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REPORT FROM THE COMMISSION

Member States' replies to the Court of Auditors' 2006 Annual Report

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1. SCOPE OF THE REPORT

Every year the European Court of Auditors (ECA) provides its Statement of Assurance (DAS) concerning the reliability of the accounts of the European Communities and the legality and regularity of the underlying transactions¹. The DAS is mainly based on the results of the ECA's own audits which, to a large extent, take place in Member States as they in reality implement more than $\frac{3}{4}$ of total payments from the general budget of the European Communities (EC budget).

Following the publication of the ECA's 2006 Annual Report², the Commission – as required by the Financial Regulation³ – immediately communicated to Member States a list of all the observations made and errors found by the ECA concerning their country. Member States were invited to fill in a questionnaire on how they had followed up the ECA observations/findings. Member States were also invited to indicate what they found to be the main reasons for the most common errors in the area of structural actions.

This report presents a summary of the replies submitted by Member States to the Commission. It concerns only areas where management is shared between the Commission and Member States, i.e. collection of revenue and expenditure for the Common Agricultural Policy and structural actions.

The Commission should present this summary report to the Council, the ECA and the European Parliament by 28 February 2008⁴. Within that deadline, it is not possible for the Commission to verify the content of the Member States' replies, which must therefore be considered as representing the Member States' views only.

The report is accompanied by a Commission Staff Working Document⁵, which provides additional details on the Member States' replies.

2. THE ECA'S 2006 DAS FINDINGS IN SHARED MANAGEMENT

In the areas of shared management, Member States play a key role in day-to-day management and control, while the Commission supervises the work done by Member States. Good management and control structures in Member States are thus a pre-condition for avoiding errors in payments and collection of revenue.

In the 2006 Annual Report, the ECA presented an assessment of the supervisory and control systems and an estimate of the likely financial impact of errors within each sector of the EC budget. These were based on the results of systems audits and

¹ Cf. article 248 in the Treaty establishing the European Community.

² Annual Report of the Court of Auditors on the implementation of the budget concerning the financial year 2006, together with the institutions' replies, OJ C 273 of 15.11.2007.

³ Council Regulation (EC, Euratom) No 1605/2002 of 25.6.2002 amended by Council Regulation (EC, Euratom) No 1995/2006 of 13.12.2006.

⁴ Cf. article 143(6), Financial Regulation.

⁵ SEC(2008) 269.

financial audits of samples of payments carried out by the ECA in Member States and in the Commission.

The ECA found that, in 2006, supervisory and control systems were satisfactory for revenue and for almost 70 % of common agricultural policy expenditure controlled under the Integrated Administration and Control System (IACS), *cf. table 1*. For the remainder of agricultural expenditure, supervisory and control systems were considered to be only partially satisfactory.

The ECA considered control systems within structural actions to be generally ineffective or only moderately effective in Member States; the ECA also took the view that the Commission maintained only moderately effective supervision to mitigate the risk that the control systems in Member States might not prevent overstated or ineligible expenditure⁶.

Table 1. ECA assessments for areas with mainly shared management, 2005 and 2006.

Supervisory and control systems		Areas with mainly shared management	Error range	
2005	2006		2005	2006
Satisfactory	Satisfactory	Own resources	Less than 2 %	Less than 2 %
		Common agricultural policy, of which: <i>IACS</i> <i>Non-IACS</i>	Not disclosed by the ECA	Between 2 and 5 %
Satisfactory	Satisfactory		Less than 2 %	Less than 2 %
Partially satisfactory	Partially satisfactory		Greater than 5 %	Greater than 5 %
Unsatisfactory	Unsatisfactory	Structural actions	Greater than 5 %	Greater than 5 %

Source: Presentation on the Court's DAS made by Mr. Bonnici, Member of the ECA, to the Committee on Budgetary Control (COCOBU) in the European Parliament on 20.12.2006. Table 1.2 in the ECA 2006 Annual Report.

The substantive errors (i.e. errors with financial impact) found by the ECA within own resources were so few and so small that the overall error rate in this area was estimated to be lower than the materiality threshold of 2 % adopted by the ECA.

Substantive errors differed somewhat between common agricultural policy and structural actions in 2006, *cf. table 2*.

⁶ Cf. ECA opinion on the legality and regularity of the underlying transactions in the statement of assurance, chapter 1, 2006 Annual Report.

Table 2. Typical substantive errors in common agricultural policy and structural actions.

Common agricultural policy		Structural actions
<i>IACS</i>	<ul style="list-style-type: none"> The ECA found that the area of a field was smaller than claimed by the farmer. 	<ul style="list-style-type: none"> The ECA requested to see documents that could justify expenses claimed by the project manager but the project manager was not able to produce the documents in due time. The ECA found that the project manager had claimed expenses that did not qualify for such reimbursement (for instance if salary costs had not been calculated properly or costs were incurred after the time limit). The ECA found that public procurement procedures had not been respected (for example a tender had not been held although this was required). The ECA found that the project had generated revenue, which had not been taken into account when calculating the co-financing rate. The ECA found that expenditure claimed was higher than actual costs incurred (for instance because the project manager had claimed budgeted expenditure and not expenditure actually incurred).
<i>Non-IACS</i>	<ul style="list-style-type: none"> The ECA found that the farmer had not fully respected one or more of the measures under the agri-environmental scheme. 	

In agriculture, the ECA estimated that market measures and direct aid combined covering 85 % of EAGGF Guarantee expenditure (including IACS) were below the 2 % threshold. For payments to rural development schemes, the ECA highlighted agri-environmental measures as being prone to a high incidence of errors because farmers did not meet the (often complex) eligibility conditions⁷. The overall error rate for agricultural payments was nevertheless estimated to be just above 2 %.

Errors in structural actions tended to have a significantly higher financial impact than errors in agricultural policy. The ECA stated that it was reasonably confident that, in the 2006 budget year, at least 12 % of the total amount reimbursed to Structural Policies projects should not have been reimbursed⁸. The ECA's findings were based on the audit of a sample of 177 projects that had received interim payments⁹ from the Commission in 2006.

⁷ Cf. paragraph 5.72, 2006 Annual Report.

⁸ Cf. paragraph 6.39, 2006 Annual Report.

⁹ In structural actions, each Member State adopts operational programmes for financing certain types of projects. Over the programme period, the national authorities select projects for funding and project managers declare expenditure to them for reimbursement. The national authorities, in turn, declare their expenditure to the Commission several times a year and receive interim payments to reimburse them for the EU contribution to the expenditure. At the end of the programme period, the national authorities present a final declaration of expenditure to the Commission accompanied by a winding-up declaration from an independent audit body and are paid the balance of EU co-financing due. Controls at various stages in the programme cycle seek to prevent or correct errors. Errors are corrected by recovering payments from the beneficiary, reducing other payments or replacing ineligible expenditure by other eligible expenditure.

Both the Commission and the ECA have identified structural actions as a sector of the EC budget where errors seem to be persistently frequent¹⁰ and with a higher financial impact than in other sectors of the EC budget. The same types of errors are repeated from year to year - although their relative importance may vary – which indicates that control systems are not working well.

A Member State must set up four levels of control, and the Commission must supervise whether control systems are set up properly and working effectively, *cf. table 3*. The Commission carries out extensive audit work in Member States and when it finds deficiencies in their systems which can lead to errors remaining undetected it gets them to carry out remedial action plans and can also suspend interim payments or impose financial corrections.

Table 3. Control structure in structural actions.

Member State	Managing Authority	Day-to-day checking of project operations (including so-called art. 4 checks)
	Paying Authority	Certifying project expenditure
	Audit body	System audits and ex post sample checking of project operations
	Winding-up body	Validating the final declaration of project expenditure
Commission	Supervision through audits, action plans, suspension of payments and financial corrections	

The ECA presented its assessment of 19 control systems in nine Member States in the 2006 Annual Report¹¹. In each case, the ECA assessed whether the relevant level in the control structure was satisfactory, partially satisfactory or unsatisfactory, *cf. table 4*.

Table 4. ECA assessment of 19 control systems in Member States, 2006 Annual Report.

	Unsatisfactory	Partially satisfactory	Satisfactory	Total
Managing Authorities	11	7	1	19
Paying Authorities	10	6	3	19
Audit bodies	4	7	8	19
Winding-up bodies	0	8	11	19

The ECA identified the main problems to be at the first levels of control in Member States (slightly more than half of the managing and paying authorities examined were considered unsatisfactory), whereas the final control level was working relatively well (no winding-up bodies were considered to be unsatisfactory).

¹⁰ Apart from EAGGF Guidance.

¹¹ Cf. Annex 6.1, 2006 Annual Report. The 9 Member States were Germany, Poland, Spain, France, Slovenia, UK (Scotland), Italy, Greece, Austria/Hungary.

3. MEMBER STATES' FEEDBACK ON MOST COMMON ERRORS IN STRUCTURAL ACTIONS

In the light of the ECA's findings, the Commission asked Member States to provide more information on the underlying reasons for the most common errors in structural actions and details of the action Member States had taken in order to avoid such errors. Almost all Member States replied.

The main reasons most often highlighted by Member States related to:

- *Legislation*: Conditions for EU co-financing are fixed in the basic legislation concerning structural actions¹². Legislation is proposed by the Commission and adopted by the Council, in some cases after having obtained the assent of the European Parliament. Member States often described EU legislation as being too complex. In other cases, differences between national and EU legislation had led to confusion (for instance, differences between national and EU rules on how long documents must be kept). A few Member States also mentioned that in some cases their interpretation of EU legislation was different from that of the ECA.
- *Staff*: Several Member States mentioned a lack of expertise among staff in implementing organisations as a main reason for errors. Negligence or careless mistakes made by the staff were also mentioned.
- *Documentation*: Several Member States mentioned lack of filing, inconsistent filing or loss of documents (in some cases due to reorganisation or liquidation of a project management unit) as the main reasons.

The Commission asked Member States whether they had taken action to prevent the most common errors from recurring. All Member States replying to this part of the questionnaire said that they had taken some kind of action. The most common actions were related to:

- *Information*: Many Member States replied that they had taken some kind of action in order to improve the level of knowledge of rules and procedures among staff involved in day-to-day management of projects.
- *Controls*: Some Member States had changed their control procedures or had tried to improve the functioning of these procedures, for instance by introducing new checklists to be used during controls.
- *Legislation*: Some Member States had introduced new national legislation in order to clarify or to simplify procedures.

Member States were not able to report concrete results of action taken, but as a rule they expected fewer (and smaller) errors in the future.

The Commission asked Member States to indicate what they believed to be the main reasons for errors relating to public procurement, revenue and missing documents.

¹² For an overview of basic legislation in structural actions, see the Commission's website: http://ec.europa.eu/regional_policy/sources/docoffic/official/reglem_en.htm

As regards errors relating to public procurement rules, there seemed to be a consensus among Member States that “Lack of knowledge about rules” and “Ambiguity in interpretation of rules” were the two most common reasons.

As regards errors relating to revenue, Member States indicated “Lack of knowledge by implementing bodies” and “Ambiguity of rules applicable” as the two most common reasons, followed by “Underestimation of revenue by beneficiaries”.

As regards errors relating to missing documents, there seemed to be less agreement between Member States about the most common reasons. The two most frequent replies were “Documents still existed but the auditee was unclear which documents were required by the ECA” and “The auditee was not able to find the documents due to archives not being properly organized. Documents have later been found”. Then came “The auditee by mistake retained the documents only according to national and not EU rules” and “The auditee was not able to find the documents due to archives not being properly organized. Documents have still not been found.”

Spain and the United Kingdom

The feedback from Spain and the United Kingdom seemed particularly important as these two Member States accounted for about half of total quantifiable error identified for 2006 by the ECA in structural actions¹³.

Spain’s reply seemed to relate only to issues concerning the ESF, although the majority of errors identified by the ECA in Spain in 2006 concerned the ERDF. Spain said the main reasons for the most common errors in its view were *“problems in understanding the requirements laid down in Community law, particularly as regards the differences between the requirements of Community and national legislation”*. It would publish in 2008 a summary of queries received and answers provided on the website of UAFSE (Spain’s ESF administration unit). It also planned to produce a manual for ESF recipients aimed at dispelling the doubts that had given rise to most of the errors made. The actions to be taken in 2008 were expected to reduce the level of error, as most of the errors committed were due to lack of knowledge or misinterpretation of Community legislation.

The United Kingdom highlighted: 1) lack of sufficient audit trail¹⁴, 2) failure to understand the regulations and the national rules, 3) complicated rules as main reasons for errors. It said that managing authorities had several on-going actions during 2007, including strengthening Article 4 controls carried out by the managing authority. Guidance had been issued to remind project managers of the need to keep documentation and of the type of documentation required for audit purposes. The level of error was expected to rise initially as more issues were identified, and then decrease as these issues were addressed. Error rates identified through ex post controls (article 10 controls) were expected to fall by the time the closure process was completed.

¹³ In both these Member States the Commission had found system deficiencies in its own audit work and remedial action plans or procedures to suspend payments were in progress.

¹⁴ The United Kingdom noted that “Retention of documents can also be difficult for small third sector organisations where the onerous rules can require retention for 13+ years.”

4. **TAKING ACCOUNT OF MEMBER STATES' POSITIONS IN THE ECA'S ANNUAL REPORT**

The ECA gathers the evidence on which to base its Annual Report through audits in the Commission and Member States. It checks a sample of transactions and examines whether supervisory and control systems are set up and working well. The ECA also takes into account the Annual Activity Reports and declarations of the Commission's Directors-General (and the synthesis) as well as work of other auditors¹⁵.

The ECA is required to present its Annual Report, including the DAS for year N, at the latest by 15 November in year N+1. This is a very tight deadline when taking into account that the ECA must carry out audit missions in the Commission/Member States, analyse findings made on missions, prepare a letter (Statement of Preliminary Finding or SPF) to the relevant Commissioner/National Supreme Audit Institution, await the reply of the Commission/Member State (normal deadline is two months), analyse the reply, and sometimes prepare a second letter to the relevant Commissioner/National Supreme Audit Institution with the ECA's final position on the findings. Each stage may require time for translation of documents.

The ECA finalised its draft 2006 Annual Report at the end of May/beginning of June 2007, *cf. table 5*. This marked the start of a contradictory procedure between the ECA and the Commission services.

¹⁵ Cf. paragraphs 1.38 and 1.39, 2006 Annual Report.

Table 5. SPFs, replies and analyses concerning shared management, 2006 Annual Report.

	2006												2007											
	J	F	M	A	M	J	J	A	S	O	N	D	J	F	M	A	M	J	J	A	S	O	N	D
96 SPFs sent by the Court		1			1		1	1	2	3	7	9	9	10	15	10	13	10	2		1	1		
87 replies received from MS					1			1		2	2	2	5	8	9	5	6	19	13	8	4	2		
65 analyses sent by the Court									1				2	2	6	5	3	5	6	5	11	17	2	
Procedure for the 2006 Annual Report													Draft report prepared by the Court			Contra- dictory procedure								

Note. The table includes letters sent to and by Member States concerning audits in own resources, common agricultural policy and structural actions and relating to the 2006 Annual Report. Light shade indicates that 1-3 letters were sent. Medium shade indicates that 4-6 letters were sent. Dark shade indicates that more than 6 letters were sent.

In the contradictory procedure, ECA and Commission services met to discuss the ECA findings and the Commission's replies in the light of any new information available, including replies from Member States¹⁶. Most of the meetings took place in July 2007 and a few meetings in the first half of September 2007. The ECA adopted the 2006 DAS on 27 September 2007.

Unfortunately, on 1 July 2007 almost one third of Member States' replies to SPF letters were still outstanding. In those cases, the Commission often did not have information available to determine whether the ECA findings were still valid. This was also pointed out by France, which made the general remark that *"..the audit used by the [ECA] as a basis for drawing up its annual report for 2006 is still at the adversarial stage and that the [ECA] has yet to deliver its final conclusions"*.

5. MEMBER STATES' FOLLOW-UP OF ERRORS IN AGRICULTURAL POLICY AND STRUCTURAL ACTIONS

The Commission asked each Member State to indicate for each error attributed to it by the ECA what action the Member State had taken to follow up the error, as well as the timing, content and expected outcome of the action. If action had neither been taken nor was planned, then Member States were asked to state the reason for the lack of action.

¹⁶ In light of the division of responsibilities set out in the Treaty establishing the European Communities, a similar contradictory procedure between the Court and Member States does not take place.

Member States replied for about 60 % of the DAS errors within agricultural policy and about three quarters of the errors within structural actions. Slightly more than half of the errors for which no reply was received concerned Spain, about one quarter concerned Italy and Portugal, with the remainder being split between five other Member States. Reminders have been sent to these Member States, and replies may therefore still be forthcoming.

In some cases, Member States said they had not taken action on the error identified by the ECA because they did not accept the error. The rate of disagreement varied somewhat between the different categories of errors. It was highest (5 out of 10) for substantive errors in structural actions, where the United Kingdom in particular tended to disagree with the ECA findings. In agricultural policy, disagreement on substantive errors was much lower (2 out of 10).

For formal errors, disagreement was high (4 out of 10 errors) in agricultural policy, in particular due to cases concerning Greece. Disagreement was slightly lower in structural actions (fewer than 3 out of 10 errors) and more evenly spread between several Member States.

When Member States accepted the error identified by the ECA, they were almost always able to indicate the action already taken or about to be taken. For formal errors, many different actions were taken. In agricultural policy, typical actions were making payments that had been late, improving recording of various data or carrying out checks in cases where the ECA had found that control procedures had not been fully observed.

In structural actions, the range of actions also included making payments that had been late, ensuring that EU funding was publicized as required, or changing procedures in relation to tendering and time recording.

For substantive errors concerning agricultural policy, Member States generally claimed to have recovered or be in the process of recovering payments. In some cases, the respective farm had been selected for additional on-the-spot controls.

In structural actions, Member States claimed to have withdrawn ineligible expenditure from the claim or to have initiated recovery in around half of the cases. Other actions included improving audit trails, repeating checks or improving information to beneficiaries about the rules.

6. CONCLUSION

Almost all Member States replied to the Commission's questionnaire concerning the European Court of Auditors' 2006 Annual Report, although some Member States submitted partial replies. Reminders have been sent to some Member States, and further replies may be forthcoming.

The replies indicate that:

- In structural actions, Member States consider EU legislation to be complex and staff involved in day-to-day management of projects to have insufficient

knowledge of the rules. Archives are sometimes not properly organized or documents are not kept long enough. These problems lead to repetition of the same types of errors. Member States must address these key issues in an effective and efficient manner – as early as during the legislative process - if the level of error in structural actions is to be reduced.

- The ECA works to a very tight timetable, making it difficult for Member States to provide their reaction to a significant number of the errors identified by the ECA in due time before the ECA adopts its DAS. The ECA has already increased its efforts to inform Member States more quickly of errors identified. Currently, the ECA informs Member States of its findings by sending a letter to the relevant national supreme audit institution, which then collects information from the auditee. Member States might be able to provide replies faster if the ECA also sent its letter directly to the authority/body audited and extended its use of electronic communication. The ECA already presents each finding in a standardized format (a DAS error form). Further developing this form to also include a standardized reply section to be completed by the auditee could also be considered, if Member States find that this might help them provide the right information to the ECA (and the Commission) more quickly.
- The Commission should improve its own follow-up of ECA findings in Member States to help ensure that Member States provide replies on time and of good quality. The Commission therefore intends to step up its monitoring of Member States' replies to the ECA findings, for instance by providing regular overviews to Member States of findings where input from Member States will be important to the Commission during the contradictory procedure. The Commission will also continue to discuss with Member States and the ECA the reasons for the most common errors and the practical steps that need to be taken to prevent them.
- When Member States accept the errors identified by the ECA, they appear to take appropriate action – often by recovering the funds concerned or withdrawing ineligible expenditure when errors have a financial impact.
- Member States do not always agree with the errors identified by the ECA. This is a particular problem for errors with a financial impact in structural actions. The Commission and the ECA are currently discussing how to minimise disagreements on interpretation of rules in the future.

The Commission welcomes the many and prompt replies received from Member States. They are an important contribution to the Commission's follow-up of the ECA's findings. When Member States agree with the ECA findings, they do seem to follow up in an appropriate manner, including recovering funds. Nevertheless, prevention of errors must be improved by ensuring that those involved in day-to-day management are aware of the rules and procedures to be followed and have the appropriate resources.