	Year	Application of Directive 77/435/EEC				Application of Regulation (EEC) No 283/72 (*)	
		Number of undertakings above 100 000 u.a. or 120 895 ECU	Number of visits	Irregularities declared		Irregularities declared	
				Number of cases	Amount (ECU)	Number of cases	Amount (ECU)
Belgium	1980	250	> 125	*	*	4	5 078 691
	1981	269	140	1	2 025 243	1	177 910
	1982	248	160	1	12 156	1	210 074
Denmark	1980	*	*	*	*	11	92 782
	1981	405	1 200	0	0	32	349 421
	1982	332	600	*	*	19	131 255
Germany	1980	1 155	1 499	55 (?)	7 000 000 (?)	93	12 948 067
	1981	1 207	1 976	65 (?)	7 000 000 (?)	114	12 858 135
	1982	810	1 115	65 (?)	5 000 000 (?)	109	7 003 809
Greece	1980	*	*	*	*	*	*
	1981	*	*	*	*	*	*
	1982	*	*	*	*	*	*
France	1980	*	250	4	121 809	37	421 759
	1981	750	375	1	12 290	40	456 461
	1982	1 000	504	0	0	18	232 436
Ireland	1980	205	79	*	*	1	— (?)
	1981	218	110	0	0	6	665 362
	1982	119	81	1	29 722	1	29 722
Italy	1980	1 040 (*)	*	*	*	21	1 987 168
	1981	1 040 (*)	*	*	*	2	970 186
	1982	1 040 (*)	*	*	*	34	27 167 976
Luxembourg	1980	*	*	*	*	0	0
	1981	*	*	*	*	0	0
	1982	8	6	1	<1 000	0	0
Netherlands	1980	150	77	7	315 530	25	589 747
	1981	463	154	8	<8 000	5	56 187
	1982	*	*	*	*	9	59 167
United Kingdom	1980	> 1 000	965	13	606 070	54	764 040
	1981	> 2 700	1 945 (?)	16	150 670	42	598 282
	1982	> 2 067	1 323 (?)	8	*	23	138 272
Total on the basis of existing information	1980	> 4 290	> 2 995	± 80	**	246	21 482 254
	1981	> 7 050	> 5 450	± 90	**	242	16 111 944
	1982	> 6 000	> 3 239	± 80	**	390	36 634 217

(1) This information which represents all the irregularities declared by the Member States arising from their various control activities (including those of the Directive) provides purely guideline figures not comparable with each other (cf. Annual Report for 1982, paragraph 4.50, OJ No C 357 of 31 December 1983, page 48).

(2) These are approximate figures, the German authorities stating that approximately 60 % of the cases declared under Regulation (EEC) No 283/72 were discovered by means of *ex post facto* controls.

(3) Amount declared as being unknown.

(4) 1975 estimates.

(5) Including approximately 550 accounting controls directly related to management.

* Information not provided by the Member States.

** A total arrived at from imprecise information would be meaningless here.

- (c) The text finally adopted, however, is considerably different. It provides that the checks should be representative of the transactions financed by the EAGGF and cover a number at least equal to half the number of undertakings situated above this threshold. This method of calculation makes it possible to arrive at the size of the sample to be inspected, a sample which must be representative, i.e. which must include all categories of undertakings in proportion to their financial importance within the total system of financing.
- (d) The Member States which only inspect the undertakings situated above the threshold of 100 000 u. a. do not apply the Directive to the letter. It should be recognized, however, that the undertakings situated above the threshold account for a volume of subsidies and/or levies representing over a quarter of the total expenditure of the EAGGF, Guarantee Section.
- (e) In order to maintain consistency, therefore, these Member States should have an absolutely perfect system of detection for undertakings situated above the threshold of 100 000 u. a. It appears, however, that the two Member States in this position belong to those which have set up a badly coordinated system of obtaining information which does not make it possible to identify those undertakings which, if the sum of transactions managed by different bodies is taken into account, exceed the threshold (cf. paragraph 3.13).

De facto exclusion of small undertakings

3.10. On the other hand, the exclusion of small bodies making or receiving payments in certain Member States, either because they are not considered as undertakings and are excluded from the field of application of the Directive, or because they are not obliged to keep accounts, leads to a situation whereby the representative nature of the inspections is also greatly reduced. The small undertakings receiving or making payments may in certain sectors (olive oil, for example) be involved in a considerable share of the operations financed by the EAGGF.

3.11. Nevertheless, the same observation as in paragraph 3.9 applies, and while it may run counter to the letter of the Directive it does not appear to be contrary to its spirit to consider that the effort required to carry out audits of the type provided for by the Directive must be applied by priority and systematically to the some 7 000 large beneficiaries. Furthermore, it would undoubtedly be illusory to read the Directive too closely and impose an obligation that in reality would

be impossible to observe. Taking account of traditions, such would often be the case if small farmers were obliged to keep accounts.

Differing control techniques

3.12. There are differences in the control techniques used, some of which are likely to weaken considerably the quality of such controls:

- (a) Absence of control of accounts to ensure that transactions are actually carried out

On scrutinizing accounting documents certain Member States refrain from ensuring that the transactions are actually carried out by not examining the financial flows of the undertakings (absence of scrutiny of bank documents for fictitious operations which only exist 'on paper').

- (b) Absence of cross-checking with third parties

The same comment applies to the Member States who refrain from making any cross-check of the data checked with that held by third parties (suppliers, buyers, transporters, etc.).

- (c) Non-separation of control duties

In some Member States the principle of allocating duties has led the implementation of the controls laid down under the Directive to be entrusted to the departments already responsible for carrying out the first-level checks and/or inspections, while in other Member States the entrusting of these different types of control to the same departments had been systematically avoided. This second approach is obviously better in so far as it reinforces the supplementary nature of the controls effected under the Directive (cf. paragraph 2.4 (b) (iv)).

Absence or lack of coordination

3.13. The absence or failure to coordinate within certain Member States who have chosen to employ several departments (customs, paying agencies, agricultural inspection departments, etc.) in the implementation of the Directive is a shortcoming that is frequently found. This affects in particular the calculation of the minimum number of checks to be carried out, the planning of the controls, their exploitation and the follow-up to their results. For example, in situations where these various departments of the Member States calculate, each with regard to that which concerns them, the number of undertakings situated above the threshold of 100 000 u. a., the Member States cannot ensure that all the undertakings situated above the threshold are listed (mainly when the undertakings

receive or pay amounts from or to various bodies). Only a statistical approach incorporating a probability ratio, such as that practised by one Member State, would make it possible to make a realistic assessment of this number of undertakings. As a result some of these Member States control, *de facto*, fewer undertakings than they should and, in any event, these controls may no longer be considered to be of a systematic nature (in particular when the failure to coordinate extends to the selection of undertakings to be inspected).

Exclusion of public storage operations

3.14. More serious are the numerous discrepancies established in the entry of public storage operations in the accounts :

- (a) A majority of the Member States take into account only those selling operations at reduced price which they analyze as subsidies while others ignore these sales and almost all consider that neither the public purchases nor the storage operations fall within the scope of the controls of the Directive.
- (b) The failure to consider these factors amounts to considerably reducing the number of undertakings situated above the threshold of 100 000 u.a. and therefore the number of controls to be carried out under the Directive.
- (c) One may only wonder at such an approach, particularly when it has the effect of barring these operations from inspection. The arguments put forward for such an exclusion are the contribution of the Member States to the financing scheme for public storage, the contractual nature of the operations of purchase, storage and sale, the lack of apparent profit when goods are placed in intervention and the lack of provision of services in the case of storage. These arguments have no weight because :
 - (i) firstly, the storage operations form part of the financing system of the EAGGF ;
 - (ii) secondly, it is always possible to commit fraud in respect of any of the abovementioned elements and this can sometimes only be detected or quantified following a scrutiny of the commercial documents. In any event, such fraud would be carried out to the detriment of the sound management of the EAGGF and Community funds.
- (d) Last but not least, when the sales at reduced price of stored products are excluded from the field of control of the Directive, there exists an anomaly which is difficult to accept when it is known that

the price reduction is completely covered by the Community budget.

Absence of complementarity between levels of control

3.15. The last significant discrepancy in the implementation of the Directive, and undoubtedly that of the greatest consequence, is to be found at the level of the overall effectiveness of the system of control obtained after the implementation of the Directive.

- (a) A majority of the Member States are in a situation where the operations financed by the EAGGF are subject to two levels of control which are different in nature. The first level, carried out on all of the transactions before payment, is of a physical nature (taking of samples, calculation of quantity, etc.) and an administrative nature (scrutiny of specific documents). The second level, effected by sampling after payment, concerns commercial documents (this is the control imposed by the Directive).
- (b) On the other hand, other Member States are in a situation where the operations financed by the EAGGF, or some of them, do not undergo this dual complementary control :
 - (i) In some rare cases, the Member States considered that some of their physical and administrative controls, effected beforehand, offered such guarantees that a second level of control of an accounting nature proved futile.
 - (ii) In some other cases, the Member States considered that the single controls carried out beforehand were of an accounting nature and satisfied the requirements of the Directive and were of the view that it would be futile to repeat these controls.
 - (iii) In other Member States, with a system where several levels of control are superimposed, it appears that the first levels of control combine inspections of a physical nature often carried out by sampling with inspections of transactions again effected by sampling and based on an examination of registers and commercial documents. While these controls are to a certain extent less detailed, they are of the same nature as those laid down under the Directive.

3.16. In accordance with its second recital, the spirit of the Directive was to create a situation wherein all the Member States submitted the operations financed by the EAGGF to a minimum control by sampling which supplements the controls already carried out by the Member States on the whole of the current management of the EAGGF. It may be inferred therefrom

that only those systems which have led to the introduction of two different levels of control which allow for cross-checking and where at least one level concerns all operations correspond to these objectives.

3.17. In any event, in terms of effectiveness, it is such systems where the physical and administrative controls are supplemented by accounting controls which create the best conditions for:

- (a) Detecting 'merry-go-round' operations (placing of the same product in intervention several times).

Implemented alone, physical and administrative controls which are based on a control of material

information do not make it possible to detect such practices. On the other hand, the accounting controls combined with the former controls are more likely to detect these operations which have not, in principle, any commercial counterpart (absence of accounts, invoices, etc., in the commercial documents).

- (b) Detecting operations which only exist 'on paper'.

Such operations which imply completely falsified accounts would not be revealed by accounting controls only. On the other hand, if these latter cross-checked physical and administrative controls, any operation lacking a corresponding material counterpart could be detected.

CONTROL OF THE APPLICATION OF THE DIRECTIVE BY THE COMMISSION

Intermittent activity of the Commission

4.1. During its enquiry the Court established that:

- (a) from 1977 to 1980 the Commission departments developed a definite course of action (seminars, meetings of specialists, monitoring of the measures taken by the Member States, with the initiation of the first stages of legal action against five Member States which lasted until 1983 for two of the Member States who were particularly late);

- (b) in 1981 there was a break in their activities under the pretext that the 'national expert' to whom the file had been entrusted had since been called back by his parent department, without being immediately replaced;

- (c) the departments recommenced their work in 1982 (specialists' meetings, seminars for exchanging experiences, analysis of the first activity reports received from the Member States, surveillance of the Member States who were late and adoption on 15 February 1983 of Regulation (EEC) No 269/83⁽¹⁾ recommending control measures for certain sales of butter at reduced price in accordance with the procedures of the Directive);

- (d) in 1983, as in 1981, the work of the departments was again suspended due to the departure of the second 'national expert' made available to them;

⁽¹⁾ OJ No L 31, 2. 2. 1983, p. 5.

- (e) at the beginning of 1984 the departments concentrated on other activities and merely registered the information sent them by the Member States.

4.2. One cannot fail to notice the intermittent nature of the activity carried out by the Commission. The almost total absence of monitoring of the introduction of the Directive into the legislation of the Member States during the years 1981 and 1983 has obviously weakened the quality of all of the work carried out by the Commission. This state of affairs has at times, when it was necessary to monitor the implementation of the Directive in the Member States, if only in the area of interpretation, resulted in abnormal situations. Member States were threatened with legal action before the Court of Justice under Article 169 of the Treaty for failure to fulfil an obligation while at this period (1982 to 1983) some of them had taken measures intended to implement the Directive.

Absence of reflection on the systems of control

4.3. The analysis of its activity, in particular as from 1981, shows that the Commission has concentrated on the formal application of the mechanism of the Directive. With regard to interpretation, assistance and surveillance, it appears that the Commission departments have not examined the conditions under which the accounting checks were really carried out on the undertakings or how the Directive fitted into the overall system of control of the Member States.

Consequences of the Commission's attitude

4.4. The intermittent and superficial activity of the Commission has contributed, on the one hand, to the weakening of the scope of the Directive and, on the other hand, has not made it possible to turn it hitherto into a real means of strengthening Community controls.

Weakening of the scope of the Directive

4.5. The tendency to exclude public storage activities from the field of the Directive (cf. paragraph 3.14) appears to have been furthered firstly by the hesitancy of the Commission within the group of experts responsible for the application of the Directive in 1979, then in 1980 and above all by the position that it took at a meeting of this group in March 1983, during which it indicated that there was 'no obligation to control the accounts of a manufacturer of products which are bought by the intervention agency'.

4.6. Moreover, the adoption on 1 February 1983 of a Regulation laying down that the control related to the granting of certain aid would henceforth be effected in accordance with Directive 77/435/EEC (cf. paragraph 4.1 (c)) would seem to go in a direction where the controls of the Directive become to a certain extent basic controls and are no longer considered as second-level controls required to duplicate the controls directly related to management. Thus the 'safety net' effect initially contained in the Directive would be lost. With regard to the sole type of control remaining, it would be weakened considerably since, 'effected in accordance with Directive 77/435/EEC' it would only concern a very limited number of beneficiaries selected by means of sampling.

No real strengthening of Community controls

Lack of identification of optimal control techniques

4.7. Had they examined in detail the control techniques implemented by the Member States within the framework of the Directive, the Commission departments could not have been unaware of the most interesting amongst them which, together with the control practices found in all the Member States, could have constituted the foundation for an optimal system of control.

4.8. The following guidelines have emerged from the Court's enquiry:

- (a) If there is more than one department responsible for control, a coordination unit should be created which has the information required to take the sample, supervise the selection of undertakings and the planning of controls, monitor the implementation of controls, centralize and supervise the follow-up to the results of the controls.
- (b) Exact knowledge by the Member State of the number of undertakings to be controlled, on the basis of data-processing, if possible, of all of the accounting data by undertaking (or setting up of a sound method of statistical calculation).
- (c) Implementation of controls by departments other than those which have taken part in controls directly related to the management of the EAGGF or, at least, when the need for specialists involves using departments having taken part in the above-mentioned controls, constitution of joint control teams.
- (d) Utilization of programmes, questionnaires, audit checklists making it possible to standardize, in the best way, audit approaches and to guarantee supervision thereof (by supervisory authorities or by external control departments).
- (e) More complete audit techniques involving:
 - (i) cross-checking with the data possessed by third parties (banks, suppliers, customers, carriers, etc.);
 - (ii) cross-checking with physical data which may be directly checked (stock controls, standards of quality, etc.);
 - (iii) sufficient liaison with other types of accounting controls existing in the Member State (e.g. fiscal controls);
 - (iv) reasonableness tests (e.g. control of energy consumption);
 - (v) controls of elements not directly related to payment but situated either upstream or downstream from the elements related to payment (e.g. control of the utilization of finished products in the event of a control of the denaturing of a basic product);
 - (vi) controls not made solely on the basis of payments-receipts, but frequently effected in the opposite direction on the basis of basic elements extracted from the undertaking's activities (e.g. on the basis of an export contract).

Shortcoming in the organization of a complementarity of controls

4.9. By effecting a general study of the contribution of the Directive to strengthening the controls in the Member States, the Commission would have noted that:

- (a) a strengthening had mainly been obtained in the Member States which had already effected physical and administrative types of control before payment-receipt on the operations and which then found themselves adding a second level of control by sampling;
- (b) on the other hand, the strengthening was less in the Member States who, already having experience of the accounting type of audit and ignoring the concept of the physical and administrative type of control carried out before payment-receipt on the operations, had not amended their systems of control.

4.10. Consequently, given the complementarity between these two types of control and in order to achieve the real objectives of Directive 77/435/EEC, the Commission could have envisaged supplementing the Directive by a measure of the same nature relating to the physical and administrative type of control. It would involve fixing the minimum conditions with which, in all the Member States, those controls should comply to which, in accordance with the second recital of the Directive, controls of commercial documents are added. Such a step could have been the moment to:

- (a) define more accurately the principle of the physical and administrative types of control, if possible prior to payments, effected by departments other

than those effecting the accounting type of control;

- (b) determine the main procedures relating to control by sampling in the event of analyses, quality controls, etc.

Lack of progress towards a dehortatory system of penalties

4.11. By extending further its field of study, the Commission would not have failed to see the disadvantages posed by the current gaps in the area of penalties for irregularities. Indeed, for a long time projects have been under way to create an economic code of criminal law⁽¹⁾ applicable to financial infractions incurred to the detriment of the EAGGF, in order that the penalties resulting from controls are of the same nature and of comparable effectiveness in all the Member States. However, while awaiting such progress in Community law, the system of preventative control represented by the implementation of the Directive would be supplemented and strengthened if the Member States, while retaining the responsibility to make decisions on specific cases in accordance with their own legislation, were encouraged to implement a dehortatory system of penalties based on a single model.

4.12. The Member States could, for example, extend to the EAGGF, Guarantee Section, those procedures which the majority of them already followed (in the fiscal or customs field), whereby the undertakings making payments were personally bound to ensure the veracity and validity of the information that they declared. Any substantial error in the declaration would constitute a breach and be suppressed as such when discovered. Such systems covering requests for subsidies would be particularly dissuasive, in particular if combined with suitable penalties and accorded adequate publicity.

CONCLUSION

5.1. The Directive has now been implemented in almost all the Member States. Its effective operation is slow in beginning and the initial results of the controls are not quantitatively significant. It may be considered, however, that eventually, if the Commission became more active in its role of surveillance and assistance, a minimum level of scrutiny of the accounting documents of the undertakings concerned by the financing of the EAGGF would be operated in all the Member States. In order that this effort may give rise to concrete results, certain elements in the implementation of the Directive should be considerably improved and the strengthening of controls should remain a priority objective and be constantly under review.

5.2. In this respect:

- (a) the identification of better control techniques implemented by the Member States in order to

determine an optimal method of accounting control;

- (b) the fixing of conditions making it possible to achieve complementarity between different levels of control;

- (c) and the search for a truly dehortatory system of penalties,

appear to be the three minimum measures that the Commission should undertake if it wishes to achieve greater prevention of frauds and irregularities, which is the main objective of Directive 77/435/EEC.

⁽¹⁾ OJ No L 222, 22. 9. 1979, pp. 2 and 13.

These observations were adopted by the Court of Auditors at its meeting of 11 October 1984.

Luxembourg, 17 October 1984.

By the Court of Auditors

Pierre LELONG

President

THE COMMISSION'S REPLIES

INTRODUCTION

The Commission welcomes this report from the Court of Auditors which has taken a comprehensive look at the application in the Member States of Directive 77/435/EEC on the scrutiny by Member States of transactions forming part of the system of financing by the EAGGF.

This report includes a detailed analysis of a number of aspects of the application in the individual Member States and highlights apparent areas of weakness. It should be noted, however, that a number of the procedural weaknesses discussed relate in many instances to only one or two Member States and, in some cases, to historical weaknesses (in that the situation has since improved) or cases where procedures were introduced as an interim measure only. In order to achieve a balanced view of the application of the Directive, it is necessary to look at the individual picture of progress in each Member State. This reflects, in the Commission's view, a generally satisfactory situation. Notwithstanding this, however, it is obvious that the report raises a number of important questions and suggests improvements in the methods applied which the competent services of the Commission will need to address themselves to in order to consider how best to overcome those weaknesses, which exist at the moment.

Paragraph 3.3

The Commission recognizes the need and the value of a continuous follow-up of the implementation of this Directive and other similar legal instruments. The actual efforts which can be made are, however, dependent on staff availability and consequent priority decisions to be taken.

It must, however, be stressed that it remains the responsibility of Member States to implement Community legislation in due time and in accordance with the detailed provisions of the individual legal instruments.

Paragraphs 3.9 and 3.10

In the meetings in the group of experts from Member States and documents prepared in this connection, the Commission has always stressed the need for representativity and that the full range of undertakings must be subjected to audits under the Directive.

Similarly, the Commission has emphasized that the threshold of 100 000 u.a. is to be used to establish the annual minimum number of undertakings to be inspected and is otherwise only one of the parameters

to consider when selecting firms of all categories to be audited.

The Commission is prepared to stress once again these rules for Member States.

Paragraph 3.12 (a) and (b)

The points raised here relate to good audit practice and they will be considered by the Commission in the content of future discussions with Member States — with a view to achieving improvements where appropriate.

Paragraph 3.13

The Commission recognizes the points raised by the Court but would point out that reference to the Special Chapters provided by the Member States, on the application of the Directive, suggests that, in some cases, a good deal more than the minimum number of undertakings are audited. The problem is not, therefore, of the magnitude suggested here.

Paragraph 3.14

A number of points are raised here. Before commenting on them individually, however, it is perhaps worth making one or two general observations.

Firstly, the Commission takes the view that there must be a financial relationship between the EAGGF and the undertaking to be inspected. If, however, experience shows that the scope of the Directive needs to be extended to those undertakings not having a financial relationship with the EAGGF, then clearly revision of the number of undertakings specified under Article 2. (2) of the Directive (determining the minimum number of undertakings to be audited) might have to be considered.

Secondly, it is worth noting that in some Member States where the relevant national legislation already exists, the competent authorities do carry out audit checks in respect of undertakings forming part of an economic link to the prime beneficiary under the EAGGF, in cases, for example, of goods sold into intervention.

(a) *Sales of goods at reduced prices*

The Commission's view is that such sales — for example, those relating to the sale of butter — are subject to a check under the Directive.

(b) The Directive does not define the relationship between the undertaking to be audited and the EAGGF, Guarantee Section, in terms of the type of financing but the general assumption is that it is based on direct payments chargeable to the Fund.

There is, therefore, no obligation to carry out an audit on a producer of goods taken into intervention although national legislation in some Member States enables such checks to be carried out on this category of business. Checks on such businesses are, however, essential if the records available at an undertaking receiving direct payments are suspect or inadequate and further investigation is needed to check on the regularity of the measures receiving aid.

(c) *Storage of intervention products*

Such expenditure, relating as it does to the rental of storage space from a firm, is regarded by the Commission as being in the form of a contractual payment, i.e. compensation for a service rendered, and falls, therefore, outside the scope of the Directive. Similar checks can, however, be carried out when necessary using other powers.

Paragraphs 3.15 to 3.17

The Commission agrees with the Court of Auditors that the objective of the Directive is to institute a system of supplementary checks. The first level of checks, i.e. those carried out at the time of the operation, and the supplementary checks prescribed by the Directive should preferably be undertaken by different services.

It must be stressed, however, that the framework in which the scrutiny operates is a Directive, where the legal requirement is for the aims to be achieved whilst leaving the means of achieving this to the Member State. Due to the considerable organizational consequences that would arise (i.e. if we had to implement the suggestion put forward by the Court of Auditors) and to the particular nature of the administration of certain measures, the Commission would hesitate to try to enforce the implementation of such ideas. Any such steps must also respect the legislation obtaining. Reference is in particular made to Article 8 (1) of Regulation (EEC) No 729/70, according to which it is the responsibility of Member States, in accordance with national provisions laid down by law, regulation or administrative action, to take the necessary measures in question.

Paragraphs 4.1 and 4.2

The Commission agrees with the Court that periods of reduced or no activity can result in problems about the correct and speedy implementation of the Directive. Such situations are, of course, undesirable but will, in view of the available administrative resources, inevitably arise from time to time and, more particularly,

where staffing is to an extent dependent upon availability of national experts.

The work of Directive 77/435/EEC has, therefore, had to be slowed at a certain moment but at no time has it been neglected; nor has there been a situation of 'almost complete failure to follow up the introduction of the Directive into the law of the Member States'. The ongoing discussions between Member States and Commission staff should not be ignored and advice on interpretation questions in connection with the 'audit of systems' and 'clearance of accounts' visits is a considerable supplement to meetings and seminars, etc. It should not be overlooked that the availability of a dialogue direct with the Commission, on any points requiring clarification, is also used by the Member States wherever this is deemed necessary.

It should be pointed out that since early 1984 the services of the Commission have been examining the application of the Directive in Member States with a view to identifying those areas where, in the view of the Commission, the best scope lies for achieving tangible results that might stem from any suggestions for improvements or modification to existing procedures. There is still a considerable amount of work to be done in this field, and many of the points raised by the Court of Auditors will be helpful to the Commission in its analysis of the position before decisions are taken as to where the next thrust of policy should be concentrated.

Paragraph 4.3

The Commission does not agree with the suggestions made by the Court as to the aims pursued. In fact, the efforts made, be it in the expert group meetings, seminars or in bilateral discussions with Member States, not only concern the application of the enacting terms of the Directive but certainly also the actual possibilities of availing of the measures, considering the legal and factual circumstances in the Member States.

The seminar held on 23, 24 and 25 November 1982 is an example of the efforts made to relate the provisions of the Directive to practical questions and the evolution within the field.

Paragraph 4.6

The Commission's basic view on whether checks prescribed in certain Regulations, for example, Regulation (EEC) No 1725/79, should count for the purposes of the Directive, is that it is acceptable for a proportion of such visits to be included. A Member State has, however, to be satisfied as to the criteria of representativity — both in terms of financial importance and activity within the agricultural sector. Provided these criteria are met, the Commission has agreed that it

would not seek to tie the Member State's hands too narrowly when determining the minimum level of undertakings to be visited and whether cases such as those above could be included or not.

The Commission further agrees that the application of a first level control, using the methods prescribed by the Directive, should be kept to a minimum in order to respect the principle of the complementary nature of the checks envisaged under the Directive.

It must, however, be recognized that with certain measures the methodology prescribed by the Directive is the most appropriate form of check to be applied in order to ensure the proper administration and effective control of expenditure under the EAGGF. In such cases the Commission will ensure that the frequency of such checks is appropriate to the requirements of the measure.

Paragraphs 4.7 and 4.8

The Commission notes with interest the suggestions put forward by the Court of Auditors which could lead to the more efficient application of the Directive in practice. It is with this in mind that the examination in detail of the practices applied in the Member States (referred to at paragraphs 4.1 and 4.2 above) is currently being undertaken. This will include such suggestions that have been made by the Court of Auditors. It is hoped that, bearing in mind that it is within the framework of a Directive and Member

States' legislation that the Commission will have to operate, it will, nevertheless, be possible to follow up with Member States those areas where there is real scope for improvement.

Paragraphs 4.9 and 4.10

One of the main purposes of the Directive, as already pointed out by the Court of Auditors earlier in the report, was to introduce a supplementary level of post-payment check. It must be emphasized, however, that it remains the responsibility of each Member State to determine the detailed methods of check to be applied at both levels of control, to the extent that specific controls are not prescribed in Community legislation. See in this connection the principal remarks on the responsibility on the subject, already set out in connection with the remarks to paragraphs 3.15 to 3.17.

The Commission sees as one of its main tasks the encouragement and promotion of good ideas, as already indicated above at paragraphs 4.7 and 4.8, and ideas such as those suggested in these paragraphs of the report will, of course, be evaluated in this context.

Paragraphs 4.11 and 4.12

The Commission recognizes the problem of sanctions in connection with controls but does not consider the framework of the application of the Directive to be the appropriate forum to discuss the questions raised here.

CONCLUSION

One of the main reasons for the introduction of the Directive was to introduce into Member States the type of inspection which, it was hoped, would lead to better protection of EAGGF funds and would reinforce the campaign against irregularities.

A Directive was recognized from the start as being the most appropriate form of legislation since the Community was seeking to strengthen (at this time) nine national systems, all with different legislation, accounting bodies and methods of approach. Recognition of the need for time to adjust, in terms of procedures, etc., in order to implement the provisions of the Directive, was recognized in Article 11 of the Directive. It is true that in some cases Member States have taken longer than originally anticipated; experience has shown that the Commission and indeed Member States were over-optimistic in allowing for the time that would be required to implement the Directive in full.

During the early years of the application of the Directive, the Commission concerned itself, quite properly, with questions of interpretation, legal questions and the more mechanistic aspects of the Directive. This was necessary in order to ensure that a proper basis was established for the correct future functioning of the Directive. During this period, the Commission has been most conscious of the fact that within the legal framework imposed by the Directive, Member States had to be allowed to organize and carry out the checks required in a way most suited to the internal organization and methods of the relevant competent bodies. On balance, however, the Commission feels that reasonable progress has been made. Undoubtedly, there is scope for improvement to be made in certain areas, as recognized in this report. It will be the aim of the Commission, as indicated above, to evaluate these, together with the results of its own examination of the working practices used in Member States and to seek to encourage the adoption of better methods wherever this is found to be appropriate.

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